Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Susan H. Deidrich
Senior Manager, Servicewide Penalty Program
SBSE Exam Policy

from: Ashton P. Trice
Chief, Branch 2
(Procedure & Administration)

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subject: Reference Numbers and the Failure-to-Pay Penalties

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the IRS may use the reference numbers of transactions posted to an account to allocate an abatement or other adjustment by type of tax, if doing so would change the calculation of the failure-to-pay (FTP) penalty under section 6651(a)(2) or (a)(3) from the way the penalty is currently calculated.

CONCLUSION

The IRS may not, consistent with section 6651(a)(2) or (a)(3), use reference numbers to calculate either FTP penalty, if the amount of the penalty as recalculated would be different from the penalty amount as calculated by the current methods.

FACTS

Our advice is based on the following example that you provided. An individual taxpayer files a Form 1040 on April 15 reporting $1,000 in income tax from wages, $500 in self-employment tax, and total tax of $1,500. The taxes are unpaid. The IRS assesses $1,500 in unpaid tax with a 150 transaction code and a reference number of 889, indicating that $500 is self-employment tax. The IRS assesses the section 6651(a)(2)

FTP penalty based on $1,500 as shown on the return. At a 0.5 percent rate, the maximum penalty, after 50 months, is $375 ($1,500 x .25).

Following deficiency procedures, the IRS assesses an additional $600 in unreported income tax four months after the TC 150. When the taxpayer fails to pay the deficiency amount within 21 days of notice and demand, the IRS assesses the section 6651(a)(3) penalty on $600, the amount required to be but not shown on the return. As with the (a)(2) penalty, the (a)(3) penalty accrues at a 0.5 percent rate per month, and the maximum penalty is $150 ($600 x .25 = $150). The maximum amount of FTP penalties for which the taxpayer is potentially liable therefore is $525 ($375 + $150, or .25 x $2,100).

During the period in which both the section 6651(a)(2) and (a)(3) penalties are still accruing each month, the IRS abates $500 of tax, which posts to the account with the reference number for self-employment tax (889). Under current procedures, the total monthly FTP penalties will be calculated from that point at 0.5 percent of $1,600 ($2,100 – $500). In addition, the (a)(3) penalty that had accrued up to the time of the abatement will be recalculated as 0.5 percent of $100 for each month, rather than 0.5 percent of $600 for each month. In other words, the abatement is made first to the assessment that is last in time, and then working backward, without any distinction by type of tax. Under the proposal to use the reference numbers to allocate abatements for penalty purposes, the (a)(3) penalty would remain unchanged, and the (a)(2) penalty would be recalculated as 0.5 percent of $1,000. More precisely, because the tax abated was self-employment tax, the abatement would relate back to the $500 of self-employment tax originally assessed, in determining the amount subject to the penalty.

Using the reference numbers would potentially result in different penalty amounts, as compared to current procedures. In a simple case where the taxpayer pays, post-abatement, all assessed tax at once—say, at the 20-month point after the return was filed and the tax originally assessed—the amount of the (a)(2) penalty would be more under current procedures than it would be were reference numbers used. The amount of the (a)(3) penalty, in contrast, would be less under current procedures than under a reference-number process, but the difference would itself be subsumed by the larger difference in the (a)(2) calculations. The combined amount of both penalties would thus be higher under current procedures because the amount of tax subject to the (a)(2) penalty exceeds the amount of tax subject to the (a)(3) penalty and because the (a)(2) penalty period is 20 months long, while the (a)(3) penalty period is only 16 months long. As can be see, however, there could be other situations—ones with amounts of tax substantially different from those in the example or paid at different times—in which the use of reference numbers would *increase* a taxpayer's overall liability for FTP penalties.

