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Suggested Questions and Answers Regarding Section 6661, Substantial Understatement of Liability as Enacted by the Tax Equity and Fiscal Responsibility Act of 1982

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

FEDERAL TAX DIVISION

SUGGESTED QUESTIONS AND ANSWERS

REGARDING

SECTION 6661, SUBSTANTIAL UNDERSTATEMENT OF LIABILITY

AS ENACTED BY THE

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

DECEMBER 21, 1982

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A. DEFINITION OF SUBSTANTIAL UNDERSTATEMENT

An understatement of income tax for a taxable year is substantial if it exceeds the greater of (a) 10% of the tax required to be shown on the return or, (b) $5,000 ($10,000 for corporation other than Subchapter S corporations and personal holding companies). An understatement is defined as an amount by which the tax required to be shown on the return exceeds the tax imposed which is shown on the return. The amount of the understatement is reduced by an amount attributable to either:

(1) the treatement of an item for which there is or was substantial authority, or

(2) an item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached thereto.

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1) Q. Taxpayer's individual return was examined; three separate issues were developed and remained unagreed at the agent level. The deficiency was $6,000, which was also in excess of 10% of the tax as redetermined, assumed to be $25,000.

Subsequently, at Appeals Division level, the taxpayer and Appeals officer agreed to a settlement which eliminated one issue, compromised on another, and accepted the third. This settlement reduced the deficiency to $3,000. Would the §6661 (a) penalty be applied?

A. No. The understatement is less than the statutory threshhold of $5,000.

2) Q. If the taxpayer had submitted an amended return, prior to the inception of the examination, which increased the tax paid by $3,000, would the penalty apply?

A. No. The understatement would be less than the statutory threshhold. An understatement is the amount by which the tax required to be shown on the return exceeds the tax imposed which is shown on the return including any such amended returns. An amended return filed prior to the inception of an examination will be considered <u>the</u> return for purposes of §6661.

B. DEFINITION OF SUBSTANTIAL AUTHORITY

The amount of any understatement attributable to a non-tax shelter item is not subject to the §6661 penalty if the taxpayer had or has "substantial authority" for the tax treatment of the item (§6661(b)(2)(B)(i)). The substantial authority standard was chosen by Congress in part because it is a new term of art and, therefore, susceptible of interpretation in a manner consistent with the purpose of the new provision. The Conference Report indicates that a taxpayer has substantial authority when the weight of authorities that support his position are substantial in comparison to those which support other positions. The standard is less stringent that the "more likely than not" standard applicable to tax shelters but more stringent than a "reasonable basis" standard. The Conference Report states that a "reasonable basis" is a position that is arguable, but fairly unlikely to prevail in court... (_H._ _Conf._ _Rep._ _No._ 97-760, 97th Cong., 2nd Sess. at 574-576 - hereinafter "_Conf._ _Rep._").

The substantial authority standard does not require a taxpayer to predict which position will ultimately prevail nor does it require that the taxpayer reasonably believe that he will prevail. Rather, it only requires an accumulation of authorities which are substantial when compared to authorities which support an opposing position. Thus, contrary positions can each have substantial authority.

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1) Q. If the taxpayer relied on a single lower court decision could such a decision constitute substantial authority?

A. Yes, assuming no overwhelming authority in opposition.

2) Q. Can the taxpayer rely on the conclusions reached in published (periodical) literature as substantial authority in opposition to regulations, rulings or settled cases?

A. No. A conclusion reached in published (periodical) literature does not in and of itself represent substantial authority.

3) Q. Taxpayer takes a position on a tax return which has been litigated and favorably decided in several jurisdictions. However, the prevailing case in his own jurisdiction supports the IRS position. Is there substantial authority for the taxpayer's position?

A. Yes. Since the matter has not been finally adjudicated and since taxpayers have prevailed in more than an isolated case, the taxpayer has substantial authority and may avoid the imposition of the penalty.

4) Q. Same facts as above, except most jurisdictions hold for the IRS but taxpayer's jurisdiction sustains the taxpayer's position. Is there substantial authority?

