



Confession is Good for the Soul and Pocketbook  
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## **Penalties for Substantial Understatement and Adequate Disclosure**

The IRS has issued Revenue Procedure 2005-75, which updated Revenue Procedure 2004-73 on what constitutes adequate disclosure for the purpose of escaping penalties for substantial understatement of tax under §6662(d) and the preparer penalty under §6694(a). This procedure goes through the details of what is involved with disclosing various positions, as well as spelling out the general rules in this area.

### ***Substantial Underpayment Penalty***

IRC §6662(a) provides the following penalty

6662(a) IMPOSITION OF PENALTY. -- If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

In §6662(b) we find enumerated the items to which this penalty will apply:

6662(b) PORTION OF UNDERPAYMENT TO WHICH SECTION APPLIES. --  
This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

- (1) Negligence or disregard of rules or regulations.
- (2) Any substantial understatement of income tax.
- (3) Any substantial valuation misstatement under chapter 1.
- (4) Any substantial overstatement of pension liabilities.
- (5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

The item we are concerned with today is the substantial understatement provisions, which are defined at §6662(d):

6662(d) SUBSTANTIAL UNDERSTATEMENT OF INCOME TAX. --  
6662(d)(1) SUBSTANTIAL UNDERSTATEMENT. --  
6662(d)(1)(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 --  
6662(d)(1)(A)(i) 10 percent of the tax required to be shown on the return for the taxable year, or 6662(d)(1)(A)(ii) \$5,000.  
6662(d)(1)(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 --  
6662(d)(1)(B)(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or  
6662(d)(1)(B)(ii) \$10,000,000.  
6662(d)(2) UNDERSTATEMENT. --  
6662(d)(2)(A) IN GENERAL. --For purposes of paragraph (1), the term "understatement" means the excess of --  
6662(d)(2)(A)(i) the amount of the tax required to be shown on the return for the taxable year, over

6662(d)(2)(A)(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.

As you will note, this provides for a fairly mechanical determination of what is a substantial understatement of tax. However, Congress did provide that all such understatements will not be subject to this penalty. Aside from tax shelters (which are subject to special disclosure penalties under §6662A as you may recall), Congress indicated that a properly disclosed, nonfrivolous position would not be subjected to this penalty. That is, Congress recognized that the law can be complex, and that reasonable people can come to different conclusions on a tax matter.

The mere fact that the taxpayer eventually fails to prevail on a position is not, by itself, an indication that the position deserves to be singled out for a special penalty. However, Congress was concerned with taxpayers who may have taken “audit lottery” positions, failing to properly disclose a position and then hoping the IRS would never figure out the issue prior to the expiration of the statute. That was the group Congress really intended to penalize.

For that reason, the following exception was written to give an escape hatch from the mechanical application of the provision.

6662(d)(2)(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 --

6662(d)(2)(B)(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

6662(d)(2)(B)(ii) any item if --

6662(d)(2)(B)(ii)(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

6662(d)(2)(B)(ii)(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.

The tax shelter exception to the exception is shown below:

6662(d)(2)(C) REDUCTION NOT TO APPLY TO TAX SHELTERS. --

6662(d)(2)(C)(i) IN GENERAL. --Subparagraph (B) shall not apply to any item attributable to a tax shelter.

6662(d)(2)(C)(ii) TAX SHELTER. --For purposes of clause (i), the term "tax shelter" means --  
6662(d)(2)(C)(ii)(I) a partnership or other entity,  
6662(d)(2)(C)(ii)(II) any investment plan or arrangement, or  
6662(d)(2)(C)(ii)(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.

Those who have looked at the Circular 230 covered opinion standards will find much of that language very familiar—and that similarity might raise some interesting questions for those who see a broad application of Circular 230 to wonder if that same position would apply to this penalty. There may also be some concern that a zealous revenue agent might decide if a position was covered by a disclaimer notice from a tax professional, maybe that would indicate that the transaction met the tax shelter definition in the tax professional's view—as if you need one more “nightmare” scenario for the Circular 230 rules.

