

LB&I International Practice Service Process Unit – Audit

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Unit Name	Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement
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Process Overview

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Process Description

An accuracy related penalty under IRC § 6662 applies to the portion of an underpayment of tax attributed to a valuation misstatement. Thresholds apply to determine whether a valuation misstatement arising from an IRC § 482 allocation is a substantial valuation misstatement or gross valuation misstatement, either of which may be subject to a net adjustment penalty or a transactional penalty.

This Unit focuses on a substantial valuation misstatement and explains how to calculate an underpayment of tax, a net section 482 adjustment, and the net adjustment penalty. The Unit discusses the requirements that must be met to exclude an amount from the net section 482 adjustment. Also, the Unit uses an example to illustrate how the ordering rules of Treas. Reg. § 1.6664-3 determine the total amount of penalties imposed under IRC §§ 6662 and 6663. Although the focus of this Unit is the net adjustment penalty, the transactional penalty and the reasonable cause and good faith exception will also be discussed.

Subsequent units will focus on the gross valuation misstatement and the two types of penalties - net adjustment and transactional.

Example Circumstances Under Which Process Applies

- Any transfer price adjustment under IRC § 482 for which the threshold is met for a substantial valuation misstatement and for which a net adjustment penalty applies.

Determination of Process Applicability

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

To apply an IRC § 6662 penalty, there must be a return filed and an underpayment of tax. To apply a valuation misstatement penalty under IRC § 6662(e) or (h), such underpayment must also exceed a dollar threshold.

Criteria	Resources	6103 Protected Resources
<p>A return filed. The accuracy related penalty of IRC § 6662 applies only to a tax return filed by a taxpayer. Thus, the Service may not apply the penalty on a substitute for return.</p>	<ul style="list-style-type: none"> ▪ IRC 6664(b) Penalties applicable only where return filed. ▪ Treas. Reg. 1.6662-2(a) Accuracy related penalty. In general. 	
<p>Underpayment of income tax. There must be an amount by which <u>any income tax imposed</u> exceeds the excess of:</p> <p>a. the sum of:</p> <ul style="list-style-type: none"> i. the <u>amount shown as tax by the taxpayer on the return</u>, plus ii. <u>amounts not so shown that were previously assessed</u>, plus iii. <u>amounts collected without assessment</u>, over <p>b. the <u>amount of rebates made</u>.</p> <p>Note: See the following slides for definitions of the phrases underlined above.</p>	<ul style="list-style-type: none"> ▪ IRC 6664(a) Underpayment. ▪ Treas. Reg. 1.6664-2(a) Underpayment defined. 	

Determination of Process Applicability (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

To apply an IRC § 6662 penalty, there must be a return filed and an underpayment of tax. To apply a valuation misstatement penalty under IRC § 6662(e) or (h), such underpayment must also exceed a dollar threshold.

Criteria	Resources	6103 Protected Resources
<p><u>Any income tax imposed.</u> The amount of any income tax imposed is determined without regard to:</p> <ul style="list-style-type: none"> a. credits for withholding under IRC §§ 31 and 33, b. payments of tax or estimated tax, c. credits resulting from the collection of termination (IRC § 6851) or jeopardy assessments (IRC § 6861), and d. any tax not required to be assessed on a return. <p><u>Amount shown as tax by the taxpayer on the return.</u> The amount shown as tax by the taxpayer on the return is the amount of tax liability shown on the return:</p> <ul style="list-style-type: none"> a. determined without regard to: <ul style="list-style-type: none"> i. credits for withholding under IRC §§ 31 and 33, ii. payments of tax or estimated tax, iii. credits resulting from the collection of termination or jeopardy assessments, and 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6664-2(b) Amount of income tax imposed. ▪ Treas. Reg. 1.6664-2(c) Amount shown as the tax by the taxpayer on his return. 	

Determination of Process Applicability (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

To apply an IRC § 6662 penalty, there must be a return filed and an underpayment of tax. To apply a valuation misstatement penalty under IRC § 6662(e) or (h), such underpayment must also exceed a dollar threshold.

Criteria	Resources	6103 Protected Resources
<p>Underpayment of income tax (cont'd)</p> <p>b. reduced by the excess of:</p> <ul style="list-style-type: none"> i. the amounts shown on the tax return by the taxpayer as credits for withholding under IRC §§ 31 and 33, plus ii. the amounts shown on the tax return by the taxpayer as payments of tax, over <p>c. the amounts of tax actually withheld and paid.</p> <p><u>Amounts not so shown as previously assessed.</u> Amounts not so shown as previously assessed means only amounts that are assessed by the Service before the return is filed that were not shown on the return.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6664-2(d) Amounts not so shown previously assessed (or collected without assessment). 	

Determination of Process Applicability (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

To apply an IRC § 6662 penalty, there must be a return filed and an underpayment of tax. To apply a valuation misstatement penalty under IRC § 6662(e) or (h), such underpayment must also exceed a dollar threshold.

Criteria	Resources	6103 Protected Resources
<p>Underpayment of income tax (cont'd)</p> <p><u>Amounts collected without assessment.</u> Amounts collected without assessment is the amount by which the total of the</p> <ul style="list-style-type: none"> a. credits allowable under IRC § 31 and 33, plus b. estimated tax payments, plus c. other payments made before the return is filed, exceed <p>the tax shown on the return (provided such excess has not been refunded or allowed as a credit to the taxpayer).</p>		

Summary of Process Steps

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement	
Step 1	Review the thresholds for determining substantial and gross valuation misstatements and related considerations.
Step 2	Review the statutory exclusions from the net section 482 adjustment.
Step 3	Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.
Step 4	Consider the transactional penalty and the reasonable cause and good faith exception.
Step 5	Review the ordering rules for determining the total amount of penalties imposed under IRC §§ 6662 and 6663.
Step 6	Determine the portion of the tax underpayment on which no penalty applies.
Step 7	Determine the portion of the tax underpayment on which a 20% penalty under IRC § 6662 applies.
Step 8	Determine the portion of the tax underpayment on which a 40% penalty under IRC § 6662 applies.
Step 9	Determine the portion of the tax underpayment on which a 75% penalty under IRC § 6663 applies.
Step 10	Calculate the net adjustment penalty for a substantial valuation misstatement.

Step 1

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>Substantial valuation misstatement. In the case of any transaction between related parties described in IRC § 482, a substantial valuation misstatement exists when the price for any property or service, claimed on any tax return, is 200% or more, or 50% or less, of the price determined under IRC § 482 to be correct. A penalty applied based on meeting this threshold is referred to as the transactional penalty.</p>	<ul style="list-style-type: none">▪ IRC 6662(e)(1)(B)(i) Substantial valuation misstatement under chapter 1. In general.▪ IRC 6662(e)(1)(B)(ii) Substantial valuation misstatement under chapter 1. In general.	

