

## § 1.6661-1

## 26 CFR Ch. I (4-1-04 Edition)

(Pub. L. 103-66, 107 Stat. 486), allows a corporate taxpayer to make an annual election to use a different annualization period to determine annualized income for purposes of paying any required installment of estimated income tax for a taxable year beginning after December 31, 1993.

(b) *Time and manner for making the election.* An election under section 6655(e)(2)(C) must be made on or before the date required for the payment of the first required installment for the taxable year. For a calendar or fiscal year corporation, Form 8842, Election to Use Different Annualization Periods for Corporate Estimated Tax, must be filed by the 15th day of the 4th month of the taxable year for which the election is to apply. Form 8842 must be filed with the Internal Revenue Service Center where the corporation files its income tax return.

(c) *Revocability of election.* The election described in this section is irrevocable.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996]

### § 1.6661-1 Addition to tax in the case of a substantial understatement of tax liability.

(a) *In general.* Section 6661 imposes an addition to tax (penalty) for an understatement of tax liability that constitutes a substantial understatement of income tax. This section prescribes the effective date of the penalty. The manner of computing understatements subject to the penalty is set forth in § 1.6661-2. The definition of "substantial authority" is set forth in § 1.6661-3. Rules concerning the adequacy of disclosure are set forth in § 1.6661-4. The treatment of "tax shelters" is provided in § 1.6661-5. The circumstances in which the penalty may or will be waived by the Commissioner are set forth in § 1.6661-6.

(b) *Effective date.* The penalty under section 6661 applies to returns the due date (determined without regard to extensions of the time for filing) of which is after December 31, 1982. The penalty does not apply to amended returns, so-called, if the due date for the return to which the amended return relates (de-

termined without regard to extensions) is before January 1, 1983.

[T.D. 8017, 50 FR 12014, Mar. 27, 1985]

### § 1.6661-2 Computation of penalty; meaning of terms.

(a) *Amount of penalty.* If there is a substantial understatement of income tax for a taxable year (as defined in paragraph (b) of this section), section 6661 imposes a penalty equal to 10 percent of the understatement of tax liability.

(b) *Substantial understatement.* The term *substantial understatement* means an understatement (as defined in paragraph (c) of this section) that exceeds the greater of—

(1) 10 percent of the tax required to be shown on the return for the taxable year (as defined in paragraph (d)(4) of this section); or

(2) \$5,000 (\$10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)).

(c) *Understatement.* The term *understatement* means the excess of—

(1) The amount of tax required to be shown on the return for the taxable year (as defined in paragraph (d)(4) of this section), over

(2) The amount of tax shown on the return for the taxable year (as defined in paragraph (d)(2) of this section), reduced by any rebate (as defined in paragraph (d)(3) of this section).

(d) *Determination of amounts—(1) Amount of tax.* For purposes of section 6661, the amount of tax is the amount of tax imposed by Subtitle A of the Code.

(2) *Tax shown on return.* For purposes of section 6661, the amount of tax shown on the return for the taxable year is determined with the adjustments prescribed in this paragraph (d)(2), without regard to the items described in paragraph (d)(5) of this section, without regard to any net operating loss carryback, tax credit carryback, capital loss carryback, or commodity futures loss carryback ("carryback"), and without regard to any amount of additional tax shown on a return (including an amended return, so-called) filed after the taxpayer is first contacted by the Internal Revenue

Service concerning the tax liability of the taxpayer for the taxable year. See § 1.6661-6(c) for rules relating to waiver of the penalty if the taxpayer files a “qualified amended return.” If no return was filed for the taxable year or if the return (other than a return filed under section 6014) shows no tax due, the amount of tax shown on the return is considered to be zero. The amount of tax shown on the return for the taxable year is determined by computing the tax as if the following items (in addition to the items that were properly reported on the return) had received the proper tax treatment:

(i) Items (other than tax shelter items as defined in § 1.6661-5(c)) for which there is or was substantial authority for the treatment claimed (as provided in § 1.6661-3).

