

**Internal Revenue Service  
memorandum**

CC:INTL-0148-95  
Br1:WEWilliams

date: APR 17 1995

to: Chief, Examination Division  
Assistant Commissioner (International)  
Attn: Vincent Corrado CP:IN:C:D:EX:HQ:1111

from: Chief, Branch No. 1  
Associate Chief Counsel (International) CC:INTL:1

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subject: Request for advice regarding Rev. Proc. 94-69  
Taxpayer: [REDACTED]

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This responds to your request for informal advice concerning an issue involving I.R.C. § 6662.

Issue:

Whether a disclosure statement that describes the nature of an item reported on a previously-filed income tax return, but does not identify the precise amount of the item, satisfies the disclosure requirements for avoiding the section 6662(a) penalty for negligence or substantial understatement of income tax?

Background:

[REDACTED] is a large case, coordinated examination program taxpayer. It files its U.S. income tax returns on a calendar year basis. The returns in question are for [REDACTED]

In connection with audit of the Forms 1120-F filed by taxpayer, the IRS agent requested that taxpayer furnish Rev. Proc. 94-69 statements. As explained below, to the extent that such statement adequately discloses an item, that item is not taken into consideration in computing the understatement for purposes of the negligence and understatement of income tax penalties under I.R.C. § 6662(b)(1) and (2). In response to the agent's request for disclosure statements, taxpayer submitted a Disclosure Statement, Form 8275, for each of the three years. The Forms 8275 for [REDACTED] disclosed the

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same four items; the Form 8275 for [REDACTED] disclosed these four items and also a fifth item. As required by the Form, taxpayer identified the line on the Form 1120-F on which the item appeared. You state that for one or more of the items taxpayer included the entire amount that appeared on the line on the Form 1120-F and not just the amount of the item itself.

### Discussion

I.R.C. § 6662(a) imposes a penalty of 20 percent on the portion of certain underpayments. Subsection (b) states that the penalty will apply to an underpayment attributable to

- (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.

Apparently, any underpayments in this case would be attributable to underpayments described in section 6662(b)(1) and/or (2).

For purposes of section 6662(b)(1), "negligence" is defined in section 6662(c) as including

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.

For purposes of section 6662(b)(2), in the case of a corporation other than an S corporation or a personal holding company, a substantial understatement of income tax exists

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

(iii) \$10,000.

I.R.C. § 6662(d)(1). The term "understatement" is defined in section 6662(d)(2) as

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)).

However, for purposes of section 6662, an understatement is 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.

I.R.C. § 6662(d)(2)(B).

For purposes of returns filed on or before March 14, 1994 (see Treas. Reg. § 1.6662-7T(a)(2)), the negligence penalty under section 6662(b)(1) is not

imposed on any portion of an underpayment that is attributable to negligence or a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section and, in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation. This disclosure exception does not apply, however, in the case of a position that is frivolous or where the taxpayer fails to keep adequate books and records or to substantiate items properly. [Emphasis added.]

Treas. Reg. § 1.6662-3(c)(1).<sup>1/</sup> Section 13251 of the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66 (Aug. 10, 1993), amended section 6662(d)(2)(B) to eliminate the "frivolous" test in section 1.6662-3(c)(1) of the Treasury Regulations. The Conference Committee Report includes the following:

The penalty for negligence or disregard of rules or regulations does not apply where the position taken is adequately disclosed, the position is not "frivolous", and the taxpayer has adequate books and records and has substantiated items properly (Treas. Reg. sec. 1.6662-3(c)). [Footnote omitted.]

\* \* \*

The House bill replaces the "not frivolous" standard with a "reasonable basis" standard for purposes of the accuracy-related and income tax return preparer penalties. Thus, under the House bill, a taxpayer can avoid a substantial understatement penalty by adequately disclosing a return position only if the position has at least a reasonable basis.

\* \* \*

The Senate amendment is the same as the House bill, except that (i) the "not frivolous" standard remains applicable with respect to the income tax return preparer penalty ....

\* \* \*

The conference agreement follows the Senate amendment.

- H.R. No. 103-213, 103d Cong., 1st Sess. 204-205 (Aug. 4, 1993). The change from a not "frivolous" to a "reasonable basis" test is reflected in the proposed regulation published on March 17, 1994. The proposed regulation amends the last sentence of section 1.6662-3(c)(1) to read as follows:

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<sup>1/</sup> For returns filed after March 14, 1994, "[t]he penalty for negligence in section 6662(b)(1) may not be avoided by disclosure of a return position." Treas. Reg. § 1.6662-7T(b).