Step 1 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>A substantial valuation misstatement also exists when the increase in net income resulting from IRC § 482 transfer price adjustments for the tax year (i.e., the “net section 482 adjustment”) exceeds the lesser of \$5 million or 10% of the taxpayer’s gross receipts. A penalty applied based on meeting this threshold is referred to as the net adjustment penalty. Note: This paragraph is particularly relevant to the focus of this unit.</p> <p>Substantial valuation misstatements are subject to a 20% penalty.</p>	<ul style="list-style-type: none"> ▪ IRM 20.1.5.9.3(2) and (3) IRC 6662(e)(1)(B), Valuation Misstatement Penalties for Transfer Pricing Transactions Under IRC 482 ▪ IRC 6662(e)(3)(A) Net section 482 transfer price adjustment. In general. ▪ IRC 6662(e)(1)(B)(ii) Substantial valuation misstatement under chapter 1. <p>IRC 6662(a) Imposition of penalty.</p>	

Step 1 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>Gross valuation misstatement. In the case of any transaction between related parties described in IRC § 482, a gross valuation misstatement exists when the price for any property or service, claimed on any tax return, is 400% or more, or 25% or less, of the price determined under IRC § 482 to be correct. A penalty applied based on meeting this threshold is referred to as the transactional penalty.</p> <p>A gross valuation misstatement also exists when the increase in net income resulting from IRC § 482 transfer price adjustments for the tax year (i.e., the “net section 482 adjustment”) exceeds the lesser of \$20 million or 20% of the taxpayer’s gross receipts. A penalty applied based on meeting this threshold is referred to as the net adjustment penalty.</p> <p>Gross valuation misstatements are subject to a 40% penalty.</p>	<ul style="list-style-type: none"> ▪ IRC 6662(h)(2)(A)(ii) Gross valuation misstatements. ▪ IRC 6662(h)(2)(A)(iii) Gross valuation misstatements. IRC 6662(h)(1) Increase in penalty in case of gross valuation misstatements. 	

Step 1 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>Net section 482 adjustment. “Net section 482 adjustment” is defined as “the sum of all increases in taxable income for the taxable year resulting from allocations under IRC § 482 (determined without any regard to amounts carried to such taxable year from another taxable year) less any decreases in taxable income attributable to collateral adjustments as described in [Treas. Reg. §] 1.482-1(g).” Appropriate collateral adjustments may include correlative allocations, conforming adjustments, and setoffs.</p>	<ul style="list-style-type: none"> ▪ IRC 6662(e)(3)(A) Net section 482 transfer price adjustment. In general. ▪ Treas. Reg. 1.6662-6(c)(1) Net section 482 adjustment. ▪ Treas. Reg. 1.482-1(g) Collateral adjustments with respect to allocations under section 482. 	
<p>Net section 482 adjustment includes only transfer price adjustments. The net section 482 adjustment includes only adjustments under IRC § 482 in the price for any property or services (or for the use of property), including purchase prices, fees, services, rents, interest, and advances. The term property includes both tangible and intangible property.</p>	<ul style="list-style-type: none"> ▪ IRC 6662(e)(3)(A) Net section 482 transfer price adjustment. In general. ▪ FSA 200108003 ▪ HR Rep No 101-964 at 454 (1990) ▪ IRM 20.1.5.9.3(1) & (4) IRC 6662(e)(1)(B), Valuation Misstatement Penalties for Transfer Pricing Transactions Under IRC 482 ▪ Treas. Reg. 1.6662-5(e)(3) Property. 	

Step 1 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>Net section 482 adjustment includes only transfer price adjustments (cont'd)</p> <p>The Service has stated that the net section 482 adjustment does not include non-transfer price adjustments under IRC § 482. An example of a non-transfer price adjustment under IRC § 482 is the reallocation of lease income to a partner (that contributed property leases to a partnership and subsequently sustained the deductions attributable to the leased properties) in lieu of the allocation under the partnership agreement of lease income to tax-indifferent foreign partners.</p>	<ul style="list-style-type: none"> ▪ FSA 200108003 	

Step 1 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>Determination of gross receipts. Gross receipts includes those receipts properly recognized under the taxpayer's accounting method during the taxable year as adjusted for IRC § 482 allocations. For example, gross receipts include sales (net of returns and allowances), amounts received for services, and income from investments.</p> <p>For a consolidated return, taxpayer gross receipts means the gross receipts of the group.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(c)(5) Gross receipts. ▪ Treas. Reg. 1.448-1T(f)(iv) Determination of gross receipts. ▪ Treas. Reg. 1.6662-6(c)(7) Example 5. 	

Step 1 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>Setoffs reduce the net section 482 adjustment. A setoff takes into account the effect of any non-arm's length transfer pricing transaction, between the same controlled taxpayers in the same taxable year, on any transaction for which the Service has made an IRC § 482 adjustment. The net section 482 adjustment is reduced by setoffs when the taxpayer:</p> <ol style="list-style-type: none"> 1. establishes that the transaction, which is the basis of the setoff, was not at arm's length, and establishes the appropriate arm's length amount, 2. documents all correlative adjustments resulting from the setoff, and 3. notifies the IRS of the basis of the setoff within 30 days of the earlier of: <ol style="list-style-type: none"> a. the date of the letter transmitting the revenue agent report, or b. the date of a statutory notice of deficiency. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(c)(4) Setoff allocation rule. ▪ Treas. Reg. 1.482-1(g)(4) Setoffs. 	

Step 1 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 1: Review the thresholds for determining substantial and gross valuation misstatements and related considerations.

A valuation misstatement can be either substantial [IRC § 6662(e)] or gross [IRC § 6662(h)].

Considerations	Resources	6103 Protected Resources
<p>Setoffs reduce the net section 482 adjustment (cont'd)</p> <p>For purposes of determining the net section 482 adjustment, setoffs reduce all IRC § 482 transfer price adjustments ratably. Thus, even IRC § 482 adjustments that meet the requirements to be excluded from the net section 482 adjustment are reduced by their ratable portion of setoffs.</p> <p>If the effect of a setoff changes the character or source of the income or deductions, or otherwise distorts taxable income, in such a manner to affect the U.S. tax liability of any member, adjustments will be made to reflect the correct amount of each category of income or deductions.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(c)(4) Setoff allocation rule. ▪ Treas. Reg. 1.482-1(g)(4)(i) Setoffs. In general. 	

Step 2

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>The amount of each IRC § 482 transfer price adjustment is included in the net section 482 adjustment unless one of the following requirements for exclusion is met:</p> <p>a. The taxpayer establishes that both the specified method and documentation requirements of Treas. Reg. § 1.6662-6(d)(2) are met with respect to that transaction. (See Slide 16 for discussion of meeting these requirements.)</p> <p>b. The taxpayer establishes that both the unspecified method and documentation requirements of Treas. Reg. § 1.6662-6(d)(3) are met with respect to that transaction. (See Slide 20 for discussion of meeting these requirements.)</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(1) Amounts excluded from net section 482 adjustment. In general. ▪ Treas. Reg. 1.6662-6(d)(2)(i) Application of a specified section 482 method. In general. ▪ Treas. Reg. 1.6662-6(d)(3)(i) Application of an unspecified method. In general. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
c. The taxpayer's taxable income is increased due to an IRC § 482 allocation for a controlled transaction solely between foreign corporations, unless the consequences of that allocation affects either foreign corporation's (1) income from sources within the U.S. or (2) income effectively connected with a U.S. trade or business ("ECI"). (See Slide 23 for more discussion of foreign to foreign transactions.)	▪ Treas. Reg. 1.6662-6(d)(4) Certain foreign to foreign transactions.	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Specified method and documentation requirements. The specified method requirement is met when a taxpayer selects, and applies in a reasonable manner, a method described in the regulations under IRC § 482. Also, such method must apply to transactions of the type under review. Specified methods and the application of them are discussed in Treas. Regs. § 1.482-3 for transfers of tangible property, § 1.482-4 for transfers of intangible property, § 1.482-7 for cost sharing arrangements, and 1.482-9 for service transactions.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(2)(i) Application of a specified section 482 method. In general. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Specified method and documentation requirements (cont'd)</p> <p>A specified method is selected and applied in a reasonable manner if, given the available data and applicable pricing methods, the taxpayer reasonably concluded that the method and its application provided the most reliable measure of an arm's length result under the principles of the best method rule of Treas. Reg. § 1.482-1(c). A taxpayer can reasonably conclude they have met this hurdle only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods.</p> <p>The documentation requirement is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application) provided the most reliable measure of an arm's length result under the best method rule.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(2)(ii)(A) Specified method requirement. ▪ Treas. Reg. 1.6662-6(d)(2)(iii)(A) Documentation requirement. In General. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Specified method and documentation requirements (cont'd)</p> <p>Such documentation must be provided to the Service within 30 days of a request for it in connection with an examination of the tax year to which the documentation relates.</p> <p>The required principal and background documentation is described in Treas. Reg. § 1.6662-6(d)(2)(iii)(B) and (C), respectively. With the exception of the ninth and tenth listed principal documentation described in the regulations, all required documentation must exist when the return is filed. The Service may excuse a minor or inadvertent failure of the documentation requirements only if the taxpayer makes a good faith effort to promptly comply when the failure becomes known.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(2)(iii)(A) Documentation requirement. In General. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
 CONSULTATION: Consider contacting a Technical Specialist in the Income Shifting IPN or a Tax Law Specialist in the Transfer Pricing Practice (“TPP”) for assistance in determining whether a taxpayer met the specified method and documentation requirements.		