(ii) Items (other than tax shelter items as defined in § 1.6661-5(c)) with respect to which there is adequate disclosure (as provided in § 1.6661-4).

(iii) Tax shelter items (as defined in § 1.6661-5(c)) for which there is or was substantial authority for the treatment claimed (as provided in § 1.6661-3), and with respect to which the taxpayer reasonably believes that the tax treatment of the item was more likely than not the proper tax treatment (as provided in § 1.6661-5(d)).

(iv) Items taken into account in computing the amount of any net operating loss, unused tax credit, or net capital loss for a taxable year the return for which was due (determined without regard to extensions of time for filing) before January 1, 1983 (regardless of whether there is substantial authority or adequate disclosure with respect to such items).

(3) *Rebate.* For purposes of section 6661, the amount of a rebate is the rebate (within the meaning of section 6211(b)(2) and § 301.6211-1(f)), determined as if any items to which the rebate is attributable that are described in paragraphs (d)(2) (i) through (iv) of this section (in addition to the items that were properly reported on the return) had received the proper tax treatment.

(4) *Tax required to be shown.* For purposes of section 6661, the amount of tax required to be shown on the return for the taxable year is the amount of tax imposed on the taxpayer for the tax-

able year determined without regard to items described in paragraph (d)(5) of this section and without regard to any allowable carryback that was not taken into account in computing the amount of a rebate for the taxable year.

(5) *Items disregarded.* The amount of tax shown on the return for the taxable year and the amount of tax required to be shown on the return for the taxable year are both determined without regard to—

(i) The credit under section 31 for tax withheld;

(ii) The credit under section 33 for tax withheld at source on nonresident aliens and foreign corporations;

(iii) Any credit resulting from the collection of amounts assessed under section 6851 as the result of a termination assessment;

(iv) Payments of tax or estimated tax by the taxpayer; and

(v) Any tax that the taxpayer is not required to assess on the return (such as the tax imposed by section 535 on the accumulated taxable income of a corporation).

(6) *Treatment of carryovers—(i) In general.* A net operating loss carryover, tax credit carryover, or capital loss carryover shall be treated for purposes of section 6661 as a credit or deduction in the year in which the carryover is taken into account. See paragraph (d)(2)(iv) of this section for rules applicable to carryovers from a taxable year the return for which was due (without regard to extensions of time for filing) before January 1, 1983.

(ii) *Carryovers treated as carrybacks.* For purposes of section 6661, a carryover to a taxable year shall be treated as a carryback rather than a carryover with respect to such year to the extent such carryover exceeds the amount of the carryover determined without taking into account carrybacks from taxable years subsequent to such years.

(e) *Examples.* The following examples illustrate the computation of an understatement:

*Example (1).* In 1983, An individual calendar year taxpayer, files a return for 1982, which shows taxable income of \$18,200 and tax liability of \$3,194. Subsequent adjustments on audit for 1982 increase taxable income to \$51,500 and tax liability to \$17,068. There was

substantial authority for an item resulting in an adjustment that increases taxable income by \$5,300. The item is not a tax shelter item. In computing the amount of the understatement, the amount of tax shown on A's return is determined as if the item for which there was substantial authority had been given the proper tax treatment. Thus, the amount of tax that is treated as shown on A's return is \$4,837 (the tax on \$23,500) (\$18,200 taxable income actually shown on A's return plus \$5,300, the amount of the adjustment for which there was substantial authority). The amount of the understatement is \$12,231 (\$17,068 (the amount of tax required to be shown) less \$4,837 (the amount of tax treated as shown on A's return after adjustment for the item for which there was substantial authority)). Because the understatement exceeds the greater of 10 percent of the tax required to be shown on the return for the year (\$1,707 (\$17,068×.10)) or \$5,000, A has a substantial understatement of income tax for the year. The amount of section 6661 penalty is \$1,223.10 (.10×\$12,231).