This disclosure exception does not apply, however, in the case of a position that does not have a reasonable basis or where the taxpayer fails to keep adequate books and records or to substantiate items properly. [Emphasis added.][<sup>2/</sup>]

For purpose of the negligence penalty under section 6662(b)(1), adequate disclosure is a disclosure made in accordance with sections 1.6662-4(f)(1), (3), (4) and (5) which deal with the substantial understatement of income tax penalty under section 6662(b)(2).<sup>3/</sup> For purposes of the substantial understatement of income tax penalty, and the negligence penalty if the Forms 8275 were filed on or before March 14, 1994,

[d]isclosure 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 ... 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) ....

Rev. Proc. 94-69, 1994-44 I.R.B. 17, allows a taxpayer in the Coordinated Examination Program to avoid the penalties imposed by section 6662(b)(1) and (2) by furnishing a statement within 15 days after requested by an IRS employee.

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<sup>2/</sup> Further, Treas. Reg. § 1.6662-7T(c) states the following:

The penalties for disregarding rules or regulations in section 6662(b)(1) and for a substantial understatement of income tax in section 6662(b)(2) may be avoided by adequate disclosure of a return position only if the position has at least a reasonable basis. See §§ 1.6662-3(c) and 1.6662-4(e) and (f) for other applicable disclosure rules. [Emphasis added.]

<sup>3/</sup> As pointed out above, the negligence penalty under section 6662(b)(1) may be avoided by disclosure only for returns filed on or before March 14, 1994. Under Rev. Proc. 94-69, an adequate disclosure statement submitted after the filing of an original return, and in accordance with the revenue procedure, is treated as an amended return. Thus, if the Forms 8275 satisfy the requirements of the revenue procedure, they will have the effect of reducing an understatement for purposes of the negligence penalty only if filed on or before March 14, 1994.

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The statement is treated as a qualified amended return. Among the requirements for such a statement is that it include

a description of all items that would result in adjustments if the taxpayer, in lieu of furnishing a written statement, filed a properly completed amended return. The description of an item is adequate if it consists of information that reasonably may be expected to apprise the Internal Revenue Service of the identity of the item, its amount, and the nature of the controversy or potential controversy. For example, the statement that certain amounts deducted as expenses should instead have been capitalized is adequate only if it refers to specific accounts and amounts recorded in invoices or journal entries. [Emphasis added.]

In this case, taxpayer's statements on Forms 8275, submitted at the request of a revenue agent, describe the issues related to each of the items for which taxpayer intends to make a disclosure to avoid the penalty under section 6662(a). You have not asked us to comment on whether these statements are adequate as to the explanation of the substantive issue. Your question relates to the fact that with respect to at least some of the items taxpayer has not identified the precise amount of the item reported on its return. Rather, with regard to these items, taxpayer has stated the amount as the total reported on the line of the return on which the item appears.

Rev. Proc. 94-69 superseded Rev. Proc. 85-26, 1985-1 C.B. 580, which provided rules for disclosure statements from CEP taxpayers. One reason for publishing Rev. Proc. 94-69 was to correct a problem CEP examiners had identified. The problem was that some CEP taxpayers were submitting disclosure statements that were too general for the CEP examiner to adequately identify the items that the taxpayer knows have not been given the proper tax treatment. Thus, one purpose of Rev. Proc. 94-69 is to clarify that a taxpayer's written statement will not constitute adequate disclosure for purposes of the revenue procedure, unless it describes an item with sufficient specificity to reasonably apprise the IRS of the identity of the item and its amount. In this regard, we note that there are no exceptions described in Rev. Proc. 94-69.

While we do not think that Rev. Proc. 94-69 allows the IRS to waive the requirement that a disclosure statement specify the amount of an item, the revenue procedure allows flexibility with regard to the time period within which a disclosure statement must be furnished. Therefore, we think that in the case where calculation of the amount of an item

requires a time-consuming computation, the IRS should permit the taxpayer sufficient time and take a liberal approach to the time limitations stated in Rev. Proc. 94-69. That is, the revenue procedure requires that a disclosure statement be submitted within 15 days of a request by the IRS

(or any later date agreed to in writing by the appropriate District official upon a showing of reasonable cause) ....

See Rev. Proc. 94-69, secs. 3.01(2) and 5.

Conclusions:

Rev. Proc. 94-69 requires that the amount of an item be listed in order for a disclosure statement to be adequate to avoid the accuracy-related penalties under section 6662. The revenue procedure contains no exceptions to this requirement. Therefore, while the IRS has considerable flexibility on the time within which information must be submitted in connection with a disclosure statement, the Service may not waive the requirement that the amount of an item be specifically stated.



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If you have any questions or if we can be of further assistance, please call Ed Williams at 874-1490.

  
GEORGE M. SELLINGER