



Into the Penalty Box! Updated Preparer Penalty Provisions in New Law
Podcast of June 2, 2007



Feed address for Podcast subscription:

<http://feeds.feedburner.com/EdZollarsTaxUpdate>

Home page for Podcast: <http://ezollars.libsyn.com>

©2007 Edward K. Zollars, CPA

The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.

The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.

This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.

Prior Week Errata

Another quick update on the “kiddie tax”—it appears that, when looked at in detail, the kiddie tax actually now breaks down into three categories under the new law. The actual tests appear to be:

- Under 18 as of the end of the tax year--automatically apply the kiddie tax to “excess” unearned income
- Exactly age 18 as of the end of the tax year--kiddie tax applies to “excess” unearned income if the child’s earned income is less than 1/2 of support, regardless of whether the child is a student
- Ages 19-23 as of the end of the year—the kiddie tax applies to “excess” earned income if the child is a student and the child’s earned income less than 1/2 of support.

The key issue is that the new law refers to IRC §152(c)(3)(A) for the “post 18” test, and that provision has one test for those under 19, and a second for those that have attained age 19 but not yet attained age 24. The “full time student” test only comes into play for the latter group.

So, once again, Congress has “simplified” our lives—and apparently created an incentive for children with significant unearned income to drop out of school and go ahead and get that Porsche...

Changes in Preparer Penalties

We look this week at the new provisions under IRC §6694 that increased the preparer penalties and lowered the standard for testing whether a preparer is subject to such penalties. We’ll look at the practical consequences of the change as well.

Prior Law Section 6694

Before the change in the law, §6694(a) and (b) read as follows:

Sec. 6694 Understatement of taxpayer's liability by income tax return preparer

(a) Understatements due to unrealistic positions

If--

(1) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits,

(2) any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and

(3) such position was not disclosed as provided in section 6662(d)(2)(B)(ii) or was frivolous, such person shall pay a penalty of \$250 with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

The definition of what constitutes a “realistic possibility” was found in Reg. §1.6694-2(b)(1), which provided:

(b) Realistic possibility of being sustained on its merits.

(1) In general.

A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits (realistic possibility standard). In making this determination, the possibility

that the position will not be challenged by the Internal Revenue Service (e.g., because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account. The analysis prescribed by section 1.6662-4(d)(3)(ii) for purposes of determining whether substantial authority is present applies for purposes of determining whether the realistic possibility standard is satisfied.

One key point to note, and which is referred to time again and again under all provisions related to such matters, is that you cannot consider any “audit lottery” type considerations. That includes:

- The chance the return will not be audited
- The issue would not be raised on audit
- The issue would be compromised down the line in appeals

Rather, your analysis has to effectively assume the case will be heard by a judge in a court of law, with both parties represented by competent counsel.

However, under the old rules we had a “one in three” chance of being sustained. Thus, a preparer could sign a return with an undisclosed position that the preparer concluded would most likely not be sustained if challenged, so long as the preparer believed that there was enough support for the position that there was at least a one out of three chance that the position would be sustained.

The regulations provided a number of examples of applying the “realistic possibility” standard at Reg. §1.6694-2(b)(3):

EXAMPLE 1. A new statute is unclear as to whether a certain transaction that a taxpayer has engaged in will result in favorable tax treatment. Prior law, however, supported the taxpayer's position. There are no regulations under the new statute and no authority other than the statutory language and committee reports. The committee reports state that the intent was not to adversely affect transactions similar to the taxpayer's transaction. The taxpayer's position satisfies the realistic possibility standard.

