TAX UPDATE

Ed Zollars, CPA

Substantial Understatements—the Penalty under §6662(b)(2)

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Substantial Understatement Penalty

We pick up the second of the penalties under §6662 that we are considering in this series of podcasts this week. This week we look the penalty that falls under §6662(b)(2) for “any substantial understatement of income tax” as defined by this section. Like the other penalties under §6662, this penalty will cost the taxpayer 20% of the amount the resulting underpayment.

The key operational provisions for this penalty are found at §6662(d). As might be expected, a “substantial” understatement is triggered by a quantitative measurement, and the definition of the amounts that trigger the penalty are found at §6662(d)(1):

> (1) Substantial understatement
>
> (A) In general

> For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of--
>
> (i) 10 percent of the tax required to be shown on the return for the taxable year, or
>
> (ii) $5,000.

Under the general rule, we have a floor of $5,000—an understatement below that level will not trigger the penalty. That floor would apply to taxpayers until the total tax on the return for the year in question (after adjustment) exceeds $50,000. From that point forward, the penalty is triggered if the assessment is more than 10% of the amount finally found to be due.

A different test is applied for most corporations, as found in §6662(d)(1)(B):

> (B) Special rule for corporations
>
> In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of--
>
> (i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or
>
> (ii) $10,000,000.

For corporations (other than S corporations or personal holding companies), the penalty has a $10,000 floor for returns that have an overall liability of less than $100,000, a floor of 10% of the tax eventually determined to be due on the return for returns with total tax of $100,000 to $100,000,000, and then a $10,000,000 trigger for all returns after that point.

Computing the Understatement

The IRC provides the basic computation of the underpayment at §6662(d)(2)(A):

> (2) Understatement
>
> (A) In general
>
> For purposes of paragraph (1), the term "understatement" means the excess of--

> (i) the amount of the tax required to be shown on the return for the taxable year, over
>
> (ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).
>
> The excess under the preceding sentence shall be determined without regard to items to which section 6662A applies.

§6662A is the special penalties applicable to reportable transactions when an underpayment is assessed.

In the regulations, the IRS gives some additional details about this computation[1]. That information is found at Reg. §1.6662-4(b)(2):

> 2) Understatement.
>
> Except as provided in paragraph (c)(2) of this section (relating to special rules for carrybacks), the term "understatement" means the excess of --
>
> (i) The amount of the tax required to be shown on the return for the taxable year (as defined in paragraph (b)(3) of this section), over
>
> (ii) The amount of the tax imposed which is shown on the return for the taxable year (as defined in paragraph (b)(4) of this section), reduced by any rebate (as defined in paragraph (b)(5) of this section).
>
> The definition of understatement also may be expressed as --
>
> UNDERSTATEMENT = X - (Y - Z)
>
> where X = the amount of the tax required to be shown on the return; Y = the amount of the tax imposed which is shown on the return; and Z = any rebate.

The amount of tax imposed on the return is defined indirectly in Reg. §1.6662-4(b)(3):

> (3) Amount of the tax required to be shown on the return.
>
> The "amount of the tax required to be shown on the return" for the taxable year has the same meaning as the "amount of income tax imposed" as defined in section 1.6664-2(b).

Reg. §1.6664-2(b) defines that term as follows:

> (b) Amount of income tax imposed.

[1] Special rules apply to carrybacks and carryovers as they impact this calculation that we won't cover in this presentation. If you have that situation, consult Reg. §1.6662-4(c).

> For purposes of paragraph (a) of this section, the "amount of income tax imposed" is the amount of tax imposed on the taxpayer under subtitle A for the taxable year, determined without regard to --
>
> (1) The credits for tax withheld under sections 31 (relating to tax withheld on wages) and 33 (relating to tax withheld at source on nonresident aliens and foreign corporations);
>
> (2) Payments of tax or estimated tax by the taxpayer;
>
> (3) Any credit resulting from the collection of amounts assessed under section 6851 as the result of a termination assessment, or section 6861 as the result of a jeopardy assessment; and
>
> (4) Any tax that the taxpayer is not required to assess on the return (such as the tax imposed by section 531 on the accumulated taxable income of a corporation).

