Adequate disclosure can be a defense to the application of the extended six-year statute of limitations for assessment of tax based on a substantial understatement of gross income, a defense to substantial understatement penalties, and a defense to preparer penalties, as well as an important factor in whether the IRS exercises its discretion to impose penalties in other situations. Because the method and manner of disclosure differs in each of these situations, it is crucial to understand these rules in order to counsel your clients on whether and how to disclose a tax return position on their returns.

Adequate Disclosure as a Defense to the Extended Six-Year Statute of Limitations for Substantial Understatement

Under Code Sec. 6501(a), the IRS must assess a tax deficiency within three years after the return was filed. There are numerous exceptions to this rule, including Code Sec. 6501(e)(1)(A), which extends the time period for assessment to six years if the taxpayer omits an amount in excess of 25 percent of the gross income stated on the return. The purpose of the extended statute of limitations for assessment in cases of substantial omissions of gross income is to “level the playing field when the taxpayer’s omission of income places the IRS at a disadvantage in discovering errors.” Accordingly, an amount is not considered to have been omitted from gross income if it was “disclosed on the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.”

In considering whether there was adequate disclosure, courts consider “whether a reasonable person would discern the fact of the omitted gross income from the fact of the return.” The return need not include every underlying fact but “must provide a clue more substantial than one that would intrigue the likes of Sherlock Holmes.” On the other hand, a disclosure is not adequate if the IRS “must thoroughly scrutinize the return to ascertain whether gross income was omitted.” The “return” in question consists of a taxpayer’s own return, and if the taxpayer is a partner in a partnership or a shareholder in an S corporation, the partnership or S corporation’s information return.
For partnerships governed by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), there is a similar statute of limitations provision. Code Sec. 6229(a) provides that the limitations period for assessing tax, where the tax is attributable to a partnership item, expires three years after the partnership return is filed. Like Code Sec. 6501(e)(1), Code Sec. 6229(c) extends the statute of limitations to six years if there has been a “substantial omission of income” on the partnership return. Code Sec. 6229(c), by its terms, however, does not contain an exception for adequate disclosure. In 

*CC&P Western Operations Ltd. Partnership*, the First Circuit questioned whether the adequate disclosure defense should be read into Code Sec. 6229. However, this is not the position of the IRS. In a 1999 Field Service Advisory, the IRS explained that since it has taken the position that Code Sec. 6229 imports the basic statute of limitations rules of Code Sec. 6501 (such as the definition of “gross income” in Code Sec. 6501(e)(1)(a)(i)), it cannot reasonably argue that the adequate disclosure provisions do not apply as well. Accordingly, partnerships in TEFRA proceedings can avoid the extended six-year statute of limitations by showing that they adequately disclosed the items of gross income in question.

In considering whether there was adequate disclosure, courts consider “whether a reasonable person would discern the fact of the omitted gross income from the fact of the return.”

As with other tax returns, for TEFRA partnership returns, “the disclosure, to be adequate, must be apparent from the return itself, including sufficient detail to alert the Service as to the nature of the transaction and enable it to make a reasonably informed decision on whether to select the return for audit.” Adequate disclosure does not require the IRS to “search through myriad documents that may be in its possession with respect to another entity or taxpayer,” except that any disclosures made on a partnership return are considered in connection with the return of a partner in that partnership.

The timing of the filing of the income tax and information returns is important. In a 2013 Chief Counsel Advisory (CCA), the IRS explained that information provided after the original return was filed will not be considered part of the return for purposes of Code Sec. 6501(e)(1), even though that information would be considered for other purposes. The example in the CCA is of a taxpayer who filed a Form 1040, *U.S. Individual Income Tax Return*, reporting gross income from an S corporation, and then more than three years later, the S corporation filed a Form 1120-S which showed that the taxpayer's distributive share of the S-corporation income had been under-reported. The IRS stated that the Form 1120-S was not adequate disclosure, and the six-year statute of limitations applied. As explained in the CCA:

Where the Form 1120-S is filed after the original individual return, the IRS is not required to consider a theoretical, non-existent Form 1120-S in conjunction with the Form 1040. Where the IRS is forced into the disadvantaged position of reviewing an individual's return without the benefit of the Form 1120-S, the taxpayer loses the benefit of any protection the disclosures in that Form 1120-S may have provided.