EXAMPLE 2. A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supported a position favorable to the taxpayer. The preparer believes that the new statute is inequitable as applied to the taxpayer's situation. The statutory language is unambiguous as it applies to the transaction (e.g., it applies to all manufacturers and the taxpayer is a manufacturer of widgets). The committee reports do not specifically address the taxpayer's situation. *A position contrary to the statute does not satisfy the realistic possibility standard [emphasis added].*

EXAMPLE 3. The facts are the same as in Example 2, except the committee reports indicate that Congress did not intend to apply the new statutory provision

to the taxpayer's transaction (e.g., to a manufacturer of widgets). Thus, there is a conflict between the general language of the statute, which adversely affects the taxpayer's transaction, and a specific statement in the committee reports that transactions such as the taxpayer's are not adversely affected. *A position consistent with either the statute or the committee reports satisfies the realistic possibility standard. However, a position consistent with the committee reports constitutes a disregard of a rule or regulation and, therefore, must be adequately disclosed in order to avoid the section 6694(b) penalty. [Emphasis added]*

EXAMPLE 4. The instructions to an item on a tax form published by the Internal Revenue Service are incorrect and are clearly contrary to the regulations. Before the return is prepared, the Internal Revenue Service publishes an announcement acknowledging the error and providing the correct instruction. Under these facts, a position taken on a return which is consistent with the regulations satisfies the realistic possibility standard. On the other hand, a position taken on a return which is consistent with the incorrect instructions does not satisfy the realistic possibility standard. *However, if the preparer relied on the incorrect instructions and was not aware of the announcement or the regulations, the reasonable cause and good faith exception may apply depending on all facts and circumstances. See section 1.6694-2(d). [Emphasis added]*

EXAMPLE 5. A statute is silent as to whether a taxpayer may take a certain position on the taxpayer's 1991 Federal income tax return. Three private letter rulings issued to other taxpayers in 1987 and 1988 support the taxpayer's position. However, proposed regulations issued in 1990 are clearly contrary to the taxpayer's position. After the issuance of the proposed regulations, the earlier private letter rulings cease to be authorities and are not taken into account in determining whether the taxpayer's position satisfies the realistic possibility standard. See section 1.6694-2(b)(2) and section 1.6662-4(d)(3)(iii). The taxpayer's position may or may not satisfy the realistic possibility standard, depending on an analysis of all the relevant authorities.

EXAMPLE 6. In the course of researching whether a particular position has a realistic possibility of being sustained on its merits, a preparer discovers that a taxpayer took the same position on a return several years ago and that the return was audited by the Service. The taxpayer tells the preparer that the revenue agent who conducted the audit was aware of the position and decided that the treatment on the return was correct. The revenue agent's report, however, made no mention of the position. *The determination by the revenue agent is not authority for purposes of the realistic possibility standard. [Emphasis added]* However, the preparer's reliance on the revenue agent's determination in the audit may qualify for the reasonable cause and good faith exception depending on all facts and circumstances. See section 1.6694-2(d). Also see section 1.6694-2(b)(4) and section 1.6662-4(d)(3)(iv)(A) regarding affirmative statements in a revenue agent's report.

EXAMPLE 7. In the course of researching whether an interpretation of a phrase incorporated in the Internal Revenue Code has a realistic possibility of being sustained on its merits, a preparer discovers that identical language in the taxing statute of another jurisdiction (e.g., a state or foreign country) has been authoritatively construed by a court of that jurisdiction in a manner which would be favorable to the taxpayer, if the same interpretation were applied to the phrase applicable to the taxpayer's situation. *The construction of the statute of the other jurisdiction is not authority for purposes of determining whether the position satisfies the realistic possibility standard.* See section 1.6694-2(b)(2) and section 1.6662-4(d)(3)(iii). *However, as in the case of conclusions reached in treatises and legal periodicals, the authorities underlying the court's opinion, if relevant to the taxpayer's situation, may give a position favorable to the taxpayer a realistic possibility of being sustained on its merits. [Emphasis added]* See section 1.6694-2(b)(2) and section 1.6662-4(d)(3)(iii).

EXAMPLE 8. In the course of researching whether an interpretation of a statutory phrase has a realistic possibility of being sustained on its merits, a preparer discovers that identical language appearing in another place in the Internal Revenue Code has consistently been interpreted by the courts and by the Service in a manner which would be favorable to the taxpayer, if the same interpretation were applied to the phrase applicable to the taxpayer's situation. No authority has interpreted the phrase applicable to the taxpayer's situation. The interpretations of the identical language are relevant in arriving at a well reasoned construction of the language at issue, but the context in which the language arises also must be taken into account in determining whether the realistic possibility standard is satisfied.