Most readers aren't going to find that computation terribly surprising.

The amount of tax imposed which is shown on the return is defined by Reg. §1.6662-4(b)(4) as follows:

> (4) Amount of the tax imposed which is shown on the return.
>
> The "amount of the tax imposed which is shown on the return" for the taxable year has the same meaning as the "amount shown as the tax by the taxpayer on his return," as defined in section 1.6664-2(c), except that --
>
> (i) There is no reduction for the excess of the amount described in section 1.6664-2(c)(1)(i) over the amount described in section 1.6664-2(c)(1)(ii), …

We have to stop here and look at Reg. §1.6664-2(c)

> (c) Amount shown as the tax by the taxpayer on his return
>
> (1) Defined.
>
> For purposes of paragraph (a) of this section, the amount shown as the tax by the taxpayer on his return is the tax liability shown by the taxpayer on his return, determined without regard to the items listed in paragraphs (b)(1), (2), and (3) of this section, except that it is reduced by the excess of --
>
> (i) The amounts shown by the taxpayer on his return as credits for tax withheld under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), as payments of estimated tax, or as any other payments made by the taxpayer with respect to a taxable year before filing the return for such taxable year, over

> (ii) The amounts actually withheld, actually paid as estimated tax, or actually paid with respect to a taxable year before the return is filed for such taxable year.

It's important to note that the withholdings and other payments are removed from equation—again not surprisingly.

However, another issue is the existence of a qualified amended return, if it exists. Such a return will add nonfraudulent positions to the original tax reported.

> (2) Effect of qualified amended return.
>
> The amount shown as the tax by the taxpayer on his return includes an amount shown as additional tax on a qualified amended return (as defined in paragraph (c)(3) of this section), except that such amount is not included if it relates to a fraudulent position on the original return.

That raises the question of what is a qualified amended return, and the regulation goes on to define that:

> (3) Qualified amended return defined
>
> (i) General rule.
>
> A qualified amended return is an amended return, or a timely request for an administrative adjustment under section 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) and before the earliest of --
>
> (A) The date the taxpayer is first contacted by the Internal Revenue Service (IRS) concerning any examination (including a criminal investigation) with respect to the return;
>
> (B) The date any person is first contacted by the IRS concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters) for an activity with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan or arrangement described in section 6700(a)(1)(A);
>
> (C) In the case of a pass-through item (as defined in § 1.6662-4(f)(5)), the date the pass-through entity (as defined in § 1.6662-4(f)(5)) is first contacted by the IRS in connection with an examination of the return to which the pass-through item relates;
>
> (D)(1) The date on which the IRS serves a summons described in section 7609(f) relating to the tax liability of a person, group, or class that includes the taxpayer (or pass-through entity of which the taxpayer is a partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) with respect

to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly.

(2) The rule in paragraph (c)(3)(i)(D)(1) of this section applies to any return on which the taxpayer claimed a direct or indirect tax benefit from the type of activity that is the subject of the summons, regardless of whether the summons seeks the production of information for the taxable period covered by such return; and

(E) The date on which the Commissioner announces by revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction. This rule applies only to a taxpayer who participated in the listed transaction and for the taxable year(s) in which the taxpayer claimed any direct or indirect tax benefits from the listed transaction. The Commissioner may waive the requirements of this paragraph or identify a later date by which a taxpayer who participated in the listed transaction must file a qualified amended return in the published guidance announcing the listed transaction settlement initiative.

(ii) Undisclosed listed transactions.