LAW AND ANALYSIS

If a taxpayer fails to pay "the amount shown as tax on any return" on or before the unextended due date, section 6651(a)(2) imposes a penalty equal to 0.5 percent of the amount for the first month and each succeeding month or part thereof during which the tax remains unpaid, up to a maximum of 25 percent. The penalty applies to amounts shown as tax on returns described in section 6651(a)(1) (the failure-to-file penalty). *See* IRM 20.1.2.4 (04-25-2008) (stating that the penalty applies to income tax returns, excise tax returns, and estate and gift tax returns, but it does not apply to information returns, estimated taxes, or partnership returns). The penalty is calculated from the due date of the return. The penalty does not apply if the failure to pay is due to reasonable cause and not willful neglect. Under section 6651(c)(2), if the amount required to be shown as tax on the return is less than the amount actually shown, the penalty is only 0.5 percent per month of the amount required to be shown. [1]

The plain meaning of section 6651(a)(2)'s reference to "the amount shown as tax" on a return is the total amount of tax shown a return, regardless of any allocation or attribution that can be made as to the income or other items resulting in the tax or by the type of tax. *See Hanover Bank v. Commissioner*, 369 U.S. 672, 687 (1962) (statutes, including the tax laws, are interpreted where possible in their ordinary, everyday sense); *Rosenspan v. United States*, 438 F.2d 905, 911 (2d Cir. 1971) ("When Congress uses . . . a non-technical word in a tax statute, presumably it wants administrators . . . to read it in the way that ordinary people would understand . . . ."). By "tax" shown on a return, we presume that Congress meant the word in the broadest sense—as any and all internal revenue tax required to be reported on a tax return described in section 6651(a)(1). [2] Interpreting it differently is inconsistent with not only the words of the statute but also their purpose. The evident purpose of the penalty is to address the failure to pay whatever amount of tax is reported on a return. Type of tax or subparts to the tax are immaterial to that purpose. [3]

The penalty therefore should be applied to the total tax reported on the return, which is on line 61 of the current Form 1040, line 31 of Form 1120, line 3 (part III) of Form 720, and so forth. The total tax can and often does have multiple components. Form 1040,

[1] The penalty rate under (a)(2), as well as (a)(3), is increased from 0.5 percent in certain circumstances and decreased in others, not relevant here. I.R.C. § 6651(d), (h).

[2] When it enacted the FTP penalties, Congress explained that it sought to address taxpayers' failure to pay "income tax." S. Rep. No. 91-552, 91st Cong., 1st Sess. 11, 297-98 (1969), 1969-3 C.B. 429, 611-12; H.R. Conf. Rep. No. 91-782, 1st Sess. 339-40 (1969), 1969-3 C.B. 68; Joint Committee on Taxation Staff, *General Explanation of the Tax Reform Act of 1969*, 91st Cong., 1st Sess.258-59 (1969). But section 6651(a) clearly covers more than income tax, and Congress did not express any intention that administration of the penalty should involve distinctions or differentiations by tax type.

[3] We do not mean to imply that separate types of tax can be treated as one tax in other contexts, such as determinations of joint liability.

for example, has not only a line to report the tax on the filer's taxable income (line 56), but also separate lines to report "Other Taxes " (lines 57–60), including self-employment tax, household employment taxes, and social security and Medicare taxes on tips not reported to the taxpayer's employer. [4] These other taxes are added to the income tax (less any credits) to arrive at the line 61 "Total Tax." The section 6651(a)(2) penalty should be calculated based on the combined amount of reported tax that is unpaid. Any one of the constituent taxes can by itself be the basis for the penalty, but when there is more than one reported on a return, the penalty applies to the whole.

A similar analysis applies to the section 6651(a)(3) penalty, and we reach the same basic conclusion. The (a)(3) penalty is imposed for failure to pay "any amount . . . of any tax required to be shown on a return . . . which is not so shown" within 21 calendar days from the date of notice and demand for payment (10 business days if the amount exceeds $100,000). The penalty is 0.5 percent of the unpaid amount per month (or part thereof), but not more than 25 percent in the aggregate. Again, by all appearances, the "tax" referenced is the total tax required to be shown on the return (the amount that should have been reported on line 61, Form 1040, for example). And as with the (a)(2) penalty, it would not make sense, given the straightforward purpose of the (a)(3) penalty, to factor into the penalty calculations any divisions by tax type to which the total tax may be susceptible.