EXAMPLE 9. A new statutory provision is silent on the tax treatment of an item under the provision. However, the committee reports explaining the provision direct the Treasury to issue regulations interpreting the provision in a specified way. No regulations have been issued at the time the preparer must recommend a position on the tax treatment of the item, and no other authorities exist. The position supported by the committee reports satisfies the realistic possibility standard.

For purposes of coming to the conclusion on “realistic possibility” issues, we looked to the sources cited in Reg. §1.6662-4(d)(3)(iii) [Reg. §1.6694-2(b)(2)]. That regulation provides some interesting analysis in general on the level of authorities:

(2) Substantial authority standard.

The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in

section 1.6662-3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) Determination of whether substantial authority is present.

(i) 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 treatment. 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. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) Nature of analysis.

The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

(iii) Types of authority.

Except in cases described in paragraph (d)(3)(iv) of this section concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item. Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

(iv) Special rules

(A) Written determinations.

There is substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter (as defined in section 301.6110-2(d) and (e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer ("written determinations"). The preceding sentence does not apply, however, if --

(1) There was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based, or

(2) The written determination was modified or revoked after the date of issuance by --

(i) A notice to the taxpayer to whom the written determination was issued,

(ii) The enactment of legislation or ratification of a tax treaty,

(iii) A decision of the United States Supreme Court,

(iv) The issuance of temporary or final regulations, or

(v) The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin.

Except in the case of a written determination that is modified or revoked on account of section 1.6662-4(d)(3)(iv)(A)(1), a written determination that is modified or revoked as described in section 1.6662-4(d)(3)(iv)(A)(2) ceases to be authority on the date, and to the extent, it is so modified or revoked. See section 6404(f) for rules which require the Secretary to abate a penalty that is attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the Internal Revenue Service.

(B) Taxpayer's jurisdiction.

The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

(C) When substantial authority determined.

There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

The "reasonable basis" definition is found in Reg. §1.662-3(b)(3), and is defined as follows:

(3) Reasonable basis.

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable

basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in section 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in section 1.6662-4(d)(2). (See section 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in section 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

The hierarchy of “position support” noted in the above regulation, and implied by statute, would go as follows:

- More likely than likely not (greater than 50% chance of being sustained on its merits)
- Substantial authority (less than 50% chance of being sustained, but more likely than the reasonable basis)
- Reasonable basis (does not meet substantial authority level, but is based on some authority and is not frivolous or patently improper)
- Frivolous position/patently improper

Note that for purposes of the penalty on the taxpayer for an accuracy related penalty for substantial understatement under §6662(d), there is a different set of issues for disclosure. That penalty does not apply if the position meets:

- For other than tax shelters (as defined at §6662(d)(2)(C)(iii))
 - Substantial authority for a nondisclosed item
 - Reasonable basis for a disclosed item
- For tax shelters, the position must be one that the taxpayer reasonably believed met the more likely than not test¹ when the return was filed.

As many have pointed out, these rules can create a conflict, since advice on whether a client must disclose may be impacted by the potential penalties on the preparer, since the rules are not the same. That is, it is possible that you could have a “substantial authority” position that arguably might not meet the 1/3 test of the “realistic possibility” preparer test under the old law.

¹ This penalty is the one that the “covered opinion” rules found at Circular 230 ¶10.35 were aimed at. Of course, as we’ve discussed earlier, the “waiver” language found in Circular 230, and used as a routine matter by many accounting and law firms, does not restrict reliance only to this penalty provision.

However, for most preparers this seemed an unlikely situation, and most often they could persuade themselves that if the matter fell into the “disclose to avoid preparer penalty” area it likely fell into the same category for the client. That comfort zone has been eliminated under the new law.