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Unspecified method and documentation requirements. If the transaction is a type for which methods are specified in the regulations, the unspecified method requirement is met if a taxpayer reasonable concludes, given the available data, that none of the methods specified in the regulations was likely to provide a reliable measure of an arm's length result and the taxpayer selected and applied the unspecified method in a way that would likely provide a reliable measure of an arm's length result. Such conclusion may result only if a reasonable effort was made to evaluate the potential applicability of the specified methods consistent with the principles of the best method rule. Factors relevant to this conclusion include those in Treas. Reg. § 1.6662-6(d)(2)(ii).</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(3)(ii)(A) Unspecified method requirement. In general. ▪ Treas. Reg. 1.6662-6(d)(3)(ii)(B) Specified method potentially applicable. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Unspecified method and documentation requirements (cont'd)</p> <p>If the transaction is a type for which no methods are specified in the regulations, the unspecified method requirement is met if the unspecified method was selected and applied in a reasonable manner. Such selection and application is reasonable if the taxpayer reasonably concludes that the method and its application provided the most reliable measure of an arm's length result consistent with the principles of the best method rule. Factors relevant to this conclusion include those in Treas. Reg. § 1.6662-6(d)(2)(ii).</p> <p>The documentation requirement is met if the taxpayer maintains sufficient documentation to establish that the unspecified method requirement is met and provides such documentation to the Service within 30 days of a request for it. Such documentation must exist when the return is filed.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(3)(ii)(C) No specified method applicable. ▪ Treas. Reg. 1.6662-6(d)(3)(iii)(A) Documentation requirement. In general. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Unspecified method and documentation requirements (cont'd)</p> <p>The Service may excuse a minor or inadvertent failure of the documentation requirements only if the taxpayer makes a good faith effort to promptly comply when the failure becomes known.</p> <p>The required principal and background documentation is described in Treas. Reg. § 1.6662-6(d)(2)(iii)(B) and (C), respectively.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(3)(iii)(A) Documentation requirement. In general. ▪ Treas. Reg. 1.6662-6(d)(3)(iii)(B) Principal and background documents. 	
<p> CONSULTATION: Consider contacting a Technical Specialist in the Income Shifting IPN or a Tax Law Specialist in the TPP for assistance in determining whether a taxpayer met the unspecified method and documentation requirements.</p>		

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Foreign to foreign transactions excluded. An example of a foreign to foreign transaction excluded from a net section 482 adjustment is interest paid by one controlled foreign corporation ("CFC") to another CFC that (a) is adjusted under IRC § 482 and (b) causes an increase in the U.S. shareholder's Subpart F income. If the IRC § 482 adjustment does not affect either CFC's U.S. source income or ECI, then the IRC § 482 adjustment is excluded from the net section 482 adjustment.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(d)(6) Example (3). 	
<p>Coordination with reasonable cause exception. IRC § 6664(c) provides generally that a penalty may not be asserted under IRS § 6662 with respect to a portion of an underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.</p>	<ul style="list-style-type: none"> ▪ IRC 6664(c)(1) Reasonable cause exception for underpayments. In general. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Coordination with reasonable cause exception (cont'd)</p> <p>However, IRC § 6662(e)(3)(D) provides that, for purposes of IRC § 6664(c), the taxpayer is not treated as having reasonable cause for a portion of an underpayment attributable to a net section 482 adjustment unless the taxpayer meets the requirements of IRC § 6662(e)(3)(B)(i), (ii), or (iii) with respect to such portion. Thus, amounts that meet the requirements of IRC § 6662(e)(3)(B)(i), (ii), or (iii) are excluded from the calculation of the net section 482 adjustment, while amounts that do not meet such requirements are not excluded from the calculation because they are deemed to lack reasonable cause under IRC § 6662(e)(3)(D). Those requirements are described in detail in Treas. Reg. § 1.6662-6(d).</p>	<ul style="list-style-type: none"> ▪ IRC 6662(e)(3)(D) Coordination with reasonable cause exception. ▪ Treas. Reg. 1.6662-6(d) Amounts excluded from net section 482 adjustments. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
Note: The preceding paragraph is clarified in Slides 29 and 30 .		

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>The impact of exclusions from the net section 482 adjustment. Reasonable cause is presumed for IRC § 482 adjustments that meet the requirements of Treas. Reg. § 1.6662-6(d) and are excluded from the net section 482 adjustment.</p> <p>This Step 2 describes the analysis used to determine whether any IRC § 482 adjustments should be excluded for purposes of calculating the net section 482 adjustment. Such analysis includes whether:</p> <ol style="list-style-type: none"> a. the specified and unspecified methods were reasonably selected and applied, b. a specified method could apply, if taxpayer selected an unspecified method, c. the documentation requirements were met, d. such documentation was provided within 30 days of their request, and 	<ul style="list-style-type: none"> ▪ IRC 6662(e)(3)(D) Coordination with reasonable cause exception. ▪ Treas. Reg. 1.6662-6(d) Amounts excluded from net section 482 adjustment. 	

Step 2 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 2: Review the statutory exclusions from the net section 482 adjustment.

Certain IRC § 482 adjustments are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>The impact of exclusions from the net section 482 adjustment (cont'd)</p> <p>e. the controlled transaction was solely between foreign corporations that did not affect either foreign corporation's (a) income from sources within the U.S. or (b) ECI.</p> <p>When all of the criteria for excluding a valuation misstatement from the net section 482 adjustment (i.e., items a through d or item e in the preceding paragraph) are met, it is presumed that reasonable cause and good faith is met for an underpayment of tax attributed to that valuation misstatement.</p>		

Step 3

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 3: Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.

