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| 2018

What is Your Authority for That?

The Office of Professional Responsibility



Why authority matters

- The Internal Revenue Code provides for penalties for positions that result in an underpayment of tax/understatement of liability that (1) lack the appropriate level of authority and/or (2) are not adequately disclosed
 - For example, 26 U.S.C. §§ 6662 and 6694
- Circular 230 Considerations
 - Section 10.22 Diligence as to accuracy
 - Section 10.34 Standards with respect to tax returns....
 - Section 10.35 Competence
 - Section 10.37 Requirements for written advice



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Substantial Authority and the § 6662 Accuracy-Related Penalty on Underpayments

- 26 U.S.C. § 6662 – provides for the imposition of an accuracy-related penalty on underpayments.
- § 6662(a) – there is an addition to tax of 20% of the applicable portion of the underpayment to which § 6662 applies
 - 40% for gross valuation misstatements (§ 6662(h))



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Substantial Authority and the § 6662 Accuracy-Related Penalty on Underpayments

- § 6662(b) - Applies 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 (defined in § 6662(e)).



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Substantial Authority and the § 6662 Accuracy-Related Penalty on Underpayments

- (4) Any substantial overstatement of pension liabilities (defined in § 6662(f)).
- (5) Any substantial estate or gift tax valuation understatement (defined in § 6662(g)).
- (6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any similar rule of law.



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Substantial Authority and the § 6662 Accuracy-Related Penalty on Underpayments

- (7) Any undisclosed foreign financial asset understatement (defined in § 6662(j)).
- (8) Any inconsistent estate basis (see § 6662(k)).



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Negligence for Purposes of § 6662

- § 6662(c) provides that the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard
- Circular 230 implications
 - Sections 10.22 Diligence as to accuracy,
 - Section 10.34 Standards with respect to tax returns
 - Section 10.35 Competence
 - Section 10.37 Requirements for written advice



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What is a “Substantial Understatement of Income Tax” - § 6662(d)

- 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.
- “Understatement” for this purpose, generally equals 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



Reduction of the “Understatement”

- § 6662(d)(2)(B) provides for a reduction of the understatement due to a position of the taxpayer or disclosed item 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 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 such item by the taxpayer.
 - Form 8275
 - Form 8275R

*Understatement reduction does not apply to tax shelters



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Effect of having substantial authority

§ 1.6662-4(d)(1)

- 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.
- For purposes of section 6662(d), the tax attributable to the item is not included in the “understatement” for that year.

*There are special rules relating to tax shelter items (§ 1.6662-4(g)).



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Substantial Authority Standard

- Objective standard
 - Involves an analysis of the law and application of the law to relevant facts.
- Not as stringent as the more likely than not (MLTN) standard
 - MLTN standard is met when there is a >50% likelihood of the position being upheld
- Substantial authority is more stringent than the reasonable basis standard as defined in § 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.



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Determining whether you have Substantial Authority – (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 should be addressed;
 - Including any authorities contrary to the treatment



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Determining whether you have Substantial Authority – (i) Evaluation of authorities

- The weight of authorities is determined in light of the pertinent facts and circumstances (in the manner prescribed by 1.6662-4(d)(3)(ii) of this section);
- There may be substantial authority for more than one position with respect to the same item; and
- Again, it's an objective standard, taxpayer's belief isn't relevant.



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Determining whether you have Substantial Authority – (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.



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Determining whether you have Substantial Authority – (ii) Nature of Analysis

- The type of document 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.



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Determining whether you have Substantial Authority – (ii) Nature of Analysis

- If the document is > 10 years old, generally 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.

*A taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.



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Determining Whether Substantial Authority is Present - (iii) Types of Authority

- Only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item (except in certain cases concerning written determinations discussed later):
 - Applicable provisions of the Internal Revenue Code and other statutory provisions;
 - Proposed, temporary and final regulations construing such statutes;
 - Revenue rulings and revenue procedures;



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Determining Whether Substantial Authority is Present - (iii) Types of Authority

- 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;



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Determining Whether Substantial Authority is Present - (iii) Types of Authority

- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda;
- Actions on decisions and general counsel memoranda issued after March 12, 1981 (and GCMs 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.



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Determining Whether Substantial Authority is Present - (iii) Types of Authority

- Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are **NOT** authority;
- 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;



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Determining Whether Substantial Authority is Present - (iii) Types of Authority

- In the case of court decisions, 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 US 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); and
- A PLR is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the IRB.



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Substantial Authority - (iv) Special Rules for Written Determinations

- Written determinations. Substantial authority for the tax treatment of an item by a particular taxpayer if:
- Supported by the conclusion of a ruling or a determination letter (as defined in § 301.6110-2(d) and (e)) issued to the taxpayer;
- Supported by the conclusion of a technical advice memorandum in which the taxpayer is named; or
- Supported by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer.