New Law

The new law, now effective, modifies §6694(a) as follows:

- (a) UNDERSTATEMENT DUE TO UNREASONABLE POSITIONS-
- (1) IN GENERAL- Any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of --
- (A) \$1,000, or
- (B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.
- (2) UNREASONABLE POSITION- A position is described in this paragraph if --
- (A) the tax return preparer knew (or reasonably should have known) of the position,
- (B) there was not a reasonable belief that the position would *more likely than not* be sustained on its merits, and
- (C)(i) the position was not disclosed as provided in section 6662(d)(2)(B)(ii), or
- (ii) there was no reasonable basis for the position.
- (3) REASONABLE CAUSE EXCEPTION- No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

Note that a preparer is now exposed to penalty for any position that fails the “more likely than not” test, while taxpayers are not exposed to substantial understatement penalties even without disclosure so long as there is substantial authority (§6662(d)(2)(B)(i) is still in the law, but note that preparers don’t get that option to get out of the penalty).

It’s also important to note that previously Section 10.34 of Circular 230 effectively “dovetailed” with §6694(a), as it prohibited a covered person from signing a return if it didn’t meet the “realistic possibility” standard. Circular 230 ¶10.34(a) provides (even today):

- (a) Realistic possibility standard. A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic

possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless--

(1) The practitioner determines that the position satisfies the realistic possibility standard; or

(2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code by adequately disclosing the position and of the requirements for adequate disclosure.

Under Circular 230, the “more likely than not” standard appears in the covered opinion arena under §10.35.

While it would not be surprising to see the IRS change the provisions of ¶10.34, and for Congress to eventually tie §6662 to the same standard, for now we have a major “disconnect” in this area.

As noted last week, the new §6662 also applies to more than just income tax returns. As well, it likely creates a conflict of interest that may give rise to certain claims down the line. Unlike the Circular 230 panic of two years ago, in my view this change in the law *will* affect many preparers, especially given the “knew or should have known” provisions in the law.

In essence, an issue could arise on any assessment where inadequate records are involved at the client level whether the preparer “should have known” about this inadequacy. And remember that the fine is a \$1,000 *minimum* fine—so even a “widows and orphans” return (and we all have them) could end up with a \$1,000 fine if good old Mrs. Jones has inadequate records that, it may be argued, we should have figured out due to her increasing state of confusion as she aged.

Adequate Disclosure

What is currently “adequate disclosure” is governed by Revenue Procedure 2006-48, which is reproduced below. As I noted when I discussed its predecessor in an earlier podcast, one of the key factors is that the instructions to the forms must be followed to have adequate disclosure—and, in some cases, additional information must be provided (such as when related parties are involved).

Rev. Proc. 2006-48

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2005-75, 2005-50 I.R.B. 1137, and identifies circumstances under which the disclosure on a taxpayer's return with respect to an item or a position is adequate for the purpose of reducing the

understatement of income tax under section 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under section 6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply with respect to any other penalty provisions (including the disregard provisions of the section 6662 accuracy-related penalty, which are subject to an exception for adequate disclosure).

This revenue procedure applies to any return filed on 2006 tax forms for a taxable year beginning in 2006, and to any return filed on 2006 tax forms in 2007 for short taxable years beginning in 2007.

SECTION 2. CHANGES FROM REV. PROC. 2005-75

.01. Editorial changes have been made in updating Rev. Proc. 2005-75.

.02. Section 4.02(3) concerning difference in book and income tax reporting is expanded by adding new Schedules M-3 for Forms 1065, U.S. Return of Partnership Income, 1120-L, U.S. Life Insurance Company Income Tax Return, 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, 1120S, U.S. Income Tax Return for an S Corporation, which reconcile net income (loss) in the financial statements to that shown on an entity's return.

SECTION 3. BACKGROUND

.01 If section 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20 percent of the portion of the underpayment to which the section applies is added to the tax. (The penalty rate is 40 percent in the case of gross valuation misstatements under section 6662(h).) Section 6662(b)(2) applies to the portion of an underpayment of tax that is attributable to a substantial understatement of income tax.

.02 Section 6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return for the taxable year or \$5,000. Section 6662(d)(1)(B) provides special rules for corporations. A corporation (other than an S corporation or personal holding company) has a substantial understatement of income tax if the amount of the understatement exceeds the lesser of 10 percent of the tax required to be shown on the return for a taxable year (or, if greater, \$10,000) or \$10,000,000. Section 6662(d)(2) defines an understatement as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate (within the meaning of section 6211(b)(2)).