An undisclosed listed transaction is a transaction that is the same as, or substantially similar to, a listed transaction within the meaning of § 1.6011-4 (b)(2) (regardless of whether § 1.6011-4 requires the taxpayer to disclose the transaction) and was neither previously disclosed by the taxpayer within the meaning of § 1.6011-4 or § 1.6011-4T, nor disclosed under Announcement 2002-2 (2002-1 C.B. 304), (see § 601.601(d)(2)(ii) of this chapter) by the deadline therein. In the case of an undisclosed listed transaction for which a taxpayer claims any direct or indirect tax benefits on its return (regardless of whether the transaction was a listed transaction at the time the return was filed), an amended return or request for administrative adjustment under section 6227 will not be a qualified amended return if filed on or after the earliest of --

(A) The dates described in paragraph(c)(3)(i) of this section;

(B) The date on which the IRS first contacts any person regarding an examination of that person's liability under section 6707(a) with respect to the undisclosed listed transaction of the taxpayer; or

(C) The date on which the IRS requests, from any person who made a tax statement to or for the benefit of the taxpayer or from any person who gave the taxpayer material aid, assistance, or advice as described in section 6111(b)(1)(A)(i) with respect to the taxpayer, the information required to be

> included on a list under section 6112 relating to a transaction that was the same as, or substantially similar to, the undisclosed listed transaction, regardless of whether the taxpayer's information is required to be included on that list.
>
> (4) Special rules.
>
> (i) A qualified amended return includes an amended return that is filed to disclose information pursuant to § 1.6662-3(c) or § 1.6662-4(e) and (f) even though it does not report any additional tax liability. See § 1.6662-3(c), § 1.6662-4(f), and § 1.6664-4(c) for rules relating to adequate disclosure.
>
> (ii) The Commissioner may by revenue procedure prescribe the manner in which the rules of paragraph (c) of this section regarding qualified amended returns apply to particular classes of taxpayers.

Note that even a "zero tax due return" may make a difference here. The provisions under Reg. §1.6662-4(e) and (f), which are the disclosure rules for the substantial underpayment penalty, as is noted as we continue with Reg. §1.6662-(b)(4):

> … and
>
> (ii) The tax liability shown by the taxpayer on his return is recomputed as if the following items had been reported properly:
>
> (A) Items (other than tax shelter items as defined in section 1.6662-4(g)(3)) for which there is substantial authority for the treatment claimed (as provided in section 1.6662-4(d)).
>
> (B) Items (other than tax shelter items as defined in section 1.6662-4(g)(3)) with respect to which there is adequate disclosure (as provided in section 1.6662-4(e) and (f)).
>
> (C) Tax shelter items (as defined in section 1.6662-4(g)(3)) for which there is substantial authority for the treatment claimed (as provided in section 1.6662-4(d)), and with respect to which the taxpayer reasonably believed that the tax treatment of the items was more likely than not the proper tax treatment (as provided in section 1.6662-4(g)(4)).

As noted, we can add additional assessments that meet those three tests to the amount on the original return for purposes of determining if the substantial understatement penalty applies.

Finally we have the definition of a rebate, found in Reg. §1.6662-4(b)(5):

> (5) Rebate.
>
> The term "rebate" has the meaning set forth in section 1.6664-2(e), except that --

> (i) "Amounts not so shown previously assessed (or collected without assessment)" includes only amounts not so shown previously assessed (or collected without assessment) as a deficiency, and
>
> (ii) The amount of the rebate is determined as if any items to which the rebate is attributable that are described in paragraph (b)(4) of this section had received the proper tax treatment.

And the cross reference at Reg. §1.6664-2(e) reads:

> (e) Rebates.
>
> The term "rebate" means so much of an abatement credit, refund or other repayment, as was made on the ground that the tax imposed was less than the excess of --
>
> (1) The sum of --
>
> (i) The amount shown as the tax by the taxpayer on his return, plus
>
> (ii) Amounts not so shown previously assessed (or collected without assessment), over
>
> (2) Rebates previously made.