But, whatever the resolution that may be, clearly a “tax shelter” will not be protected even with adequate disclosure—so that someone making use of a tax shelter who “loses” is considered warned that the penalties will be higher.

### **Revenue Procedure 2005-75**

This procedure is updated annually to line out the items that have to be disclosed on a return and how they have to be disclosed to meet the disclosure requirement in §6662(d).

In Section 4 of the procedure, we get the guidance on what will qualify for adequate disclosure. Section 1 contains the general rules.

*Fill out the forms properly.* A condition is imposed generally that in order to come under the protection of this procedure, the forms must be completed “in a clear manner and in accordance with their instructions.” That requirement indicates that if a taxpayer had not followed the instructions for the specific forms in question, the position will not be considered to be adequately disclosed for the purpose of this penalty.

That poses some problems in the e-filing arena, specifically with the troublesome area of Schedule D transactions. CPAs are used to attaching copies of schedules prepared by the taxpayer's investment adviser to a tax return. However, the instructions for Schedule D indicate a taxpayer is to enter the transaction detail, and the excess is to go on Schedule D-1. Technically that paper attachment fails to qualify—however, it would appear some justification could be given for “substantial compliance” with the view that the IRS was provided all information necessary in a reasonable form.<sup>1</sup>

<sup>1</sup> However, note that the IRS has now specifically indicated in the Form 1040 instructions for 2005 that such “attachments” are not allowed. It will be interesting to see how tax software providers respond to this, since some well known software (like CCH's *ProSystemFX*) does not complete Schedule D-1s but rather attaches statements.

Efiling presents an issue here. The IRS 1040 efile system does not allow for attachment of copies of paper documents (though the more advanced system used for corporate returns does). So many efilers have entered totals, with the indication that the detail will be provided “on request” to the IRS. The problem there is that this seems to be much more difficult to support as substantial compliance with the requirements of the Revenue Procedure.

*Amounts verifiable.* The taxpayer must be able to provide verification for the items shown on the return. Again, if the taxpayer fails this test, the protection of the Revenue Procedure is not available.

*No related party transaction.* The protection of this ruling will not cover related party transactions—rather, they must be dealt with using Form 8275 or 8275-R, disclosing both the transaction and the relationship.

*Clear descriptions if no line item description.* If an amount does not have a line item description (such as an other expense on Schedule C), the taxpayer must provide a clear identification of the item on that line and/or on a continued attachment if space is not adequate on the form.

*Reminder that certain items have no protection.* The IRS also reminds taxpayers that under this ruling, certain items have no protection. That includes

- A tax shelter as defined in §6662(d)(2) and Regulation §1.6662-4(g)
- Does not have a reasonable basis as defined in Regulation §1.6662-3(b)(3)
- The taxpayer has failed to keep adequate books and records with respect to the item or position.

## ***Specific Items***

The ruling then goes on to discuss specific items of disclosure. For Form 1040, Schedule A, the ruling gives details on adequate disclosure for medical expenses, taxes, interest expense, contributions and casualty and theft losses. Of special interest is the requirement to meet the detailed substantiation requirements for charitable contributions and the limitations on protection for interest expense if a 4952 is not completed or the deduction is disallowed under §265.

For trade and business expenses, special guidance is provided for legal expenses, bad debt charge offs, officer’s compensation, repairs, taxes and the completion of Schedule M. Of interest here is the requirement that if Schedule E is required, that the time devoted to the business must be stated as a percentage, and descriptions such as “part” or “as needed” will not be acceptable.

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I suspect this change may be specifically directed at “solving” the efile issue by simply making it a paper issue as well.

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Foreign tax items for international boycott transactions and a treaty based return position are described.

Finally, in the “other” section, special rules for moving expenses, employee business expenses, fuels credit and the investment credit are listed.

This ruling is effective for the 2005 return.