*Example (2).* Corporation X was formed on January 1, 1982. In 1983, X adopts a calendar taxable year and files a return for 1982 showing a tax liability of \$10,000. In 1984, X determines that it has an unused investment tax credit for taxable year 1983 in the amount of \$20,000. X files an amended return, so-called, for taxable year 1982 claiming an investment tax credit carryback of \$20,000 and receives a rebate of \$10,000 (the tax liability shown on X's original return for taxable year 1982). On audit for taxable years 1982 and 1983, adjustments increase tax liability for 1982 to \$24,000, and decrease the unused investment tax credit for 1983 to \$8,000. There was not substantial authority and X did not make adequate disclosure with respect to the items comprising the 1982 adjustments, but there was substantial authority for \$1,000 of the \$12,000 investment tax credit disallowed for 1983. The amount of the section 6661 penalty for 1982 is computed as follows:

(i) The amount of tax required to be shown on the return for 1982 is \$16,000 (*i.e.*, the tax liability as adjusted on audit (\$24,000) reduced by the allowable tax credit carryback taken into account in computing the amount of the rebate (\$8,000)).

(ii) The amount of tax shown on the return is \$10,000 (*i.e.*, the tax shown on the return without adjustment for carryback of the investment tax credit).

(iii) The amount of the rebate is \$9,000 (*i.e.*, the amount of the rebate determined as if the items described in paragraph (d)(2)(i) of this section (\$1,000 item for which there was substantial authority) had received the proper tax treatment (\$10,000−\$1,000=\$9,000)).

(iv) The understatement is \$15,000 (*i.e.*, the excess of the tax required to be shown (\$16,000) over the tax shown reduced by the rebate (\$10,000−\$9,000=\$1,000)).

(v) Since the understatement exceeds the greater of 10 percent of the tax required to be shown or \$10,000, X has a substantial understatement of income tax for the year. The amount of the section 6661 penalty is \$1,500 (.10×\$15,000).

*Example (3).* Corporation Y was formed on January 1, 1982. In 1983, Y adopts a calendar taxable year and files a return for 1982 showing tax liability of \$50,000. Y subsequently determines that it has unused investment tax credits in the amount of \$20,000 for taxable year 1983, \$20,000 for taxable year 1984, and \$37,000 for taxable year 1985. Y files an amended return, so-called, for taxable year 1982 claiming investment tax credit carrybacks of \$77,000 and receives a rebate of \$50,000 (the tax liability shown on Y's original return for 1982). On audit for taxable years 1982, 1983, 1984, and 1985, the only adjustments decrease the unused investment tax credit for taxable year 1983 to \$5,000, and the unused investment tax credit for 1984 to \$8,000. There was not substantial authority and X did not make adequate disclosure with respect to the items comprising the 1983 and 1984 adjustments. The amount of the section 6661 penalty for 1982 is computed as follows:

(i) The amount of the tax required to be shown on the return for 1982 is \$27,000 (*i.e.*, the original tax liability (\$50,000) reduced by the allowable carrybacks taken into account in computing the amount of the rebate (\$5,000+\$8,000+\$10,000=\$23,000)).

(ii) The amount of the tax shown on the return is \$50,000 (*i.e.*, the tax shown on the return without adjustment for carryback of the investment tax credit).

(iii) The amount of the rebate is \$50,000 (*i.e.*, the amount of the rebate determined as if any items described in paragraph (d)(2)(i)-(iv) of this section (\$0) had received the proper tax treatment (\$50,000−0=\$50,000)).

(iv) The understatement is \$27,000 (*i.e.*, the excess of the tax required to be shown (\$27,000) over the tax shown reduced by the rebate (\$50,000−\$50,000=0)).