Benefits of Disclosure

§6662(d)(2)(B) provides for relief from this mechanical penalty in certain cases if there is adequate disclosure. The provision reads:

> (B) Reduction for understatement due to position of taxpayer or disclosed item
>
> The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to--
>
> (i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
>
> (ii) any item if--
>
> (I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and
>
> (II) there is a reasonable basis for the tax treatment of such item by the taxpayer.
>
> For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation.

As should be familiar from last week, we have various levels of "comfort" that trigger penalty relief if the position obtains that level of comfort. We'll look at these levels of comfort for the general relief before considering the more limited options for tax shelters.

Substantial Authority

Reg. §1.6662-4(d) provides the basic definition, including a list of sources we looked at when discussing the general negligence standard.

> d) Substantial authority
>
> (1) Effect of having substantial authority.
>
> If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see section 1.6662-4(g).)
>
> (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.

Here we find our positioning for "substantial authority," noting that it does not require a greater than 50% possibility of success (the more likely than not standard that applies to §6694(a)), but it requires more than a "reasonable basis" of success (which is now the minimum level for a disclosed position under §6694(a)).

As we discussed last week, the reasonable basis standard is positioned as a "relatively high" standard, but clearly higher than not frivolous, according to Reg. §1.6662-3(b)(3). However, clearly it is a less rigorous standard than substantial authority. Reg. §1.6662-3 also makes clear that we use the same authorities to establish a reasonable basis position as we do for substantial authority—so it would appear it applies when the authorities aren't necessarily "substantial" but are more than a merely colorable claim—that is, some authority appears to exist aside from just the musings on what, maybe, some item in IRC might mean.

(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.

The special rules deserve some consideration—first, certain documents issued by the IRS will constitute substantial authority by default.

> (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)(l), 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.

The next provision generally indicates that a taxpayer's place of residence doesn't impact the issue of whether there is substantial authority—but then immediately carves out a large "exception" by noting that if the taxpayer's position is supported by controlling precedent for the Court of Appeals that the case would eventually end up in, that is substantial authority.

> (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.

The taxpayer gets two chances on the timing of the substantial authority test—either when the return is filed or the last day of the taxable year in question.

> (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.

Reasonable Basis Disclosure

If there exists reasonable basis for the position, the penalty may still be avoided outside the tax shelter context if the position is adequately disclosed. Reg. §1.6662-4(e) provides for the general applicability of disclosure and its restrictions:

> (e) Disclosure of certain information
>
> (1) Effect of adequate disclosure.
>
> Items for which there is adequate disclosure as provided in this paragraph (e) and in paragraph (f) of this section are treated as if such items were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to such items is not included in the understatement for that year.
>
> (2) Circumstances where disclosure will not have an effect.
>
> The rules of paragraph (e)(1) of this section do not apply where the item or position on the return --
>
> (i) Does not have a reasonable basis (as defined in section 1.6662-3(b)(3));
>
> (ii) Is attributable to a tax shelter (as defined in section 6662(d)(2)(C)(iii) and paragraph (g)(2) of this section); or
>
> (iii) Is not properly substantiated, or the taxpayer failed to keep adequate books and records with respect to the item or position.
>
> (3) Restriction for corporations.
>
> For purposes of paragraph (e)(2)(i) of this section, a corporation will not be treated as having a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction entered into after August 5, 1997, if the treatment does not clearly reflect the income of the corporation.

The method of disclosure is covered in Reg. §1.6662-4(f).

> (f) Method of making adequate disclosure
>
> (1) Disclosure statement.
>
> Disclosure is adequate with respect to an item (or group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business)

or a position on a return if the disclosure is made on a properly completed form attached to the return or to a qualified amended return (as defined in section 1.6664-2(c)(3)) for the taxable year. In the case of an item or position other than one that is contrary to a regulation, disclosure must be made on Form 8275 (Disclosure Statement); in the case of a position contrary to a regulation, disclosure must be made on Form 8275-R (Regulation Disclosure Statement).