A. Yes. Whereas it is clear that isolated support in a court decision will not ordinarily constitute substantial authority if the bulk of litigation goes the other way, there would be an exception for an isolated decision in the taxpayer's own jurisdiction because of the

extra weight and significance which would be given to his position by the court that would hear his case. Thus, a taxpayer's position will be considered to have substantial authority if it is supported either by more than an isolated case outside his jurisdiction or by the prevailing case within his own jurisdiction.

C. NO AUTHORITY ON A QUESTION OF FACT

The substantial understatement of liability penalty will apparently apply to a question of fact as well as a question of law. Under what circumstances will the Service impose the penalty where there is a difference between the taxpayer and the Service as to a question of fact?

The Senate Finance Committee Report on TEFRA indicates that Congress did not intend the substantial understatement penalty to apply where there are reasonable differences of view on issues other than tax shelter issues (S. Rep. No. 97-494, 97th. Cong., 2d Sess. 273 (1982) - hereinafter ("S. Rep."). However, where the difference is the result of an unreasonable treatment of the facts by taxpayer, the penalty will apply.

1) Q. Taxpayer sold investment real estate, and paid the attorney who arranged the sale a finder's fee of $75,000. The taxpayer's CPA advised him on the tax consequences of the sale. The attorney also gave some tax advice which had a value of no more than $500. However, he billed the taxpayer $75,000 for "tax consulting service," and the taxpayer reported this amount on his return as an ordinary deduction rather than as an expense of the sale of the property. Assuming the quantitative tests are met, would a 10% penalty be imposed with respect to the deduction?

A. Yes. Taxpayer knew the attorney did not provide any significant tax consulting services, and thus lacked a reasonable basis for claiming this amount as an ordinary deduction.

D. ADEQUATE DISCLOSURE

The amount of any understatement attributable to a non-tax shelter item is not subject to the §6661 penalty if the taxpayer adequately discloses the relevant facts affecting the item's tax treatment in the return or in a statement attached to the return. What will constitute adequate disclosure of the relevant facts?

The Senate Finance Committee Report indicates that an item is "adequately disclosed" within the meaning of §6661 if the item is disclosed in such a way as to apprise the Secretary of the nature of the controversy surrounding the item and the amount of such item (S. Rep. at 273-274). In other words, the taxpayer must disclose facts sufficient to enable the Internal Revenue Service to identify the potential controversy if it analyzed the information.

Q. Taxpayer retained an attorney to provide financial planning advice, and draft his will. The attorney billed the taxpayer $10,000 for "financial planning services and preparation of will". The taxpayer deducted the $10,000 on his return describing the deduction as "attorney's fee - financial planning and preparation of will". Upon examination, the IRS maintains that only $6,000 of the attorney's fee is deductible as an expense incurred "in connection with the determination, collection, or refund of any tax" and, therefore, disallows $4,000 of the deduction. Assuming the quantitative tests are met, would a §6661 penalty be imposed?

A. No. The taxpayer's description would be sufficient disclosure of the nature and amount of the item to avoid a

penalty with respect to the deduction.

Q. Taxpayer reports as long-term capital gain on his return the gain from the sale of 12 lots, listing specific acquisition and sales dates for each lot. The IRS determines that, in spite of the fact that the lots were not part of a single subdivision or master plan, the taxpayer was in the business of buying and selling lots. Was there adequate disclosure on the return?

A. Yes. The taxpayer, by separately listing and properly identifying each transaction, has disclosed to the IRS, the nature of his activity and has made, by his classification as capital gain, a statement that the lots represented separate capital assets. His failure to sustain such position does not warrant the imposition of a §6661 penalty.

3) Q. An officer and sole shareholder of corporation X is paid $300,000 per year as compensation for his services. The amount of the officer's salary and percent of his stockholdings are properly reported on Schedule E of X's Form 1120, and "Time Devoted to Business," has been answered "Part." In fact, the officer's corporate duties and management responsibilities are limited to attending weekly staff meetings and reviewing annual budgets with the other corporate officers. Assume further that the officer only devotes 10% of his actual business time to corporate affairs. Has the Corporation adequately disclosed the relevant facts concerning the issue of unreasonable compensation?

A. Yes. The taxpayer has disclosed that the officer devotes "part" of his time to corporate affairs. Since neither the form nor the instructions call for time devoted to business to be expressed as a percentage, the response "part" is sufficient to enable the Internal Revenue Service to identify the issue of unreasonable compensation.