Identify all IRC 482 adjustments and determine the amounts that are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Determining if the net adjustment penalty for a substantial or gross valuation misstatement applies involves considering all increases in taxable income resulting from IRC § 482 transfer price adjustments and if certain of those adjustments are excluded from the net section 482 adjustment.</p> <p>Example. Assume a U.S. corporation reported \$30 million of current year gross receipts as adjusted to reflect IRC § 482 allocations. Under audit, four IRC § 482 transfer price adjustments to the return are proposed:</p> <p style="padding-left: 40px;"><u>Increases to taxable income</u></p> <p>§ 482 adj. #1 for controlled services provided</p> <p>§ 482 adj. #2 for controlled services provided</p> <p>§ 482 adj. #3 for purchase of tangible property</p> <p>§ 482 adj. #4 for sale of intangible property</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(c)(5) Gross receipts. 	

Step 3 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 3: Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.

Identify all IRC 482 adjustments and determine the amounts that are excluded for purposes of determining the net section 482 adjustment.

Considerations					Resources	6103 Protected Resources
Example (cont'd)						
Adj.	R	C	R/C	M		
#1	\$1.0 mil	\$2.0 mil	50%	\$1.0 mil		
#2	1.0 mil	4.0 mil	25%	3.0 mil		
#3	1.0 mil	0.5 mil	200%	0.5 mil		
#4	1.0 mil	3.0 mil	33%	<u>2.0 mil</u>		
Total				\$6.5 mil		
<p>R = the price as reported on the original return C = the price as ultimately determined to be correct M = the increase in taxable income for the taxable year</p>						

Step 3 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 3: Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.

Identify all IRC 482 adjustments and determine the amounts that are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Example (cont'd) Adjustment #1: The price claimed on the return for adjustment #1 (\$1 million) is 50% or less (but not 25% or less) of the amount determined under IRC § 482 to be correct (\$2 million), Thus, the \$1 million valuation misstatement meets the threshold for a substantial valuation misstatement subject to the transactional penalty at the 20% rate. (For discussion of thresholds, see Slides 9 through 11.)</p>		

Step 3 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 3: Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.

Identify all IRC 482 adjustments and determine the amounts that are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Example (cont'd) Adjustment #2: The price claimed on the return for adjustment #2 (\$1 million) is 25% or less of the amount determined under IRC § 482 to be correct (\$4 million). Thus, the \$3 million valuation misstatement meets the threshold for a gross valuation misstatement subject to the transactional penalty at the 40% rate. Also, the \$3 million valuation misstatement is still included in the net section 482 adjustment for purposes of determining whether the threshold is met for the net adjustment penalty at the 20% rate.</p>		

Step 3 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 3: Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.

Identify all IRC 482 adjustments and determine the amounts that are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Example (cont'd) (For more information, see the discussion of Coordinating the transactional and net adjustment penalties on Slide 50.)</p> <p>Adjustment #3: The price claimed on the return for adjustment #3 (\$1 million) is 200% or more (but not 400% or more) of the amount determined under IRC § 482 to be correct (\$500,000). Thus, the \$500,000 valuation misstatement meets the threshold for a substantial valuation misstatement subject to the transactional penalty at the 20% rate.</p> <p>Adjustment #4: The price claimed on the return for adjustment #4 (\$1 million) is 50% or less (but not 25% or less) of the amount determined under IRC § 482 to be correct (\$3 million). Thus, the \$2 million valuation misstatement meets the threshold for a substantial valuation misstatement subject to the transactional penalty at the 20% rate.</p>		

Step 3 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 3: Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.

Identify all IRC 482 adjustments and determine the amounts that are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Example (cont'd)</p> <p>The net section 482 adjustment. Assume for adjustments #1, #2 and #3 that the taxpayer did not meet the specified or unspecified method requirements and the documentation requirement. Also, assume such adjustments did not arise from a foreign to foreign transaction. Thus, the \$4.5 million increase in net income from such three adjustments are included in the net section 482 adjustment. For adjustment #4, assume the taxpayer selected and applied a specified method in a reasonable manner and met the documentation requirement. Thus, the \$2 million increase in net income resulting from adjustment #4 is excluded for purposes of determining the net section 482 adjustment. In that case, the net section 482 adjustment for adjustments #1, #2 and #3 is \$4.5 million, which exceeds the lesser of \$5 million or 10% of the taxpayer's gross receipts (10% of \$30 million equals \$3 million).</p>		

Step 3 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 3: Analyze each IRC § 482 adjustment and calculate the net section 482 adjustment.

Identify all IRC 482 adjustments and determine the amounts that are excluded for purposes of determining the net section 482 adjustment.

Considerations	Resources	6103 Protected Resources
<p>Example (cont'd).</p> <p>Thus, the net section 482 adjustment is a substantial valuation misstatement subject to the net adjustment penalty at the 20% rate.</p> <p>Note: This example does not include an IRC § 482 transfer price adjustment that in and of itself does not meet a substantial or gross valuation misstatement threshold for a transactional or net adjustment penalty. However, such an adjustment would be included in the calculation of a net section 482 adjustment for purposes of determining if either the substantial or gross valuation misstatement threshold is met for a net adjustment penalty. (For discussion of thresholds, see Slides 9 through 11.)</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(c)(1) Net section 482 adjustment. 	

Step 4

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 4: Consider the transactional penalty and the reasonable cause and good faith exception.

The transactional penalty will not be imposed on any underpayment of tax for which reasonable cause and good faith under Treas. Reg. § 1.6664-4 is met.

Considerations	Resources	6103 Protected Resources
<p>Reasonable cause and good faith. If the net section 482 adjustment (after the exclusions described in Step 2) does not meet the threshold amounts for the net adjustment penalty, the transactional penalty and the reasonable cause and good faith exception should be considered for any adjustment amounts that were not excluded under Treas. Reg. § 1.6662-6(d).</p>	<ul style="list-style-type: none">▪ IRC 6664(c)(1) Reasonable cause exception for underpayments. In general.▪ Treas. Reg. 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.▪ Treas. Reg. 1.6662-6(b)(3) Reasonable cause and good faith.	

Step 4 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 4: Consider the transactional penalty and the reasonable cause and good faith exception.

The transactional penalty will not be imposed on any underpayment of tax for which reasonable cause and good faith under Treas. Reg. § 1.6664-4 is met.

Considerations	Resources	6103 Protected Resources
<p>Example - variation. For the analysis in this Step 4 only, assume the facts are the same as in the Example on Slide 31, except that adjustments #2, #3 and #4 met the requirements in Treas. Reg. § 1.6662-6(d) and were excluded from the net section 482 adjustment. In that case, the \$1 million increase in net income from adjustment #1 is the only adjustment included in the calculation of the net section 482 adjustment. Thus, the net section 482 adjustment falls below the thresholds for a substantial or gross valuation misstatement under the net adjustment penalty. However, the \$1 million valuation misstatement meets the threshold for a substantial valuation misstatement under the transactional penalty, and the reasonable cause and good faith exception should be considered. (For discussion of the transactional penalty thresholds, see Slides 9 through 11.)</p>		

Step 4 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 4: Consider the transactional penalty and the reasonable cause and good faith exception.

The transactional penalty will not be imposed on any underpayment of tax for which reasonable cause and good faith under Treas. Reg. § 1.6664-4 is met.