(v) Since the understatement exceeds the greater of 10 percent of the tax required to be shown or \$10,000, Y has a substantial understatement of income tax for the year. The amount of the section 6661 penalty is \$2,700 (.10×\$27,000).

(f) *Coordination with penalty for valuation overstatements—(1) In general.* The amount of the penalty imposed under section 6661 shall be determined without taking into account the portion of the substantial understatement on which the penalty under section 6659 (relating to valuation overstatements) has been imposed. The portion of the understatement on which the penalty under section 6659 has been imposed is

taken into account, however, in determining whether there is a substantial understatement of tax. For purposes of section 6661, a penalty under section 6659 is not considered to have been imposed to the extent that the penalty is waived under the authority of section 6659(e). If a penalty is imposed under section 6659, the amount to which the section 6661 penalty applies is the amount by which the understatement exceeds the amount of the underpayment attributable to a valuation overstatement as determined under section 6659.

(2) *Example.* The following example illustrates the coordination of the penalties under sections 6659 and 6661:

*Example.* In 1983, A, an individual calendar year taxpayer, files a return for 1982 which shows taxable income of \$40,000 and tax liability of \$11,408. Subsequent adjustments on audit for 1982 increases taxable income to \$70,000 and tax liability to \$26,318. The increase in taxable income is attributable to a \$20,000 adjustment for a valuation overstatement and a \$10,000 adjustment not related to a valuation overstatement. There are no adjustments under paragraph (d)(2) of this section. Since the amount of the understatement, \$14,910 (\$26,318-\$11,408), exceeds the greater of \$2,631.80 (10 percent of the tax required to be shown) or \$5,000, there is a substantial understatement. Assume that under section 6659 the \$20,000 adjustment for the valuation overstatement results in a \$10,000 underpayment attributable to a valuation overstatement on which the section 6659 penalty is imposed. The amount of the understatement on which the section 6661 penalty is imposed is \$4,910. (The amount by which the \$14,910 understatement exceeds the \$10,000 underpayment to which the section 6659 penalty applies.) The amount of the section 6661 penalty is \$491 (\$4,910×.10).

[T.D. 8017, 50 FR 12014, Mar. 27, 1985]

### § 1.6661-3 Substantial authority.

(a) *General rule*—(1) *Effect of having substantial authority.* If there is or was substantial authority for the tax treatment of an item (other than a tax shelter item as defined in § 1.6661-5(c)), the item is treated as if it were shown properly on the return for the taxable year in computing the amount of tax shown on the return. Thus, for purposes of section 6661, the tax attributable to the item is not included in the understatement for the year. (See paragraph (d)(2) of § 1.6661-2.)

(2) *Substantial authority standard.* The substantial authority standard is less stringent than a “more likely than not” standard (that is, a greater than 50-percent likelihood of being upheld in litigation), but stricter than a reasonable basis standard (the standard which, in general, will prevent imposition of the penalty under section 6653 (a), relating to negligence or international disregard of rules and regulations). Thus, a position with respect to the tax treatment of an item that is arguable but fairly unlikely to prevail in court would satisfy a reasonable basis standard, but not the substantial authority standard.

(b) *Determination of whether substantial authority is present*—(1) *Evaluation of authorities.* There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists and the weight of those authorities is determined in light of the pertinent facts and circumstances in the manner prescribed in paragraph (b)(3) of this section. There may be substantial authority for more than one position with respect to the same item. The taxpayer’s belief that the authorities with respect to the tax treatment of an item constitute substantial authority is not taken into account in determining whether there is substantial authority.

(2) *Types of authority.* In determining whether there is substantial authority (other than in cases described in paragraph (b) (4) (i) of this section), only the following will be considered authority. Applicable provisions of the Internal Revenue Code and other statutory provisions; temporary and final regulations construing such statutes; court cases; administrative pronouncements (including revenue rulings and revenue procedures); tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; and Congressional intent as reflected in committee reports, joint explanatory statements