The other significance of the rule described in the CCA is that a taxpayer cannot avoid the extended six-year statute of limitations by filing an amended return. As explained in *I. Goldring*, the taxpayer's filing of an amended return that includes income not reported on the original return does not prevent the IRS from invoking the six-year statute of limitations based upon the omission of the original return. Likewise, information discovered by the IRS after the filing of the return, such as during an audit, does not reduce the six-year statute of limitations.

The meaning of whether an item was adequately “disclosed on the return” has been the subject of much litigation. In particular, in the pass-through context, taxpayers have argued that where an item of income from an entity omitted from the individual taxpayer's return was reported on the entity's return, there was adequate disclosure. For example, in *V.C. Benderoff*, the taxpayers had disclosed their status as shareholders of a corporation and reported their shares of undistributed corporate income, but not the corporate distributions that they had received. The court held that the corporate return should be considered along with the individual return because the corporate return allowed the IRS to verify the accuracy of the information reported on the income tax returns of the individual shareholders. The crucial fact in *Benderoff* was that the individual returns "made adequate reference to" the corporate return.

In contrast, in the more recent decision of *T.J. Heckman*, the Eighth Circuit rejected an argument based on *Benderoff* because the taxpayers had not adequately
referred to the entity’s return. In Heckman, the taxpayer had participated in an employee stock ownership plan established by his company. The plan acquired a 100-percent interest in an LLC, and then distributed its interest in that LLC to the taxpayer’s individual retirement account. The taxpayer omitted the plan distribution from his gross income and did not otherwise disclose the distribution. The IRS learned about the plan distribution during an unrelated audit and issued the taxpayer a notice of deficiency within six years (but not three years) of the filing of the tax return pursuant to Code Sec. 6501(e)(1)(A) because the plan distribution exceeded 25 percent of the taxpayer’s gross income reported in that tax year. Relying on Benderoff, the taxpayers argued that because the LLC disclosed the plan in its tax filing, it was adequately disclosed for purposes of Code Sec. 6501(e)(1)(A)(ii). The court rejected this argument because the taxpayer’s return had not referenced the LLC or the distribution, so nothing on the return “gave the Commissioner a clue” that the LLC’s tax filings were relevant.

There is no exact method for adequate disclosure for purposes of Code Sec. 6501(e)(1)(A). As is discussed below, adequate disclosure of a tax return position also may be a defense to tax penalties. The method for adequate disclosure for that purpose is more formal and may require the filing of a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement. The filing of a Form 8275 certainly would constitute adequate disclosure for statute of limitations purposes, but it is not required.

**Adequate Disclosure as a Defense to Substantial Understatement and Other Tax Penalties**

Adequate disclosure also may insulate taxpayers from substantial understatement penalties where the tax position is supported by a reasonable basis. Code Sec. 6662(d) provides for a penalty where there is a substantial understatement of tax, i.e., where the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to have been shown on the return or $5,000, or if the taxpayer is a corporation (other than an S corporation or a personal holding company), the amount of the understatement exceeds the lesser of 10 percent of the tax required to be shown on the return or $10,000. In general, the penalty for a substantial understatement of tax is 20 percent of the resulting underpayment of tax.

Unless the item is attributable to a tax shelter, if the taxpayer has a reasonable basis for the tax treatment of an item, the amount of the understatement is reduced by the portion of the understatement attributable to the items with which the relevant facts were adequately disclosed in the return or in a statement attached to the return.

In Rev. Proc. 2015-16, the IRS describes the procedures for adequate disclosure. In general, unless the item is one of those enumerated in the revenue procedure, disclosure is only adequate if made on a properly completed Form 8275 or 8275-R attached to the tax return for the year at issue or to a qualified amended return. A complete and accurate disclosure of a tax position on a corporate taxpayer’s Schedule UTP (Uncertain Tax Position Statement) will be treated as if the corporation filed a Form 8275 or 8275-R disclosing that position.