Considerations	Resources	6103 Protected Resources
<p>Note: If a substantial or gross valuation misstatement under the transactional penalty also constitutes (or is part of) a substantial or gross valuation misstatement under the net adjustment penalty, then the requirements of Treas. Reg. § 1.6662-6(d) (and not the rules of Treas. Reg. § 1.6664-4) must be met.</p>		
<p>Requirements of Treas. Reg. § 1.6664-4. Determining if a taxpayer acted with reasonable cause and in good faith is generally based on analyzing all of the facts and circumstances.</p> <p>“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 the facts and circumstances, including the experience, knowledge and education of the taxpayer.”</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6664-4(b) Facts and circumstances taken into account. 	

Step 4 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 4: Consider the transactional penalty and the reasonable cause and good faith exception.

The transactional penalty will not be imposed on any underpayment of tax for which reasonable cause and good faith under Treas. Reg. § 1.6664-4 is met.

Considerations	Resources	6103 Protected Resources
<p>Reliance on opinion or advice. A taxpayer's education, sophistication and business experience is relevant to determine if the taxpayer's reliance on tax advice was reasonable and in good faith. Tax advice does not have to be in any particular form. A taxpayer will not be considered to have reasonably relied in good faith on advice unless the following requirements are satisfied:</p> <ul style="list-style-type: none"> a. The advice is based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances; a. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person; and 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6664-4(c) Reliance on opinion or advice. 	

Step 4 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 4: Consider the transactional penalty and the reasonable cause and good faith exception.

The transactional penalty will not be imposed on any underpayment of tax for which reasonable cause and good faith under Treas. Reg. § 1.6664-4 is met.

Considerations	Resources	6103 Protected Resources
<p>Reliance on opinion or advice (cont'd)</p> <p>c. Taxpayer did not rely on an opinion or advice that a regulation is invalid unless that position was adequately disclosed in accordance with Treas. Reg. § 1.6662-3(c)(2).</p> <p>Satisfaction of the above requirements, however, will not necessarily establish that taxpayer reasonably relied on the advice or opinion in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6664-4(c) Reliance on opinion or advice. 	

Step 4 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 4: Consider the transactional penalty and the reasonable cause and good faith exception.

The transactional penalty will not be imposed on any underpayment of tax for which reasonable cause and good faith under Treas. Reg. § 1.6664-4 is met.

Considerations	Resources	6103 Protected Resources
 <p>CONSULTATION: Consider contacting a Tax Law Specialist in the TPP, and/or a Technical Specialist in the Income Shifting or the Information Gathering IPN for assistance in evaluating whether a taxpayer met the requirements of Treas. Reg. § 1.6664-4 to satisfy reasonable cause for an underpayment of tax attributed to a substantial or gross valuation misstatement.</p>		
 <p>DECISION POINT: With managerial approval, contact Counsel to assist with penalty development when evaluating a taxpayer's reasonable cause arguments.</p>	<ul style="list-style-type: none"> ▪ IRM 20.1.5.3(2) Examination Penalty Assertion 	

Step 5

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 5: Review the ordering rules for determining the total amount of penalties imposed under IRC §§ 6662 and 6663.

Once a net section 482 adjustment is determined, ordering rules provide how penalties under IRC §§ 6662 and 6663 are calculated.

Considerations	Resources	6103 Protected Resources
<p>Ordering rules. Rules determine the order in which multiple adjustments to a return are taken into account for the purpose of computing the total amount of penalties imposed under IRC §§ 6662 and 6663. These rules apply when there is at least:</p> <ul style="list-style-type: none">▪ one exam adjustment for which an IRC § 6662 penalty applies and one adjustment without such penalty, or▪ two exam adjustments for which IRC § 6662 penalties apply at different rates.	<ul style="list-style-type: none">▪ Treas. Reg. 1.6664-3 Ordering rules for determining the total amount of penalties imposed.	

Step 5 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 5: Review the ordering rules for determining the total amount of penalties imposed under IRC §§ 6662 and 6663.

Once a net section 482 adjustment is determined, ordering rules provide how penalties under IRC §§ 6662 and 6663 are calculated.

Considerations	Resources	6103 Protected Resources
<p>Under the ordering rules, exam adjustments to taxable income/loss are considered made in the following order:</p> <ul style="list-style-type: none"> ▪ No penalty applies under IRC §§ 6662 or 6663 ▪ 20% penalty applies under IRC § 6662 ▪ 40% penalty applies under IRC § 6662 ▪ 75% penalty applies under IRC § 6663 <p>See the next slide for a summary of applicable penalties by rate.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6664-3(b), Order in which adjustments are taken into account. ▪ IRC 6663 Imposition of Fraud Penalty. ▪ IRM 20.1.5.14 IRC 6663, Civil Fraud Penalty 	

Step 5 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 5: Review the ordering rules for determining the total amount of penalties imposed under IRC §§ 6662 and 6663.

Once a net section 482 adjustment is determined, ordering rules provide how penalties under IRC §§ 6662 and 6663 are calculated.

Considerations	Resources	6103 Protected Resources
<p>Summary of the applicable penalties by rate.</p> <ul style="list-style-type: none"> ▪ 20% (i.e., penalties for substantial valuation misstatements, negligence or disregard of rules or regulations, and substantial understatements of income tax), ▪ 40% (i.e., penalties for gross valuation misstatement, undisclosed transaction lacking economic substance, and undisclosed foreign financial asset understatement), and ▪ 75% (i.e., the penalty for fraud under IRC § 6663) 	<ul style="list-style-type: none"> ▪ IRC 6662 Imposition of accuracy-related penalty on underpayments. ▪ IRC 6663 Imposition of fraud penalty. 	
<p> CONSULTATION: Consider contacting a Technical Specialist in the Information Gathering IPN for assistance in understanding and applying the ordering rules to compute the total amount of penalties imposed under IRC §§ 6662 and 6663.</p>		

Step 6

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 6: Determine the portion of the tax underpayment on which no penalty applies.

The first ordering rule adjustment takes into consideration the adjustments to the return that are not subject to a penalty.

Considerations	Resources	6103 Protected Resources												
<p>Summary of adjustments to the return. Modifying the example in Step 3, five adjustments to the return are proposed during the exam:</p> <table border="1" data-bbox="111 729 795 1172"> <tbody> <tr> <td>An adj. for which no IRC § 6662 penalty applies</td> <td>\$2.0 mil</td> </tr> <tr> <td>§ 482 adj. #1</td> <td>1.0 mil</td> </tr> <tr> <td>§ 482 adj. #2</td> <td>3.0 mil</td> </tr> <tr> <td>§ 482 adj. #3</td> <td>0.5 mil</td> </tr> <tr> <td>§ 482 adj. #4</td> <td><u>2.0 mil</u></td> </tr> <tr> <td></td> <td>\$8.5 mil</td> </tr> </tbody> </table> <p>Thus, taxable income per exam is \$7.5 million (assume a \$1 million taxable loss was originally reported plus \$8.5 million of adjustments to increase taxable income).</p>	An adj. for which no IRC § 6662 penalty applies	\$2.0 mil	§ 482 adj. #1	1.0 mil	§ 482 adj. #2	3.0 mil	§ 482 adj. #3	0.5 mil	§ 482 adj. #4	<u>2.0 mil</u>		\$8.5 mil		
An adj. for which no IRC § 6662 penalty applies	\$2.0 mil													
§ 482 adj. #1	1.0 mil													
§ 482 adj. #2	3.0 mil													
§ 482 adj. #3	0.5 mil													
§ 482 adj. #4	<u>2.0 mil</u>													
	\$8.5 mil													

Step 6 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 6: Determine the portion of the tax underpayment on which no penalty applies.