(2) Disclosure on return.

The Commissioner may by annual revenue procedure (or otherwise) prescribe the circumstances under which disclosure of information on a return (or qualified amended return) in accordance with applicable forms and instructions is adequate. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return.

The methods of disclosure noted above should seem familiar, since they essentially are the same methods allowed for the preparer for disclosures that are meant to get relief from the §6694(a) penalty. That includes consulting Revenue Procedure 2006-48 (and its successors for later tax years) for disclosures that qualify under Reg. §1.6662-4(f)(2).

(3) Recurring item.

Disclosure with respect to a recurring item, such as the basis of recovery property, must be made for each taxable year in which the item is taken into account.

The fact that a taxpayer disclosed the matter in the year of the original transaction does not remove the need to continue that disclosure in future years.

(4) Carrybacks and carryovers.

Disclosure is adequate with respect to an item which is included in any loss, deduction or credit that is carried to another year only if made in connection with the return (or qualified amended return) for the taxable year in which the carryback or carryover arises (the "loss or credit year"). Disclosure is not also required in connection with the return for the taxable year in which the carryback or carryover is taken into account.

Note the special rule for carryback and carryover items—disclosure is to be made on the return generating the loss or credit and is not required on the years the loss or credit is being carried to. Be sure to consult Reg. §1.6662-4(c) for special rules that impact carryovers in the overall substantial underpayment penalty arena.

(5) Pass-through entities.

> Disclosure in the case of items attributable to a pass-through entity (pass-through items) is made with respect to the return of the entity, except as provided in this paragraph (f)(5). Thus, disclosure in the case of pass-through items must be made on a Form 8275 or 8275-R, as appropriate, attached to the return (or qualified amended return) of the entity, or on the entity's return in accordance with the revenue procedure described in paragraph (f)(2) of this section, if applicable. A taxpayer (i.e., partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) also may make adequate disclosure with respect to a pass- through item, however, if the taxpayer files a properly completed Form 8275 or 8275-R, as appropriate, in duplicate, one copy attached to the taxpayer's return (or qualified amended return) and the other copy filed with the Internal Revenue Service Center with which the return of the entity is required to be filed. Each Form 8275 or 8275-R, as appropriate, filed by the taxpayer should relate to the pass- through items of only one entity. For purposes of this paragraph (f)(5), a pass-through entity is a partnership, S corporation (as defined in section 1361(a)(1)), estate, trust, regulated investment company (as defined in section 851(a)), real estate investment trust (as defined in section 856(a)), or real estate mortgage investment conduit ("REMIC") (as defined in section 860D(a)).

A special rule is provided for pass through entities. Generally the disclosure must be made on the entity's return—but that creates a problem, since the extra tax is going to arise (and the penalty be assessed) at the individual partner or shareholder level.

Reg. §1.6662-4 allows the individual shareholder or partner to make disclosure in matters where the partnership or S corporation did not, but they do so by both filing an 8275 or 8275-R with the individual return *and* sending a copy of the disclosure to the IRS service center where the pass through entity filed its return.

Remember that this will only protect the shareholder if we have an undisclosed position on the passthrough return that has a reasonable basis. If the position fails that test, the holder of the passthrough interest should likely report the item as he/she believes is proper and file the notice of inconsistent treatment with his/her return.

Tax Shelters

A different set of rules apply if the substantial understatement arises from a "tax shelter" as defined by this provision. §6662(d)(2)(C) provides the following limations on the use of authority exceptions to the penalty:

> (C) Special rules in cases involving tax shelters
>
> (i) In general
>
> In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter--

> (I) subparagraph (B)(ii) shall not apply, and

The above refers to the disclosure exception for "reasonable basis" positions. For a tax shelter, disclosure does not impact this penalty's applicability. In fact, Reg. §1.6662-4(g)(1)(iii) specifically states "disclosure made with respect to a tax shelter item of either a corporate or noncorporate taxpayer does not affect the amount of an understatement."

