

**Internal Revenue Service, Treasury**

**§ 1.6664-3**

(ii) Amounts not so shown previously assessed (or collected without assessment), over

(2) Rebates previously made.

(f) *Underpayments for certain carryback years not reduced by amount of carrybacks.* The amount of an underpayment for a taxable year that is attributable to conduct proscribed by sections 6662 or 6663 is not reduced on account of a carryback of a loss, deduction or credit to that year. Such conduct includes negligence or disregard of rules or regulations; a substantial understatement of income tax; and a substantial (or gross) valuation misstatement under chapter 1, provided that the applicable dollar limitation is satisfied for the carryback year.

(g) *Examples.* The following examples illustrate this section:

*Example 1.* Taxpayer's 1990 return showed a tax liability of \$18,000. Taxpayer had no amounts previously assessed (or collected without assessment) and received no rebates of tax. Taxpayer claimed a credit in the amount of \$23,000 for income tax withheld under section 3402, which resulted in a refund received of \$5,000. It is later determined that the taxpayer should have reported additional income and that the correct tax for the taxable year is \$25,500. There is an underpayment of \$7,500, determined as follows:

Tax imposed under subtitle A .....		\$25,500
Tax shown on return .....	\$18,000	
Tax previously assessed (or collected without assessment) .....	None	
Amount of rebates made .....	None	
<b>Balance .....</b>	<b>\$18,000</b>	
<b>Underpayment .....</b>	<b>\$7,500</b>	

*Example 2.* The facts are the same as in *Example 1* except that the taxpayer failed to claim on the return a credit of \$1,500 for income tax withheld. This \$1,500 constitutes an amount collected without assessment as defined in paragraph (d) of this section. The underpayment is \$6,000, determined as follows:

Tax imposed under subtitle A .....		\$25,500
Tax shown on return .....	\$18,000	
Tax previously assessed (or collected without assessment) .....	1,500	
Amount of rebates made .....	None	
<b>Balance .....</b>	<b>\$19,500</b>	
<b>Underpayment .....</b>	<b>\$6,000</b>	

*Example 3.* On Form 1040 filed for tax year 1990, taxpayer reported a tax liability of \$10,000, estimated tax payments of \$15,000, and received a refund of \$5,000. Estimated tax payments actually made with respect to tax year 1990 were only \$7,000. For purposes of de-

termining the amount of underpayment subject to a penalty under section 6662 or section 6663, the tax shown on the return is \$2,000 (reported tax liability of \$10,000 reduced by the overstated estimated tax of \$8,000 (\$15,000-\$7,000)). The underpayment is \$8,000, determined as follows:

Tax imposed under subtitle A .....		\$10,000
Tax shown on return .....	\$2,000	
Tax previously assessed (or collected without assessment) .....	None	
Amount of rebates made .....	None	
<b>Balance .....</b>	<b>\$2,000</b>	
<b>Underpayment .....</b>	<b>\$8,000</b>	

[T.D. 8381, 56 FR 67506, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992, as amended by T.D. 9186, 70 FR 10039, Mar. 2, 2005; T.D. 9309, 72 FR 903, Jan. 9, 2007]

**§ 1.6664-3 Ordering rules for determining the total amount of penalties imposed.**

(a) *In general.* This section provides rules for determining the order in which adjustments to a return are taken into account for the purpose of computing the total amount of penalties imposed under sections 6662 and 6663, where—

(1) There is at least one adjustment with respect to which no penalty has been imposed and at least one with respect to which a penalty has been imposed, or

(2) There are at least two adjustments with respect to which penalties have been imposed and they have been imposed at different rates.

This section also provides rules for allocating unclaimed prepayment credits to adjustments to a return.

(b) *Order in which adjustments are taken into account.* In computing the portions of an underpayment subject to penalties imposed under sections 6662 and 6663, adjustments to a return are considered made in the following order:

(1) Those with respect to which no penalties have been imposed.

(2) Those with respect to which a penalty has been imposed at a 20 percent rate (*i.e.*, a penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, or substantial valuation misstatement, under sections 6662(b)(1) through 6662(b)(3), respectively).

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(3) Those with respect to which a penalty has been imposed at a 40 percent rate (*i.e.*, a penalty for a gross valuation misstatement under sections 6662 (b)(3) and (h)).

(4) Those with respect to which a penalty has been imposed at a 75 percent rate (*i.e.*, a penalty for fraud under section 6663).