The first ordering rule adjustment takes into consideration the adjustments to the return that are not subject to a penalty.

Considerations	Resources	6103 Protected Resources		
<p>The portion of the tax underpayment on which no penalty applies. Applying the first ordering rule adjustment, the portion of the tax underpayment on which no penalty applies is determined as follows:</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6664-3(d) Example (1). 			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Taxable income / (loss) per return</td> <td style="text-align: right;">(\$1.0 mil)</td> </tr> </table>	Taxable income / (loss) per return	(\$1.0 mil)		
Taxable income / (loss) per return	(\$1.0 mil)			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Plus adj. for which no IRC § 6662 penalty applies</td> <td style="text-align: right;">2.0 mil</td> </tr> </table>	Plus adj. for which no IRC § 6662 penalty applies	2.0 mil		
Plus adj. for which no IRC § 6662 penalty applies	2.0 mil			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Plus § 482 adj. #4 which was excluded from the net section 482 adjustment</td> <td style="text-align: right;"><u>2.0 mil</u></td> </tr> </table>	Plus § 482 adj. #4 which was excluded from the net section 482 adjustment	<u>2.0 mil</u>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(b)(3) Reasonable cause and good faith. 	
Plus § 482 adj. #4 which was excluded from the net section 482 adjustment	<u>2.0 mil</u>			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">“Adjusted” taxable income</td> <td style="text-align: right;"><u>\$3.0 mil</u></td> </tr> </table>	“Adjusted” taxable income	<u>\$3.0 mil</u>		
“Adjusted” taxable income	<u>\$3.0 mil</u>			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Tax on “adjusted” taxable income (35% of \$3 million)</td> <td style="text-align: right;">1.05 mil</td> </tr> </table>	Tax on “adjusted” taxable income (35% of \$3 million)	1.05 mil		
Tax on “adjusted” taxable income (35% of \$3 million)	1.05 mil			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Less tax shown on return</td> <td style="text-align: right;"><u>-0-</u></td> </tr> </table>	Less tax shown on return	<u>-0-</u>		
Less tax shown on return	<u>-0-</u>			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Portion of tax underpayment on which no penalty is imposed</td> <td style="text-align: right;">\$1.05 mil</td> </tr> </table>	Portion of tax underpayment on which no penalty is imposed	\$1.05 mil		
Portion of tax underpayment on which no penalty is imposed	\$1.05 mil			

Step 7

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 7: Determine the portion of the tax underpayment on which a 20% penalty under IRC §§ 6662 applies.

The second ordering rule adjustment takes into consideration the adjustments to the return that are subject to a 20% penalty.

Considerations	Resources	6103 Protected Resources															
<p>Summary of the net section 482 adjustment. Continuing the example in Step 3, the IRC § 482 adjustments included in the net section 482 adjustment are as follows:</p> <table border="1" data-bbox="95 762 826 1212"> <thead> <tr> <th data-bbox="95 762 540 853">Increases to taxable income</th> <th data-bbox="540 762 669 853">R/C</th> <th data-bbox="669 762 826 853">M</th> </tr> </thead> <tbody> <tr> <td data-bbox="95 853 540 945">§ 482 adj. #1 for controlled services provided</td> <td data-bbox="540 853 669 945">50%</td> <td data-bbox="669 853 826 945">\$1.0 mil</td> </tr> <tr> <td data-bbox="95 945 540 1036">§ 482 adj. #2 for controlled services provided</td> <td data-bbox="540 945 669 1036">25%</td> <td data-bbox="669 945 826 1036">3.0 mil</td> </tr> <tr> <td data-bbox="95 1036 540 1128">§ 482 adj. #3 for purchase of tangible property</td> <td data-bbox="540 1036 669 1128">200%</td> <td data-bbox="669 1036 826 1128"><u>0.5 mil</u></td> </tr> <tr> <td data-bbox="95 1128 540 1212">Total</td> <td data-bbox="540 1128 669 1212"></td> <td data-bbox="669 1128 826 1212">\$4.5 mil</td> </tr> </tbody> </table> <p>R/C = the price as reported on the original return/ the price as ultimately determined to be correct M = the increase in net income for the taxable year</p>	Increases to taxable income	R/C	M	§ 482 adj. #1 for controlled services provided	50%	\$1.0 mil	§ 482 adj. #2 for controlled services provided	25%	3.0 mil	§ 482 adj. #3 for purchase of tangible property	200%	<u>0.5 mil</u>	Total		\$4.5 mil	<ul style="list-style-type: none"> <li data-bbox="851 568 1363 639">Treas. Reg. 1.6664-3(d) Example (1). 	
Increases to taxable income	R/C	M															
§ 482 adj. #1 for controlled services provided	50%	\$1.0 mil															
§ 482 adj. #2 for controlled services provided	25%	3.0 mil															
§ 482 adj. #3 for purchase of tangible property	200%	<u>0.5 mil</u>															
Total		\$4.5 mil															

Step 7 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 7: Determine the portion of the tax underpayment on which a 20% penalty under IRC §§ 6662 applies.

The second ordering rule adjustment takes into consideration the adjustments to the return that are subject to a 20% penalty.

Considerations	Resources	6103 Protected Resources
<p>Coordinating the transactional and net adjustment penalties. Any adjustment included in the net section 482 adjustment, that meets the threshold for the gross valuation misstatement for the transactional penalty, is subject to the 40% rate. For § 482 adjustment #2, the price claimed on the return (\$1 million) for the controlled services provided was 25% of the correct price (\$4 million) determined by the Service. Thus, the price claimed on the return with respect to adjustment #2 meets the threshold for the gross valuation misstatement which is subject to the transactional penalty at a rate of 40%. (See Slide 52.)</p> <p>The remaining portion of the net section 482 adjustment, \$1.5 million (\$4.5 million less \$3 million), is subject to the net adjustment penalty at the 20% rate even though that portion is less than the lesser of \$5 million or 10% of gross receipts. (See Slide 51.) (For discussion of thresholds, see Slides 9 through 11.)</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(f)(1) Coordination of a net section 482 adjustment subject to the net adjustment penalty and a gross valuation misstatement subject to the transactional penalty. 	

Step 7 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 7: Determine the portion of the tax underpayment on which a 20% penalty under IRC § 6662 applies.

The second ordering rule adjustment takes into consideration the adjustments to the return that are subject to a 20% penalty.