However, note the reportable transaction rules may cause a separate disclosure requirement for the taxpayer—and one that, as we've discussed in the past, may be very expensive for a taxpayer to fail to make. So be sure not to read too much into the "disclosure doesn't matter" provisions noted above. As well, the §6694 penalty doesn't contain such a "no tax shelters" provision on disclosure—so a preparer may be in a position of needing disclosure on the return even if the client's position is not improved by disclosure.

> (II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

The "more likely than not" standard makes its appearance here. For a tax shelter transaction (to be defined later), the taxpayer must demonstrate a reasonable belief that the position was more likely than not one that would be sustained. Protection from this penalty was a principal motivation for many of the tax shelter opinion letters that were issued, and those letters were the target of Circular 230 Sec. 10.35's changes in 2005, as we'll see later.

> (ii) Subparagraph (B) not to apply to corporations
>
> Subparagraph (B) shall not apply to any item of a corporation which is attributable to a tax shelter.

Note that a corporation does not get any protection from the penalty based on the perceived merits of the position, unlike other taxpayers.

Obviously, a key question is what is a tax shelter. That is defined next in the Code:

> (iii) Tax shelter
>
> For purposes of this subparagraph, the term "tax shelter" means--
>
> (I) a partnership or other entity,
>
> (II) any investment plan or arrangement, or
>
> (III) any other plan or arrangement,

> if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

If the above looks familiar, you likely saw wording like that back in the summer of 2005, but in another context. Take a look at the following portion of Circular 230 Sec. 10.35's definitions for when a "covered opinion" is required:

> (2) Covered opinion
>
> (i) In general
>
> A covered opinion is written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from--…
>
> (C) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code …

The similarity in the wording is not coincidental—the IRS intended for the covered opinion rules to deal with opinions that were being created to give taxpayers protection from penalties under §6662, specifically the tax shelter penalty we are discussing here.

The regulations go on to flesh out the definition of a tax shelter and given the identical language in Circular 230 Sec. 10.35 it would seem to also help us understand what is meant there by an entity subject to the principal purpose or significant purpose test.

Note that the language defining a tax shelter was changed from "principal purpose" to "significant purpose" in 1997, though the regulation still reflects the "principal purpose" viewpoint.

Reg. §1.6662-4(g)(2) provides:

> (2) Tax shelter
>
> (i) In general.
>
> For purposes of section 6662(d), the term "tax shelter" means --
>
> (A) A partnership or other entity (such as a corporation or trust),
>
> (B) An investment plan or arrangement, or
>
> (C) Any other plan or arrangement, if the principal purpose of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax. The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose. Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial

> uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

By switching to "significant purpose" Congress has indicated that no longer can you argue that there was another purpose that was more important than tax reduction to avoid tax shelter treatment.

The "reasonable belief" is met by the client as noted in Reg. §1.6662-4(g)(4):

> (4) Reasonable belief
>
> (i) In general.
>
> For purposes of section 6662(d) and paragraph (g)(1)(i)(B) of this section (pertaining to tax shelter items of noncorporate taxpayers), a taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) --
>
> (A) The taxpayer analyzes the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section, and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or
>
> (B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.

As most taxpayers themselves lacked the ability to analyze the tax implications of the transaction, the "reliance on a professional" option is the one most often relied upon by taxpayers—and the one the IRS was aiming at in Circular 230's revisions that took effect in June of 2005.

Circular 230 and §6662

Many preparers have made use of the disclaimer in Circular 230 on all communications with clients. Unfortunately, as a study of Circular 230 §10.35 makes clear that disclaimer is only effective for significant purpose reliance opinions, and clients would normally need such opinions only for a tax shelter. However, the actual disclaimer doesn't limit its applicability in this fashion—so that language may