E. DISCLOSURE "IN THE RETURN"

An item is "adequately disclosed" if it is disclosed in the return in such a way as to apprise the Secretary of the nature of the controversy surrounding the item and the amount of such item (S. Rep. at 273-275). The Secretary is empowered to prescribe the form of such disclosure (Conf. Rep. at 575-576). A partnership's Form 1065 may reflect both tax shelter and non-tax shelter items.

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1) Q. A partnership adequately discloses the relevant facts concerning the tax treatment of a non-tax shelter item in its Form 1065. A partner in the partnership relies on the information in his Form 1065 Schedule K-1 in preparing his individual income tax return, but does not disclose in his return the facts concerning the non-tax shelter item disclosed in the Form 1065. The partnership return is audited by the IRS in a later year and an adjustment attributable to the non-tax shelter item results in a substantial understatement of the partner's tax liability. Has the tax treatment of the non-tax shelter item been adequately disclosed so that the penalty will not be imposed on the partner?

A. Yes. In the present case, the partnership has decided on the tax treatment for a non-tax shelter item. The partnership is, therefore, in the best position to understand the nature of the controversy and decide which facts to disclose. Adequate disclosure at the partnership

level with respect to a non-tax shelter item will be considered adequate disclosure for purposes of application of §6661 to the individual partner.

F. <u>CLASSIFICATION AS A TAX SHELTER</u>

A tax shelter is generally defined in §6661(b)(2)(C)(ii) as any plan or arrangement if the principal purpose of the plan or arrangement is the avoidance or evasion of income taxes.

The Conference Report states that investors are subject to a higher standard of care where the principal purpose of an investment is the avoidance or evasion of income taxes (<u>Conf. Rep</u>. 576). The principal purpose of a transaction is a question of fact. In this context, "the principal purpose" refers to the motivation for marketing the plan or arrangement. It is not necessary, however, that reduction of income taxes be the sole motivation. Thus, an investment is a "tax shelter" for purposes of §6661 where the tax benefits to be derived are the primary reason for the investment.

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1) Q. A partnership plans to acquire residential real estate which it will operate as rental property. The project consists of 250 condominium units and the builder agrees to sell all the units at $50,000 per unit in a bulk sale to a real estate developer (at a total price of $12,500,000) with a $1,000,000 downpayment and a purchase money mortgage of $11,500,000. The developer immediately agrees to sell all the units to the partnership for $20,000,000. The terms of sale are a down payment of $1,000,000, an assumption by the partnership of the purchase money mortgage of $11,500,000, and a non-recourse second mortgage of $7,500,000. If the cash flow is insufficient to pay all required debt service on both mortgages,

payments on the second mortgage will be deferred and ultimately are only payable out of proceeds of sale or refinancing. Initial rental income will be insufficient to make any current payments on the second mortgage. Assume that it is anticipated that the investment will result in substantial tax benefits for each partner. Will the partnership be a "tax shelter" for purposes of §6661?

A. Yes. Although the negative cash flow does not in and of itself cause the transaction to be considered a tax shelter, the purchase of the project for a price of $20,000,000, coupled with the non-recourse and non-current payment terms of the second mortgage, indicates that the principal purpose of the transaction is the avoidance of income taxes. In addition, the fact that the initial rental income is insufficient to make any current payments on the second mortgage also indicates that the principal purpose of the transaction is the avoidance of income taxes. While no single factor is determinative, all factors considered together establish that this is a "tax shelter" for which a more stringent standard under §6661 is applied.

2) Q. A publicly-syndicated, limited partnership will construct and operate residential real estate. The offering memorandum contains a feasibility study which states that the property will not initially generate sufficient funds to pay all debt service. The general partner agrees to fund negative cash flow for a period of three years. In addition, the study states that investors may expect significant

appreciation in the value of the property, if a requested change in zoning is approved. The offering memorandum indicates that each investor should anticipate substantial tax benefits. Will the partnership be a tax shelter for purposes of §6661?