.03 In the case of an item not attributable to a tax shelter, section 6662(d)(2)(B)(ii) provides that the amount of the understatement is reduced by the portion of the understatement attributable to any item with respect to which the relevant facts

affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of the item by the taxpayer.

.04 Section 6694 imposes a penalty of \$250 on an income tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position for which the preparer knew or should have known that there was not a realistic possibility of being sustained on the merits and the position was not disclosed in accordance with section 6662(d)(2)(B)(ii).

.05 In general, this revenue procedure provides guidance for determining when disclosure is adequate for purposes of section 6662(d)(2)(B)(ii) and section 6694(a)(3). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the money amounts entered on these forms must be verifiable. Annual guidance under Treas. Reg. § 1.6662-4(f)(2) and Treas. Reg. § 1.6694-3(e)(1) and (2) for returns filed on 2005, 2004, and 2003 tax forms is provided in Rev. Proc. 2005-75, Rev. Proc. 2004-73, 2004-2 C.B. 999, and Rev. Proc. 2003-77, 2003-2 C.B. 964, respectively.

.06 Fiscal and short tax year returns. (a) In general. This revenue procedure may apply to a return for a fiscal tax year that begins in 2006 and ends in 2007. This revenue procedure may also apply to a short year return for a period beginning in 2007 where the return is to be filed before the 2007 forms are available. (Note that individuals are generally not put in this position as a decedent's final return for a fractional part of a year is due the fifteenth day of the fourth month following the close of the 12-month period which began with the first day of such fractional part of the year. See Treas. Reg. section 1.6072-1(b).) In the case of fiscal year and short year returns, the taxpayer must take into account any tax law changes that are effective for tax years beginning after December 31, 2006, even though these changes are not reflected on the form.

(b) Tax law changes effective after December 31, 2006. This document does not take into account the effect of tax law changes effective for tax years beginning after December 31, 2006. If a line referenced in this revenue procedure is affected by such a change and requires additional reporting, a taxpayer may have to file Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, until the Service prescribes criteria for complying with the requirement.

SECTION 4. PROCEDURE

.01 General.

(1) Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under section 6662(d) (except as

otherwise provided in section 4.02(3) concerning Schedules M-1 and M-3), provided that the forms and attachments are completed in a clear manner and in accordance with their instructions.

(2) The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form.

(3) The disclosure of an amount as provided in section 4.02 below is not adequate when the understatement arises from a transaction between related parties. If an entry may present a legal issue or controversy because of a related party transaction, then that transaction and the relationship must be disclosed on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement.

(4) Where the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an "Other Expense" category) the taxpayer must clearly identify the item by including the description on that line. For example, to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written or typed on the line of Schedule C that shows the amount of the bad debt. Also, for Schedule M-3 (Form 1120), Part II, line 25, Other income (loss) items with differences, or Part III, line 35, Other expense/deduction items with differences, the entry must provide descriptive language; for example, "Cost of non-compete agreement deductible not capitalizable." If space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.

(5) Although a taxpayer may literally meet the disclosure requirements of this revenue procedure, the disclosure will have no effect for purposes of the section 6662 accuracy-related penalty if the item or position on the return: (1) Does not have a reasonable basis as defined in Treas. Reg. § 1.6662-3(b)(3); (2) Is attributable to a tax shelter item as defined in section 6662(d)(2) and Treas. Reg. § 1.6662-4(g); or (3) Is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position. See Treas. Reg. § 1.6694-2(c) regarding limitations on the effectiveness of a disclosure regarding the section 6694 return preparer penalty.

.02 Items.

(1) Form 1040, Schedule A, Itemized Deductions:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

(c) Interest Expenses: Complete lines 10 through 14, supplying all required information. This section 4.02(1)(c) does not apply to (i) amounts disallowed under section 163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or (ii) amounts disallowed under section 265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Enter the amount of the contribution reduced by the value of any substantial benefit (goods or services) provided by the donee organization in consideration, in whole or in part. Entering the value of the contribution unreduced by the value of the benefit received will not constitute adequate disclosure. If a contribution of \$250 or more is made, this section will not apply unless a contemporaneous written acknowledgment, as required by section 170(f)(8), is obtained from the donee organization. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds \$500, attach a properly completed Form 8283, Noncash Charitable Contributions, to the return. In addition to the Form 8283, if a contribution of a qualified motor vehicle, boat, or airplane has a value of more than \$500, this section will not apply unless a contemporaneous written acknowledgment, as required by section 170(f)(12), is obtained from the donee organization and attached to the return. An acknowledgment under section 170(f)(8) is not required if an acknowledgment under section 170(f)(12) is required.