No Substantial Authority

- Substantial authority not present if 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 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.

* A written determination that is modified or revoked ceases to be authority on the date, and to the extent, it is so modified or revoked.



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Substantial Authority - (iv) Special Rules for Jurisdiction and Timing

- Jurisdiction. A 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 bullet, 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; and
- Timing. Must have substantial authority for the tax treatment of an item when filed or the last day of the taxable year to which the return relates.



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Reduction of the “Understatement” Through Adequate Disclosure - § 1.6662-4(e)

- Effect of adequate disclosure:
 - Items 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;
 - For purposes of section 6662(d), the tax attributable to such items is not included in the understatement for that year.



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Reduction of the “Understatement” Through Adequate Disclosure - § 1.6662-4(e)

- Disclosure will not have an effect if the item or position on the return:
 - (i) Does not have a reasonable basis (as defined in § 1.6662-3(b)(3));
 - (ii) Is attributable to a tax shelter; or
 - (iii) Is not properly substantiated, or the taxpayer failed to keep adequate books and records



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Making Adequate Disclosure

- (1) Disclosure statement. Disclosure is adequate with respect to an item 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 § 1.6664-2(c)(3)) for the taxable year.
 - If not contrary to a regulation, disclosure must be made on Form 8275 (Disclosure Statement);
 - 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;

Making Adequate Disclosure

- (3) Recurring item - each taxable year in which the item is taken into account;
- (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");
 - Not also required in connection with the return for the taxable year in which the carryback or carryover is taken into account.
- (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



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Different Rules Apply to Tax Shelter Items

- Noncorporate taxpayers - Tax shelter items of a noncorporate taxpayer are not included in the understatement, if:
 - (A) There is substantial authority for the tax treatment of that item; and
 - (B) The taxpayer reasonably believed at the time the return was filed that the tax treatment of that item was more likely than not the proper treatment
 - Corporate taxpayers - all tax shelter items of a corporation are taken into account in computing the amount of any understatement.
- * See § 1.6664-4(f) for certain rules regarding the availability of the reasonable cause and good faith exception to the substantial understatement penalty with respect to tax shelter items of corporations.



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Tax Shelters – Reasonable Belief

- A taxpayer is considered reasonably to believe that the tax treatment of an item is MLTN the proper tax treatment if:
 - (A) The taxpayer analyzes the pertinent facts and authorities (same analysis as with substantial authority), and in reliance upon that analysis, reasonably concludes in good faith:
 - > 50% likelihood tax treatment will be upheld if challenged by the IRS; or



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Tax Shelters – Reasonable Belief

(B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion:

- (1) is based on the tax advisor's analysis of the pertinent facts and authorities;
- (2) unambiguously states that the tax advisor concludes $> 50\%$ likelihood that the tax treatment will be upheld if challenged by the IRS



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Tax Shelters – Reasonable Belief

- * All facts and circumstances must be taken into account in determining whether a taxpayer has a reasonable belief.
- ** However, in no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor unless the requirements of § 1.6664-4(c)(1) are met.
- *** The fact that the requirements of § 1.6664-4(c)(1) are satisfied will not necessarily establish that the taxpayer reasonably relied on the opinion in good faith.
 - For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.



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Reasonable Cause and Good Faith Exception to § 6662 Penalties

- The requirements of § 1.6664-4(c)(1) are minimum requirements:
 - (i) All facts and circumstances considered;
 - (ii) No unreasonable assumptions; and
 - (iii) Reliance on the invalidity of a regulation.
 - only if adequately disclosed, in accordance with § 1.6662-3(c)(2)



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Advice

- Any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty.
- Advice does not have to be in any particular form.



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26 U.S.C. § 6694 – Understatement of taxpayer's liability by tax return preparer

- § 6694(a) – Understatement due to unreasonable positions
- § 6694(b) – Understatement due to willful or reckless conduct
- Circular 230, Section 10.34
 - IRS employees are required to refer § 6694(b) penalties to OPR
 - Referral is discretionary for § 6694(a) penalties



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26 U.S.C. § 6694(a) - Understatement due to unreasonable positions

- If a tax return preparer (1) prepares a return or claim of refund and there is an understatement of liability due to an “unreasonable position” and (2) the preparer knew (or reasonably should have known of the position), the tax return preparer is required to pay a penalty with respect to each return or claim
 - In an amount equal to the greater of \$1000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to the return/claim