Considerations	Resources	6103 Protected Resources												
<p>The portion of the tax underpayment on which a 20% penalty applies. Continuing the example in Step 3 and applying the second ordering rule adjustment, the portion of the tax underpayment on which a 20% penalty applies is determined as follows:</p> <table border="1" data-bbox="99 796 816 1330"> <tbody> <tr> <td data-bbox="99 796 609 891">“Adjusted” taxable income (from Step 6)</td> <td data-bbox="609 796 816 891">\$3,000,000</td> </tr> <tr> <td data-bbox="99 891 609 948">Plus net section 482 adjustment</td> <td data-bbox="609 891 816 948"><u>1,500,000</u></td> </tr> <tr> <td data-bbox="99 948 609 1005">“Adjusted” taxable income</td> <td data-bbox="609 948 816 1005"><u>\$4.500,000</u></td> </tr> <tr> <td data-bbox="99 1005 609 1099">Tax on “adjusted” taxable income (35% of \$4.5 million)</td> <td data-bbox="609 1005 816 1099">\$1,575,000</td> </tr> <tr> <td data-bbox="99 1099 609 1193">Less tax on “adjusted” taxable income from Step 6</td> <td data-bbox="609 1099 816 1193"><u>1,050,000</u></td> </tr> <tr> <td data-bbox="99 1193 609 1330">Portion of tax underpayment on which the 20% penalty is imposed</td> <td data-bbox="609 1193 816 1330">\$ 525,000</td> </tr> </tbody> </table>	“Adjusted” taxable income (from Step 6)	\$3,000,000	Plus net section 482 adjustment	<u>1,500,000</u>	“Adjusted” taxable income	<u>\$4.500,000</u>	Tax on “adjusted” taxable income (35% of \$4.5 million)	\$1,575,000	Less tax on “adjusted” taxable income from Step 6	<u>1,050,000</u>	Portion of tax underpayment on which the 20% penalty is imposed	\$ 525,000	<ul style="list-style-type: none"> <li data-bbox="853 568 1406 639">Treas. Reg. 1.6664-3(d) Example (1). 	
“Adjusted” taxable income (from Step 6)	\$3,000,000													
Plus net section 482 adjustment	<u>1,500,000</u>													
“Adjusted” taxable income	<u>\$4.500,000</u>													
Tax on “adjusted” taxable income (35% of \$4.5 million)	\$1,575,000													
Less tax on “adjusted” taxable income from Step 6	<u>1,050,000</u>													
Portion of tax underpayment on which the 20% penalty is imposed	\$ 525,000													

Step 8

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 8: Determine the portion of the tax underpayment on which a 40% penalty under IRC §§ 6662 applies.

The third ordering rule adjustment takes into consideration the adjustments to the return that are subject to a 40% penalty.

Considerations	Resources	6103 Protected Resources												
<p>The portion of the tax underpayment on which a 40% penalty applies. Continuing the example in Step 3 and applying the third ordering rule adjustment, the portion of the tax underpayment on which a 40% penalty applies is determined as follows:</p>														
<table border="1"> <tr> <td data-bbox="99 836 609 922">“Adjusted” taxable income (from Step 7)</td> <td data-bbox="609 836 816 922">\$4,500,000</td> </tr> <tr> <td data-bbox="99 922 609 986">Plus § 482 adjustment #2</td> <td data-bbox="609 922 816 986"><u>3,000,000</u></td> </tr> <tr> <td data-bbox="99 986 609 1051">“Adjusted” taxable income</td> <td data-bbox="609 986 816 1051"><u>\$7,500,000</u></td> </tr> <tr> <td data-bbox="99 1051 609 1143">Tax on “adjusted” taxable income (35% of \$7.5 million)</td> <td data-bbox="609 1051 816 1143">\$2,625,000</td> </tr> <tr> <td data-bbox="99 1143 609 1236">Less tax on “adjusted” taxable income from Step 7</td> <td data-bbox="609 1143 816 1236"><u>1,575,000</u></td> </tr> <tr> <td data-bbox="99 1236 609 1365">Portion of tax underpayment on which the 40% penalty is imposed</td> <td data-bbox="609 1236 816 1365">\$1,050,000</td> </tr> </table>	“Adjusted” taxable income (from Step 7)	\$4,500,000	Plus § 482 adjustment #2	<u>3,000,000</u>	“Adjusted” taxable income	<u>\$7,500,000</u>	Tax on “adjusted” taxable income (35% of \$7.5 million)	\$2,625,000	Less tax on “adjusted” taxable income from Step 7	<u>1,575,000</u>	Portion of tax underpayment on which the 40% penalty is imposed	\$1,050,000		
“Adjusted” taxable income (from Step 7)	\$4,500,000													
Plus § 482 adjustment #2	<u>3,000,000</u>													
“Adjusted” taxable income	<u>\$7,500,000</u>													
Tax on “adjusted” taxable income (35% of \$7.5 million)	\$2,625,000													
Less tax on “adjusted” taxable income from Step 7	<u>1,575,000</u>													
Portion of tax underpayment on which the 40% penalty is imposed	\$1,050,000													

Step 9

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 9: Determine the portion of the tax underpayment on which a 75% penalty under IRC § 6663 applies.

The fourth ordering rule adjustment takes into consideration the adjustments to the return that are subject to a 75% penalty.

Considerations	Resources	6103 Protected Resources												
<p>The portion of the tax underpayment on which a 75% penalty applies. Continuing the example in Step 3 and applying the fourth ordering rule adjustment, the portion of the tax underpayment on which a 75% penalty applies is determined as follows:</p> <table border="1" data-bbox="99 796 816 1368"> <tbody> <tr> <td data-bbox="99 796 609 896">“Adjusted” taxable income (from Step 8)</td> <td data-bbox="609 796 816 896">\$7,500,000</td> </tr> <tr> <td data-bbox="99 896 609 986">Plus adjustment to which a 75% penalty applies</td> <td data-bbox="609 896 816 986"><u>0</u></td> </tr> <tr> <td data-bbox="99 986 609 1043">“Adjusted” taxable income</td> <td data-bbox="609 986 816 1043"><u>\$7,500,000</u></td> </tr> <tr> <td data-bbox="99 1043 609 1139">Tax on “adjusted” taxable income (35% of \$7.5 million)</td> <td data-bbox="609 1043 816 1139">\$2,625,000</td> </tr> <tr> <td data-bbox="99 1139 609 1235">Less tax on “adjusted” taxable income from Step 8</td> <td data-bbox="609 1139 816 1235"><u>2,625,000</u></td> </tr> <tr> <td data-bbox="99 1235 609 1368">Portion of tax underpayment on which the 75% penalty is imposed</td> <td data-bbox="609 1235 816 1368">\$0</td> </tr> </tbody> </table>	“Adjusted” taxable income (from Step 8)	\$7,500,000	Plus adjustment to which a 75% penalty applies	<u>0</u>	“Adjusted” taxable income	<u>\$7,500,000</u>	Tax on “adjusted” taxable income (35% of \$7.5 million)	\$2,625,000	Less tax on “adjusted” taxable income from Step 8	<u>2,625,000</u>	Portion of tax underpayment on which the 75% penalty is imposed	\$0	<ul style="list-style-type: none"> <li data-bbox="853 568 1406 644">Treas. Reg. 1.6664-3(d) Example (1). 	
“Adjusted” taxable income (from Step 8)	\$7,500,000													
Plus adjustment to which a 75% penalty applies	<u>0</u>													
“Adjusted” taxable income	<u>\$7,500,000</u>													
Tax on “adjusted” taxable income (35% of \$7.5 million)	\$2,625,000													
Less tax on “adjusted” taxable income from Step 8	<u>2,625,000</u>													
Portion of tax underpayment on which the 75% penalty is imposed	\$0													

Step 9 (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 9: Determine the portion of the tax underpayment on which a 75% penalty under IRC § 6663 applies.

The fourth ordering rule adjustment takes into consideration the adjustments to the return that are subject to a 75% penalty.

Considerations	Resources	6103 Protected Resources
<p>The portion of the tax underpayment on which a 75% penalty applies (cont'd)</p> <p>Note: IRC § 6663 imposes the penalty of 75% on any portion of an underpayment of tax that is attributable to fraud. The example in Step 3 did not contain an adjustment to taxable income on which a penalty under IRC § 6663 applies.</p>	<ul style="list-style-type: none">▪ IRC 6663 Imposition of fraud penalty.	