In light of the requirement that any FTP penalty be calculated with reference to the total tax shown or required to be shown on a return, deviating from the current procedures to use reference numbers as described in the example would result in incorrect penalties. In the example, the IRS initially calculated and assessed the (a)(2) penalty on the amount of unpaid tax shown on the return, $1,500. That calculation conforms to the terms of the section. Although the tax shown on the return breaks down on the taxpayer's account by reference number into $1,000 of income tax and $500 of self-employment tax (evidently corresponding to what the taxpayer reported on the applicable lines of the form 1040), $1,500 nevertheless represents the "tax" for purposes of the penalty. There are not two separate amounts for penalty purposes, or two separate penalties, one on $500 of reported but unpaid self-employment tax and one on $1,000 of reported but unpaid income tax.

The next event in the example was the assessment of additional tax due of $600. That provided the basis for assessment of the (a)(3) penalty. At that point, the amount reported on the return (and unpaid) was still $1,500; only the total amount required to be shown changed, from $1,500 to $2,100. Further, these baseline amounts are unchanged by any reference numbers that accompany the transaction codes posted for the assessments. In particular, the reference number for the additional tax assessment

[4] The same is true for other returns. The total tax on Form 1041, for instance, includes, in addition to income and other taxes, any household employment taxes due, and Form 706 includes both estate tax and generation-skipping transfer tax. These separate taxes have their own reference numbers.

simply means that the $600 is income tax and that the taxpayer should have included it as such on the return.

Once it is determined to abate $500 of assessed tax, there is no longer $600 of "tax," in the section 6651(a) sense, that was both unreported and unpaid, but only $100. For penalty purposes, it is appropriate to recalculate and partially abate the (a)(3) penalty. This is the current practice. By contrast, the unpaid amount of tax shown (as required) on the return remains $1,500, irrespective of how it breaks down; hence, it would be incorrect to recalculate (reduce) the (a)(2) penalty.

In short, the IRS's current tax abatement and penalty assessment procedures are sound. Applying abatements to assessments in reverse chronology will generally lead to correct FTP penalties.[5] The same cannot be said if abatements were applied using reference numbers. For that reason, we recommend that reference numbers not be used as contemplated, at least as to the FTP penalties.

We are aware of, but not persuaded by, an argument that using reference numbers to calculate more nuanced penalties would equate to more accurate penalties. According to this argument, if the abatement in the initial example is related back to the first assessment of tax, via the self-employment tax reference number, then the (a)(2) penalty recalculated on $1,000 of tax would reflect the true situation. That is, $1,000 in income tax, which was reported on but not paid with the return, and $0 of self-employment tax. The taxpayer reported $500 in self-employment tax on the return, but as there was no self-employment tax actually required to be shown on the return, the $500 is arguably not subject to the penalty, pursuant to section 6651(c)(2). Following the argument through, the (a)(3) penalty, which is bypassed and not recalculated, is more accurate than under current procedures because the reality is that the taxpayer failed to show on the return an additional $600 in income tax, which was required to be shown.

This perspective may have some facial appeal, but it would, in fact, result in less accurate penalties for the reasons already explained. The fundamental problem with the argument is that it necessarily depends on an interpretation of the FTP penalties as properly divisible by type of tax. Nothing in section 6651 or elsewhere supports such an interpretation, however.

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Please call (202) 622-4940 if you have any questions.

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[5] That is not to suggest, however, that a LIFO approach should be strictly followed in every case. There may be situations where a particular tax or penalty assessment was improper for some reason, or there are other circumstances requiring that the particular assessment be abated.

cc: Division Counsel (Small Business/Self-Employed)