Some items, by their nature, are obvious from the face of the return or already require a form that provides information related to the item, and thus do not require the filing of a Form 8275. These items are listed in Rev. Proc. 2015-16 and include, for example, certain Schedule A itemized deductions and trade or business expenses. Another example is a treaty-based return position. In order to claim a treaty benefit, the taxpayer must attach a Form 8833, Treaty-Based Return Position Disclosure under Section 6114 or 7701(b), to the income tax return. The Form 8833 contains sufficient information about the position so that a Form 8275 is not also required. Likewise, for Schedules M-1 and M-3, Reconciliations of Book and Taxable Income, if the information contained on the forms reasonably apprises the IRS of potential controversy concerning the tax treatment of an item, it will be considered an adequate disclosure. However, if the information does not so apprise the IRS, the Form 8275 or 8275-R also must be attached.

Treasury regulations also provide specific instructions for adequate disclosure for items attributable to a passthrough entity. This regulation also provides a method for individual taxpayers to make an adequate disclosure for penalty protection even if the entity opts not to do so. Disclosure is adequate if the entity attaches a Form 8275 or 8275-R to a return or qualified amended return or as described in the revenue procedure. The taxpayer (i.e., partner, shareholder, beneficiary or holder of a residual interest in a real estate mortgage investment conduit (REMICO)) also may make adequate disclosure with respect to a passthrough item by filing a Form 8275 or 8275-R, in duplicate, one copy attached to the taxpayer’s return and the other copy filed with the IRS Center where the entity return is filed.

For taxpayers, adequate disclosure is, technically, a defense only to substantial understatement penalties. The Code does not specifically provide that taxpayers can avoid any other penalties through adequate disclosure. Rev. Proc. 2015-16 states that it only applies to Code Secs. 6662(d) and 6694(a) (discussed below) and further states that it does not apply.
to the penalty for negligence or disregard of rules or regulations under Code Sec. 6662(b)(1), the economic-substance penalty under Code Sec. 6662(b)(6) or, as noted above, if the position is with respect to a tax shelter. Disclosure nevertheless may help the taxpayer avoid other penalties. For example, in *J.T. Webber*, the taxpayer did not file a Form 8275 with his Form 1040 but had disclosed the items at issue on his gift tax returns. In declining to impose a substantial understatement penalty on the ground that the taxpayer had reasonably relied on professional tax advice, the Tax Court found that the taxpayer’s transparency “support(ed) his testimony that he believed this strategy would successfully withstand IRS scrutiny.”

In addition, disclosure of a taxpayer’s position on his return “negatives any intention on the part of the [taxpayer] to file a false and fraudulent return with intent to evade tax and, on the contrary, evidences an honesty of belief [in the position asserted].” Thus, a charge of fraud can be avoided by appending a rider to the tax return setting forth the facts of the transaction and stating the legal position the taxpayer is asserting. In this context, the disclosure must be complete. As stated by the Ninth Circuit, “[t]he fact that the taxpayer provides the IRS with a hint about omitted income does not automatically preclude a court from finding that the taxpayer acted with an intent to evade taxes. To hold otherwise would encourage unscrupulous taxpayers and their agents to make partial or opaque disclosures designed to avoid taxation without risking fraud penalties.” The disclosure to avoid fraud penalties does not necessarily require the Form 8275 or 8275-R, but may be accomplished through use of a rider or an additional description on the return.

In considering whether to make a disclosure, clients often ask whether the filing of a Form 8752 or 8275-R is a “red flag” for audit. The IRS does not look for these forms in selecting returns for audit. The IRS selects returns for exam using a variety of methods, including computer scoring, such as the Discernable Function System (DIF) score, which rates the potential for adjustments based on the IRS’s past experience with similar returns; the Unreported Income DIF (UDIF), which rates the return for potential unreported income; and information matching with third-party reports, as well as exams of related taxpayers, advisors and promoters; information from whistleblowers; and information from John Doe summonses. The filing of a Form 8275, in and of itself, does not increase the risk with respect to any of these methods for selecting returns for audit. The Form 8275 may not be a red flag for audit, but it is a “roadmap” for the IRS if a return is selected for audit. In many cases, however, the benefits of penalty protection (and a three-year statute of limitations) outweigh the potential for alerting the IRS to an issue on a return that would have been examined anyway.

### Adequate Disclosure as a Defense to Preparer Penalties

Code Sec. 6694(a) imposes a penalty on 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 an “unreasonable position.” An “unreasonable position” is a position (other than a position with respect to a tax shelter) that is not supported by substantial authority or a position that was not adequately disclosed for which there was not a reasonable belief that the position would more likely than not be sustained on its merits. Essentially, a return preparer will not be penalized if the position had a reasonable basis and was adequately disclosed.