(e) Casualty and Theft Losses: Complete Form 4684, Casualties and Thefts, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section, the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.02(1)(e) must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or non-deductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section does not apply to "golden parachute" payments, as defined under section 280G. This section will not apply to the extent

that remuneration paid or incurred exceeds the \$1 million-employee-remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Differences in book and income tax reporting.

(a) Form 1065. Schedule M-3 (Form 1065), Net Income (Loss) Reconciliation for Certain Partnerships: Column (b), Temporary Difference, and Column (c), Permanent Difference, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(b) Form 1120. (i) Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return.

(ii) Schedule M-3 (Form 1120), Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More: Column (b), Temporary Difference, and Column (c), Permanent Difference, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(c) Form 1120-L. Schedule M-3 (Form 1120-L), Net Income (Loss) Reconciliation for U.S. Life Insurance Companies With Total Assets of \$10 Million or More: Column (b), Temporary Difference, and Column (c), Permanent Difference, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(d) Form 1120-PC. Schedule M-3 (Form 1120-PC), Net Income (Loss) Reconciliation for U.S. Property and Casualty Insurance Companies With Total Assets of \$10 Million or More: Column (b), Temporary Difference, and Column (c), Permanent Difference, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(e) Form 1120-S. Schedule M-3 (Form 1120S), Net Income (Loss) Reconciliation for S Corporations With Total Assets of \$10 Million or More: Column (b), Temporary Difference, and Column (c), Permanent Difference, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

For Schedule M-1 and all Schedules M-3, the information provided reasonably must be expected to apprise the Service of the nature of the potential controversy concerning the tax treatment of the item. If the information provided does not so apprise the Service, a Form 8275 or Form 8275-R, must be used to adequately disclose the item (see Part II of the instructions for those forms).

Note: An item reported on a line with a pre-printed description, shown on an attached schedule, or "itemized" on Schedule M-1 may represent the aggregate amount of several transactions producing that item (i.e., a group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business). In some instances, the potentially controversial item may involve a portion of the amount disclosed on the schedule. The Service will not be reasonably apprised of the potential controversy by the amount disclosed. In these instances, the taxpayer must use Form 8275 or Form 8275-R regarding that portion of the item.

The combining of unlike items, whether on Schedule M-1 or Schedule M-3 (or on an attachment when directed by the instructions), will not constitute an adequate disclosure.

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, International Boycott Report. Schedule A, International Boycott Factor (Section 999(c)(1)); Schedule B, Specifically Attributable Taxes and Income (Section 999(c)(2)); and Schedule C, Tax Effect of the International Boycott Provisions, must be completed when required by their instructions.

(b) Treaty-Based Return Position: Transactions and amounts under section 6114 or section 7701(b) as disclosed on Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).

(5) Other:

(a) Moving Expenses: Complete Form 3903, Moving Expenses, and attach to the return.

(b) Employee Business Expenses: Complete Form 2106, Employee Business Expenses, or Form 2106-EZ, Unreimbursed Employee Business Expenses, and attach to the return. This section does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on the trip.

(c) Fuels Credit: Complete Form 4136, Credit for Federal Tax Paid on Fuels, and attach to the return.

(d) Investment Credit: Complete Form 3468, Investment Credit, and attach to the return.

SECTION 5. EFFECTIVE DATE

This revenue procedure applies to any return filed on a 2006 tax form for a taxable year beginning in 2006, and to any return filed on a 2006 tax form in 2007 for a short taxable year beginning in 2007.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is John M. Moran of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue procedure, contact John M. Moran at (202) 622-4940 (not a toll-free call).

I would expect the IRS to update this procedure later this year, and it will be interesting to see what changes they decide to make now that Congress appears to be giving the direction to “get tough” on preparers.