A. No. This investment is expected to produce substantial economic benefits in addition to anticipated tax benefits. It does not appear that the principal purpose of the investment is the reduction of tax. Rather, the economic and tax benefits seem, from the objective evidence presented, to be of equal importance. Thus, the investment is not a tax shelter for purposes of §6661 as the principal purpose of the investment is not the avoidance of tax.

3) Q. Taxpayer is the principal shareholder in a corporation which was merged into another corporation under a plan intended to qualify as a tax-free reorganization. A major purpose of the merger was to offset projected losses of the acquired corporation against income of the acquiring corporation. An examining agent determines that the reorganization has no business purpose, and that the exchange is therefore, taxable. Is this a "tax shelter" as defined in §6661(b)(2)(C)(ii)?

A. No. Investments not ordinarily considered "tax shelters" would be excluded for purposes of §6661. Excluded from the term "tax shelter" are investments such as, but not limited to, "municipal bonds; annuities; family trusts; qualified retirement plans; individual retirement accounts;

stock option plans; securities issued in a corporate reorganization; mineral development ventures, if the only tax benefit would be percentage depletion".(see Section 10.33(c)(2) Treasury Circular No. 230).

Q. EXISTING "TAX SHELTERS" - WAIVER OF PENALTY

The substantial understatement penalty is effective with respect to returns with a due date (determined without regard to extensions) after December 31, 1982. The amount of any underpayment attributable to a tax shelter item can be reduced for purposes of §6661 where the taxpayer reasonably believed that the tax treatment was "more likely than not" the proper treatment and there is substantial authority for the position. In the alternative, the penalty may be waived by the Secretary, in whole or in part, where there was a reasonable cause for the understatement and the taxpayer acted in good faith.

1) Q. In 1980 a taxpayer purchased a limited partnership interest in an investment classified as a "tax shelter" for purpose of §6661. The prospectus contained a tax memorandum written by an attorney which stated that there was a "reasonable basis" to amortize certain expenditures over a three year period, although the IRS might assert a longer amortization period. In order to prepare his 1982 tax return, the taxpayer relies on a schedule K-1 (form 1065) prepared by the partnership for 1982. The IRS, upon audit at later time, extends the amortization period. The change in partnership income results in a substantial underpayment of taxpayer's tax liability for 1982. Will the substantial underpayment penalty be imposed on the taxpayer where he relies on the schedule K-1?

A. No. In this case, the taxpayer, in good faith, relied on schedule K-1 which indicated his distributive share

of partnership income. The taxpayer's interest was purchased in 1980, over two years before the effective date of §6661. The penalty will be waived because the taxpayer, at the time of investment, believed in good faith that there was a reasonable basis for the position taken under rules applicable at the time of investment.

H. WAIVER OF PENALTY - GENERAL

As indicated in Section I, the Secretary may waive the §6661 penalty where there was reasonable cause for the understatement and where the taxpayer acted in good faith. These exceptions were enacted to prevent application of the penalty to taxpayers who, in good faith, attempt to comply with the provisions and interpretations of the Internal Revenue Code. Indeed, the Senate Finance Committee recognized that the "taxpayers and the Government may differ over the sometimes complex Federal tax laws and that a penalty is not appropriate . . . in many cases in which there is a large underpayment" (S. Rep. at 273). In other words, the penalty is directed at taxpayers who take questionable, though non-negligent positions, in order to win the "audit lottery" (S. Rep. at 272-273).

1) Q. A taxpayer engages in a unique transaction for which no judicial, regulatory, or statutory authority is available on either side of the tax issue. Further, assume that the taxpayer did not adequately disclose the facts relating to the item. Also assume for this purpose that the taxpayer neither had nor has substantial authority in support of his position. Taxpayer's tax advisor, however, drafted a detailed and well-reasoned memorandum based on some decisions covering somewhat analogous transactions, which concludes that the proposed tax treatement will "more likely than not" be the proper tax treatment. The taxpayer does not disagree with the

tax advisor's opinion. Will any potential penalty be waived?

A. Yes. In the present case, a competent tax advisor has rendered a detailed and well-reasoned memorandum which concludes that the proposed tax treatment is "more likely than not" the proper tax treatment. It was reasonable for the tax advisor to rely on analogies and indirect authorities in the absence of existing authority directly on point. It was also reasonable for the taxpayer to rely on the tax advisor's opinion. There was, therefore, reasonable cause for the understatement, and the taxpayer acted in good faith. Accordingly, the penalty for understatement of a tax liability will be waived.