Penalties under Code Sec. 6694(a) are an amount equal to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim for refund. Although this may not be a significant amount of money in many cases, the penalty also may lead to a referral for investigation and discipline by the IRS’s Office of Professional Responsibility and repeated violations can form the basis of an injunction action against the preparer.

Rev. Proc. 2015-16 also applies to disclosure for Code Sec. 6694(a) purposes. As stated in the revenue procedure, as well as in the statute, adequate disclosure is not a defense if the position is with respect to a tax shelter or reportable transaction to which Code Sec. 6662A applies, *i.e.*, a reportable transaction where a significant purpose of the transaction is the avoidance or evasion of federal income tax.

As noted above, taxpayers may refuse to attach a disclosure statement because of the fear that it will increase the likelihood that the IRS will audit their return. This creates

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a potential conflict between the client who does not want to be audited and the advisor who wants to protect himself or herself against penalties in situations where he or she does not believe that the return position is supported by substantial authority (or is concerned that the IRS may not think so). If the client refuses to include the Form 8275 on the return, where does this leave the preparer with concern about the potential for Code Sec. 6694(a) penalties?

The Treasury recognized the potential conflict between the advisor and the client on this issue and has determined that the preparer should not be liable for penalties if he or she advises the taxpayer to disclose, even though the taxpayer, who ultimately has the final say on what is included on his or her tax return, refuses to do so. The regulations provide that a signing preparer 49 satisfies the disclosure requirement even if the position was not, in fact, disclosed, if the preparer provides the taxpayer with a return that included the disclosure, or the preparer advises the taxpayer of the penalty standards applicable to the taxpayer under Code Sec. 6662 and contemporaneously documents the advice in his or her files. 50 A “nonsigning” preparer 51 satisfies the disclosure requirement by advising the taxpayer of the potential penalties under Code Sec. 6662 and of the opportunity to avoid penalties through disclosure and contemporaneously documenting the advice. 52

ENDNOTES

3. Id.
4. Id. (citing Quick’s Trust, 74 F.3d 353 (5th Cir. 1996)).
5. Id.
8. One of the principal purposes was to streamline the tax procedures for partnerships by providing for “a single, unified audit to determine the treatment of ‘partnership items’ for all the partners.” Bush CA-FC, 655 F3d 1323, 1325 (2011). “Partnership items” are those “items whose treatment affects the entire partnership.” Id; Code Sec. 6231(a)(3).
13. See supra note 1.
14. Id.
17. Benderoff, see supra note 11.
18. Id., at 134-35.
19. Id., at 135.
20. Heekman, see supra note 16.

Conclusion

While adequate disclosure may not be a silver bullet, when the taxpayer or advisor is concerned that the IRS may challenge a position or

22. H.L. Stein, 64 TC 1262, Dec. 48,627(M), TC Memo. 1992-651 (disclosure for penalty protection ‘compels’ greater disclosure than is necessary to avoid the 6-year statute of limitations provided for in section 6501(e) (1)(A));” (quoting Joint Comm. On Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 218 (J. Comm. Print 1983)).
23. Code Sec. 6662(d)(1).
24. Code Sec. 6662(a).
25. Penalties on tax shelter items cannot be avoided with adequate disclosure. Code Sec. 6662(d) (2). “Tax shelter” has the same meaning as in Code Sec. 6662(d)(2)(C)(ii) (a partnership or other entity, any investment plan or arrangement, or 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).
26. “Reasonable basis” is defined in Reg. §1.6662-3(b)(3), in part, as “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.” In addition, the position must be adequately substantiated. Reg. §1.6662-4(e)(2); Rev. Proc. 2015-16, 2015-7 IRB 596, Sec. 4.01(5).
27. Code Sec. 6662(d)(2)(B)(ii); Reg. §1.6662-4(a), (b), (e) and (f).
28. Rev. Proc. 2015-16, IRB 2015-7, 596. A qualified amended return is an amended return that corrects an error in a previously filed return prior to the taxpayer being contacted by the IRS regarding the return. Reg. §1.6664-2(c)(3). The effect of a qualified amended return is to eliminate the accuracy penalty under Code Sec. 6662 on the amount shown as additional tax on the qualified amended return. Reg. §1.6664-2(c)(2).
29. A corporation’s filing of a Form 8275 or Form 8275-R, however, does not satisfy the corporation’s requirement to file a Schedule UTP, where otherwise required. Rev. Proc. 2015-16, IRB 2015-7, 596, Sec. 3.08.
30. Id., at Sec. 4.02(1)(a)(e).
31. Id., at Sec. 4.02(2)(a)(f).
32. Id., at Sec. 4.02(4)(b).
33. Id., at Sec. 4.02(5).
34. Reg. §1.6662-4(f)(5).
35. Id.
37. CodeSec. 6662(d)(2); Id. at Sec. 4.01(5).
39. Id.
42. See IS-2006-10 (Jan. 2006).
43. Code Sec. 6694(a).
floundering economy.