Step 10

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Step 10: Calculate the net adjustment penalty for a substantial valuation misstatement.

Once the portions of the tax underpayment on which penalties apply are determined, the net adjustment penalty can be calculated.

Considerations					Resources	6103 Protected Resources																									
<p>Calculation of the net adjustment penalty. Continuing the example in Step 3, the net adjustment and transactional penalties are calculated as follows</p> <table border="1"> <thead> <tr> <th>Under-payment Portion</th> <th>Step Ref</th> <th>Rate</th> <th>Net Adj. Penalty</th> <th>Transactional Penalty</th> </tr> </thead> <tbody> <tr> <td>\$ 525,000</td> <td>7</td> <td>20%</td> <td>\$105,000</td> <td>\$ 0</td> </tr> <tr> <td>1,050,000</td> <td>8</td> <td>40%</td> <td>0</td> <td>420,000</td> </tr> <tr> <td><u>0</u></td> <td>9</td> <td>75%</td> <td><u>0</u></td> <td><u>0</u></td> </tr> <tr> <td>\$1,575,000</td> <td></td> <td></td> <td>\$105,000</td> <td>\$420,000</td> </tr> </tbody> </table> <p>In this example, the portion of the tax underpayment attributable to valuation misstatements, \$1,575,000, exceeds the \$10,000 limitation for corporations. Thus, the taxpayer is subject to a \$105,000 net adjustment penalty and a \$420,000 transactional penalty.</p>					Under-payment Portion	Step Ref	Rate	Net Adj. Penalty	Transactional Penalty	\$ 525,000	7	20%	\$105,000	\$ 0	1,050,000	8	40%	0	420,000	<u>0</u>	9	75%	<u>0</u>	<u>0</u>	\$1,575,000			\$105,000	\$420,000	<ul style="list-style-type: none"> ▪ IRC 6662(e)(2) Limitation. ▪ Treas. Reg. 1.6662-6(f)(3) Example (2). 	
Under-payment Portion	Step Ref	Rate	Net Adj. Penalty	Transactional Penalty																											
\$ 525,000	7	20%	\$105,000	\$ 0																											
1,050,000	8	40%	0	420,000																											
<u>0</u>	9	75%	<u>0</u>	<u>0</u>																											
\$1,575,000			\$105,000	\$420,000																											

Other Considerations / Impact to Audit

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement

Considerations	Resources
<p>Multiple accuracy related penalties imposed. An accuracy related penalty may be imposed on any portion of a tax underpayment that is attributable to a type of misconduct described in IRC § 6662(b). That means that more than one accuracy related penalty may be imposed on a return.</p>	<ul style="list-style-type: none"> ▪ IRC 6662(a) Imposition of penalty. ▪ Treas. Reg. 1.6662-2(a) In general.
<p>No stacking of accuracy related penalties. A single portion of a tax underpayment that is attributable to more than one type of misconduct described in IRC § 6662(b) may not be subject to more than one accuracy related penalty.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-2(c) No stacking of accuracy-related penalty components.
<p>Carrybacks and carryovers resulting from valuation misstatements. If a substantial or gross valuation misstatement reported on a return for a tax year resulted in a loss, deduction, or credit that was carried back or forward to the return of another tax year, the transactional and/or net adjustment penalties will be imposed on any resulting underpayment of tax in that other tax year.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-6(e) Special rules in the case of carrybacks and carryovers. ▪ CCA 200037048
<p>Disclosure exception. There is no disclosure exception to a substantial or gross valuation misstatement penalty.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6662-5(a) In general. ▪ IRM 20.1.5.9.1(4) Penalty Assertion

Other Considerations / Impact to Audit (cont'd)

Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement	
Considerations	Resources
<p>Workpaper documentation. The examiner has to address accuracy related penalties in the workpapers. When a penalty appears warranted, but it is not asserted, the applicable exceptions to the penalty will be documented in the workpapers.</p>	<ul style="list-style-type: none"> ▪ IRM 20.1.5.3(2)b & j Examination Penalty Assertion
<p>Managerial approval of IRC § 6662(e) and/or (h) penalties. No penalty under the IRC § 6662(e) and/or (h) shall be assessed unless its initial determination is approved in writing by the immediate supervisor of the agent making such determination. Generally, the immediate supervisor is the person who writes an agent's evaluation or approves the agent's leave. Such review should consider if:</p> <ul style="list-style-type: none"> ▪ The penalties were fairly imposed and accurately computed. ▪ The employee did not improperly assert the penalties in the first instance as a bargaining chip. ▪ The employee's conclusions regarding "reasonable cause" (or the lack thereof) were proper. <p>For LB&I cases, managerial approval should be documented on penalty lead sheets.</p>	<ul style="list-style-type: none"> ▪ IRC 6751(b)(1) Approval of assessment. ▪ IRM 20.1.1.2.3(1), (6) & (8) Managerial Approval for Penalty Assessments ▪ IRM 20.1.1.2.3.1(1) & (2) Examination Change Reports Assessing Penalties ▪ IRM 20.1.5.1.6(1) & (5) Managerial Approval of Penalties
<p>Managerial approval of Form 4959. After a Form 4549 (Income Tax Examination Changes), which includes IRC § 6662(e) and/or (h) penalties, is presented to the taxpayer for signature, the manager may approve such form in writing. The Form 4594 does not have to be reviewed before discussions with the taxpayer or before the taxpayer agrees to the penalties.</p>	<ul style="list-style-type: none"> ▪ IRM 20.1.1.2.3.1(1) Examination Change Reports Assessing Penalties

Training and Additional Resources

Part 17.13 Substantial Valuation Misstatement

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions		
Issue Toolkits	<ul style="list-style-type: none">▪ Job Aid – IRC § 6662(e) Penalty Analysis Flowchart▪ Job Aid – Transfer Pricing Documentation 6662 IDR▪ IRM 20.1.5.9 IRC § 6662(e), Substantial Valuation Misstatement▪ IRM 20.1.5.9.1, Penalty Assertion	

Glossary of Terms and Acronyms

Term/Acronym	Definition
ACC(I)	Associate Chief Counsel (International)
C	The price as ultimately determined to be correct
CCA	Chief Counsel Advice
CFC	Controlled foreign corporation
DCN	Document control number
ECI	Income effectively connected with a U.S. trade or business
FSA	Field Service Advice
HR Rep	House of Representatives Report
IDR	Information document request
IPN	International Practice Network
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
ISI	Income Shifting Inbound
ISO	Income Shifting Outbound

Glossary of Terms and Acronyms

Term/Acronym	Definition
M	The increase in taxable income for the taxable year
R	The price as reported on the original return
TAM	Technical Advice Memorandum
TPP	Transfer Pricing Practice

Index of Related Issues

Issue	Associated UIL(s)	References
Overview of IRC Section 482	▪ 9411.07	▪ IPS Unit Overview of IRC Section 482 ISO/9411.07_01(2013)
Review of Transfer Pricing Documentation by Outbound Taxpayers	▪ 9411.07	▪ IPS Unit Review of Transfer Pricing Documentation by Outbound Taxpayers ISO/PUO/P_1.07_02(2014)
Arm's Length Standard	▪ 9422.09	▪ IPS Unit Arm's Length Standard ISI/9422.09_06(2013)
Three Requirements of IRC 482	▪ 9422.09	▪ IPS Unit Three Requirements of IRC 482 ISI/9422.09_02(2014)