2) Q. Assume that a U.S. Corporation forms a Puerto Rican manufacturing subsidiary and establishes an intercompany price for sales to and from that subsidiary comparable to what it believes, in good faith, would be an arm's length price. Little or no authority exists, however, for the parent's pricing decision because industry data is considered proprietary and few pricing cases have been litigated with the IRS. Assume further that an understatement of income tax within the meaning of §6661 results when the IRS redetermines the company's transfer prices under §482. The taxpayer agrees to the adjustment. Will the corporation be subject to the §6661 penalty?

A. No, assuming certain guidelines are met. Congress has, enacted penalties to discourage overvaluations in other types of situations. For example, §6700 provides that a

penalty be imposed on certain persons if such person furnishes a valuation statement concerning property of services where the stated value exceeds 200% of the correct value. Further, §6659 provides that a penalty may be imposed on certain taxpayers where the stated value of the property exceeds the correct value by more than 150%. These penalties discourage overvaluations by aggressive taxpayers who play the "audit lottery."

Accordingly, as a matter of adminstrative convenience, and in order to provide taxpayers and IRS agents with objective guidelines, the §6661 penalty for substantial understatement of tax will be waived where the transfer price did not exceed 200% of the correct value of property or services if such transfer price was rendered in good faith. This "200% waiver rule" will be applied in the aggregate and not on an item by item basis. For example, if the stated transfer price of one item exceeded 200% of the redetermined price and the original stated price of another item was less than 200% of the redetermined price, then the aggregate original stated prices will be compared with the aggregate redetermined prices to determine whether the "200% waiver rule" is violated.

3) Q. Assume the same facts as in the question above. Assume further that the substantial understatement of tax penalty was waived because the taxpayer, in good faith, did not overstate the value of the property or services by more than 200%. Further, assume that the taxpayer used the original stated values for the transfer prices

in the taxable year following the year in which it agreed to the IRS redeterminations. Adequate disclosure of all the relevant facts regarding the issue was not made in the tax return for such year. A significant change of facts concerning the valuation of property had not otherwise occurred. Will the corporation be subject to the §6661 penalty?

A. Yes. The taxpayer continued to use the original stated transfer prices after agreeing with the IRS' redetermination of the prices incident to the examination of that prior year's return. This action was taken without a significant change of facts concerning the valuation of the property. Thus, the taxpayer did not value the property in good faith in such subsequent year, and therefore the understatement of tax penalty will apply regardless of whether the "200% waiver test" was violated.

4) A. Taxpayer undergoes substantial remodeling and renovation of his factory facility during the year. Upon examination, the IRS questions whether twenty separate items represent repair expenses or capital expenditures. At the Appellate level, the IRS sustains its position on some of the items and the taxpayer on others. The taxpayer, other than arguing the reasonableness of classification of the expenditures, offers no independent substantial authority for the items which are disallowed. Should the penalty be applied?

A. No. General business practices and a reasonable interpretation of facts should warrant waiver of the §6661

penalty.

5) Q. The taxpayer is examined in 1980 and the agent challenges the taxpayer's allocation between land and building of the proceeds of the sale of real estate, and proposes to treat a portion of the gain, originally reported as capital gain, as ordinary income. However, at Appellate conference that particular issue was conceded by IRS, whereas other unrelated issues are conceded by the taxpayer. In 1982, taxpayer sells similar real estate and uses the same allocation. This allocation is again challenged and the IRS ultimately prevails. Would a waiver of the §6661 penalty be appropriate in these circumstances?

A. Yes. The fact that the taxpayer had used that approach recently and had it approved by the IRS would not necessarily be substantial authority. However, the taxpayer's good faith reliance on the previous settlement would warrant waiver of the penalty.

6) Q. Same as above, except the favorable treatment was on the tax return of another taxpayer. Would a waiver of the §6661 penalty be appropriate in these circumstances?

A. Yes. Although the IRS's unpublished position on one taxpayer in and of itself has no relevance to any other taxpayer and does not, therefore, represent substantial authority, the taxpayer's good faith reliance on an unpublished position would warrant waiver of the penalty.