The preamble states that the Proposed Regulations are to apply to tax years beginning on or after the date the final regulations are published in the Federal Register. Additionally, the final regulations are to provide rules applicable to taxpayers who seek to change a method of accounting to comply with the rules in the final regulations, and taxpayers may not change or otherwise use a method of accounting in reliance on the rules contained in the Proposed Regulations until the rules are published as final regulations in the Federal Register. Unfortunately for condo developers seeking to benefit from condo sales contracts being classified as home construction contracts, the Proposed Regulations have, to date, yet to be finalized. In the 2014–2015 IRS Priority Guidance Plan, released on August 26, 2014, and covering the plan year period from July 1 through June 30, 2015, the Proposed Regulations were listed as one of 22 tax accounting projects that the IRS actively intended to work on. Despite being listed in the Priority Guidance Plan, the Proposed Regulations were not finalized during the 2014–2015 plan year, and it remains uncertain when, if ever, the Proposed Regulations will be finalized.

Until the Proposed Regulations are finalized, condo developers are faced with a difficult decision as to how to account for taxable income on contracts for the sale of condo units during development of the condominium building. Despite the fact that the preamble to the Proposed Regulations explicitly states that the Proposed Regulations apply to tax years beginning on or after the date the final regulations are published in the Federal Register, some developers have apparently chosen to report income and losses under CCM or the accrual method, consistent with other HCCs. There is an obvious risk associated with this approach, as the IRS could very well challenge the use of such methods for periods prior to finalization of the Proposed Regulations. Alternatively, a developer may opt to avoid imposition of PCM accounting by treating a condo sales agreement as an option rather than a long-term contract. However, with deposits rising as high as 50 percent of the total sales price in some parts of the country, this strategy seems riskier than ever. Further, the Proposed Regulations continue to contain Example 5, revised to include the sale of an apartment building rather than a condo unit. Nevertheless, the contract still contains the same two-percent deposit and is still classified as a long-term contract, which will continue to call into question the argument that a construction contract coupled with a small deposit should be regarded as an option agreement and not as a long-term contract that is subject to mandatory PCM reporting under Code Sec. 460. Finally, a condo developer may account for income and losses under PCM, with the unenviable result of paying tax on money it has not yet received. Until the Proposed Regulations are finalized, condo developers will continue to face the same uncertainty as they have since Code Sec. 460 was enacted in 1986.

ENDNOTES

2 All references to the "Code" are to the Internal Revenue Code of 1986, as amended, and all *Reg. §§* references are to the Treasury regulations issued thereunder.
4 Reg. §1.6694–4(b)(1).
5 Reg. §1.6694–4(b)(5).
6 Nicholas Nehamas, Tax Confusion Creates "Serious Financial Headache" for South Florida Condo Developers, Miami Herald, June 17, 2015.
7 For example, in Florida, Fla. Stat. §718.202 requires a condo developer to pay into an escrow account all payments up to 10 percent of the sale price received by the developer from the buyer towards the sale price.
8 73 FR 45180 (Aug. 4, 2008).
9 Nehamas, supra note 6.

This has the effect of allowing each condominium unit to be treated as a separate building for purposes of determining whether the underlying contract qualifies as a home construction contract. It is no coincidence that the Proposed Regulations were released during 2008, in the midst of the aforementioned Great Recession, to alleviate the financial woes confronting condo developers in a