26 U.S.C. § 6694(a) - Understatement due to unreasonable positions

- Unreasonable position (§ 6694(a)(2)). A position is an unreasonable position for purposes of § 6694(a) if:
 - (a) There was not substantial authority for the position;
 - (b) The position (1) was disclosed (as provided in § 6662(d)(2)(B)(ii)(I) and discussed earlier), (2) is NOT a tax shelter or reportable transaction, and (3) there is a reasonable basis for the position; or
 - (c) In the case of a tax shelter or reportable transaction, it is reasonable to believe the position would more likely than not be sustained on its merits



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26 U.S.C. § 6694(a) - Understatement due to unreasonable positions

- There is a reasonable cause exception if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.
- Circular 230, section 10.34(d) – A practitioner generally may relay in good faith without verification upon information furnished by the client; can't ignore the implications of information furnished to, or actually known, by the practitioner, and must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent with an important fact, or another factual assumption, or incomplete.



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26 U.S.C. § 6694(b) – Understatement due to willful or reckless conduct

- If a tax return preparer prepares a return or claim of refund and there is an understatement of liability due to “willful or reckless conduct,” the tax return preparer is required to pay a penalty with respect to each return or claim
 - In an amount equal to the greater of \$5000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to the return/claim
- Willful or reckless conduct
 - (A) a willful attempt in any manner to understate the liability for tax on the return or claim; or
 - (B) a reckless or intentional disregard of rules or regulations



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Contacting OPR

- Questions or comments, contact OPR at
 - Efax: (855) 814-1722
 - Office of Professional Responsibility
1111 Constitution Ave., N.W.
SE:OPR Rm. 7238
Washington, DC 20224
- For more info on OPR and Circular 230 visit <http://www.irs.gov/>
Search: “Circular 230 Tax Professionals”



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Appendix



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Form 8275

Form 8275	Disclosure Statement	OMB No. 1545-0049				
File: August 2018 Department of the Treasury Internal Revenue Service	Do not use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-E, Regulation Disclosure Statement. ► Information about Form 8275 and its separate instructions is at www.irs.gov/form8275 . ► Attach to your tax return.	Attachment Sequence No. 02				
Name(s) shown on return _____		Identifying number shown on return _____				
If Form 8275 relates to an information return for a foreign entity (for example, Form 5471), enter: Name of foreign entity _____ Employer identification number, if any _____ Reference ID number (see instructions) _____						
Part I General Information (see instructions)						
	(A) Reg. Ref., Rev. Proc., etc.	(B) Item or Group of Items	(C) Detailed Description of Items	(D) Form or Schedule	(E) Line No.	(F) Amount
1						
2						
3						
4						
5						
6						
Part II Detailed Explanation (see instructions)						
1						
2						
3						
4						
5						
6						
Part III Information About Pass-Through Entity. To be completed by partners, shareholders, beneficiaries, or residual interest holders. Complete this part only if you are making adequate disclosure for a pass-through item.						
Note: A pass-through entity is a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).						
1 Name, address, and ZIP code of pass-through entity		2 Identifying number of pass-through entity				
		3 Tax year of pass-through entity				
		/ / to / /				
		4 Internal Revenue Service Center where the pass-through entity filed its return				
For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 810224L Form 8275 (Rev. 8-2016)						



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Form 8275R

Form 8275-R Due August 2018 <small>Department of the Treasury Internal Revenue Service</small>	Regulation Disclosure Statement Use this form only to disclose items or positions that are contrary to Treasury regulations. For other disclosures, use Form 8275, Disclosure Statement. Information about Form 8275-R and its separate instructions is at www.irs.gov/form8275 . Attach to your tax return.	OMB No. 1545-0088 Attachment Sequence No. 02A			
Identify items on return: _____ Identifying number shown on return: _____					
If Form 8275-R relates to an information return for a foreign entity (for example, Form 5471), enter: Name of foreign entity: _____ Employer identification number, if any: _____ Reference ID number (see instructions): _____					
Part I General Information (see instructions)					
(M) Regulation Section	(N) Item or Group of Items	(P) Detailed Description of Item	(R) Form or Schedule	(S) Line No.	(T) Amount
1					
2					
3					
4					
5					
6					
Part II Detailed Explanation (see instructions)					
1					
2					
3					
4					
5					
6					
Part III Information About Pass-Through Entity. To be completed by partners, shareholders, beneficiaries, or residual interest holders.					
Complete this part only if you are making adequate disclosure for a pass-through item.					
<small>Note: A pass-through entity is a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).</small>					
1 Name, address, and ZIP code of pass-through entity	2 Identifying number of pass-through entity				
<div style="border: 1px solid black; height: 40px; width: 100%;"></div>	3 Tax year of pass-through entity _____ to _____ / /				
	4 Internal Revenue Service Center where the pass-through entity filed its return				
For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 1545-0088 Form 8275-R (Rev. 8-2018)					