(c) *Manner in which unclaimed prepayment credits are allocated.* Any income tax withholding or other payment made before a return was filed, that was neither claimed on the return nor previously allowed as a credit against the tax liability for the taxable year (an “unclaimed prepayment credit”), is allocated as follows—

(1) If an unclaimed prepayment credit is allocable to a particular adjustment, such credit is applied in full in determining the amount of the underpayment resulting from such adjustment.

(2) If an unclaimed prepayment credit is not allocable to a particular adjustment, such credit is applied in accordance with the ordering rules set forth in paragraph (b) of this section.

(d) *Examples.* The following examples illustrate the rules of this § 1.6664-3. These examples do not take into account the reasonable cause exception to the accuracy-related penalty under § 1.6664-4.

*Example 1.* A and B, husband and wife, filed a joint federal income tax return for calendar year 1989, reporting taxable income of \$15,800 and a tax liability of \$2,374. A and B had no amounts previously assessed (or collected without assessment) and no rebates had been made. Subsequently, the return was examined and the following adjustments and penalties were agreed to:

Adjustment #1 (No penalty imposed) .....	\$1,000
Adjustment #2 (Substantial understatement penalty imposed) .....	40,000
Adjustment #3 (Civil fraud penalty imposed) .....	45,000
<b>Total adjustments .....</b>	<b>\$86,000</b>
Taxable income shown on return ..	15,800
<b>Taxable income as corrected .....</b>	<b>\$101,800</b>
Computation of underpayment:	
Tax imposed by subtitle A .....	\$25,828
Tax shown on return .....	\$2,374
Previous assessments .....	None
Rebates .....	None
<b>Balance .....</b>	<b>\$2,374</b>
<b>Underpayment .....</b>	<b>\$23,454</b>

Computation of the portions of the underpayment on which penalties under section 6662(b)(2) and section 6663 are imposed:

*Step 1* Determine the portion, if any, of the underpayment on which no accuracy-related or fraud penalty is imposed:

Taxable income shown on return .....	\$15,800
Adjustment #1 .....	1,000
<b>“Adjusted” taxable income .....</b>	<b>\$16,800</b>
Tax on “adjusted” taxable income .....	\$2,524
Tax shown on return .....	2,374
<b>Portion of underpayment on which no penalty is imposed .....</b>	<b>\$150</b>

*Step 2* Determine the portion, if any, of the underpayment on which a penalty of 20 percent is imposed:

“Adjusted” taxable income from step 1 .....	\$16,800
Adjustment #2 .....	40,000
<b>“Adjusted” taxable income .....</b>	<b>56,800</b>
Tax on “adjusted” taxable income .....	\$11,880
Tax on “adjusted” taxable income from step 1 ...	\$2,524
<b>Portion of underpayment on which 20 percent penalty is imposed ...</b>	<b>\$9,356</b>

*Step 3* Determine the portion, if any, of the underpayment on which a penalty of 75 percent is imposed:

Total underpayment .....	\$23,454
Less the sum of the portions of such underpayment determined in:	
Step 1 .....	\$150
Step 2 .....	9,356
<b>Total .....</b>	<b>\$9,506</b>
<b>Portion of underpayment on which 75 percent penalty is imposed .....</b>	<b>\$13,948</b>

*Example 2.* The facts are the same as in *Example 1* except that the taxpayers failed to claim on their return a credit of \$1,500 for income tax withheld on unreported additional income that resulted in Adjustment #2. Because the unclaimed prepayment credit is allocable to Adjustment #2, the portion of the underpayment attributable to that adjustment is \$7,856 (\$9,356—\$1,500). The portions of the underpayment attributable to Adjustments #1 and #3 remain the same.

*Example 3.* The facts are the same as in *Example 1* except that the taxpayers made a timely estimated tax payment of \$1,500 for 1989 which they failed to claim (and which the Service had not previously allowed). This unclaimed prepayment credit is not allocable to any particular adjustment. Therefore, the credit is allocated first to the portion of the underpayment on which no penalty is imposed (\$150). The remaining amount (\$1,350) is allocated next to the 20 percent penalty portion of the underpayment (\$9,356). Thus, the portion of the underpayment that

is not penalized is zero (\$150—\$150), the portion subject to a 20 percent penalty is \$8,006 (\$9,356—\$1,350) and the portion subject to a 75 percent penalty is unchanged at \$13,948.

[T.D. 8381, 56 FR 67507, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992]

**§ 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.**

(a) *In general.* No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (h) of this section.

(b) *Facts and circumstances taken into account—(1) In general.* The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain

rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for certain rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

(2) *Examples.* The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty attributable to the tax shelter items of corporations.)