

Rev. Proc. 2004-73

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2003-77, 2003-2 C.B. 964, and identifies circumstances under which the disclosure on a taxpayer's return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under section 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under section 6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply with respect to any other penalty provisions (including the negligence or disregard provisions of the section 6662 accuracy-related penalty).

This revenue procedure applies to any return filed on 2004 tax forms for a taxable year beginning in 2004, and to any return filed on 2004 tax forms in 2005 for short taxable years beginning in 2005.

SEC. 2. CHANGES FROM REV. PROC. 2003-77

.01 Section 4.01(1) clarifies that if a taxpayer discloses an item on a line of a form or schedule that does not have a preprinted description identifying that item, then the taxpayer must enter the description on that line.

.02 Section 4.01(3) concerning Form 1120, *Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return*, is expanded by adding a reference to the new Schedule M-3, *Net Income (Loss) Reconciliation For Corporations With Total Assets of \$10 Million or More*, with regard to its Column (b), *Temporary Difference*, and Column (c), *Permanent Differences*, in Parts II and III. The treatment of the Schedule M-1 is also clarified by removing the reference to "netting" and describing the extent of the protection provided by an entry on the schedule. A conforming clarification is made at section 4.01.

.03 Editorial changes have been made in updating Rev. Proc. 2003-77.

SEC. 3. BACKGROUND

.01 Under section 6662(b)(2), section 6662 applies to the portion of an underpayment of tax that is attributable to a substantial understatement of income tax. If section 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20 percent of the portion of the underpayment to which the section applies is added to the tax. (The penalty rate is 40 percent in the case of gross valuation misstatements under section 6662(h).)

.02 Section 6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return for the taxable year or \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). Section 6662(d)(2) defines

an understatement as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate (within the meaning of section 6211(b)(2)).

.03 In the case of an item not attributable to a tax shelter, section 6662(d)(2)(B)(ii) provides that the amount of the understatement is reduced by the portion of the understatement attributable to any 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 to the return, and there is a reasonable basis for the tax treatment of the item by the taxpayer.

.04 Section 6694 imposes a penalty of \$250 on an income tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position for which the preparer knew or should have known that there was not a realistic possibility of being sustained on the merits and the position was not disclosed in accordance with section 6662(d)(2)(B)(ii).

.05 In general, this revenue procedure provides guidance for determining when disclosure is adequate for purposes of section 6662(d)(2)(B)(ii) and section 6694(a)(3). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the money amounts entered on these forms must be verifiable. Guidance under section 6662(d)(2)(B)(ii) and section 6694(a)(3) for returns filed for 2003, 2002, and 2001 is provided in Rev. Proc. 2003-77; Rev. Proc. 2002-66, 2002-2 C.B. 724; and Rev. Proc. 2001-52, 2001-2 C.B. 491, respectively.

SEC. 4. PROCEDURE

.01 Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income

tax under section 6662(d) (except as otherwise provided in section 4.01(3) concerning Schedules M-1 and M-3), provided that the forms and attachments are completed in a clear manner and in accordance with their instructions. The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form. Where the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an "Other Expense" category) the taxpayer must clearly identify the item by including the description on that line; e.g., to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written or typed on the line of Schedule C that shows the amount of the bad debt.

(1) Form 1040, Schedule A, *Itemized Deductions*:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

(c) Interest Expenses: Complete lines 10 through 14, supplying all required information. This section 4.01(1)(c) does not apply to (i) amounts disallowed under section 163(d) unless Form 4952, *Investment Interest Expense Deduction*, is completed, or (ii) amounts disallowed under section 265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Enter the amount of the gift reduced by the value of any substantial benefit (goods or services) provided by the donee organization in consideration, in whole or in part. Entering the amount of the gift unreduced by the value of the benefit received will not constitute adequate disclosure. If a contribution of \$250 or more is made, this section will not apply unless a contemporaneous written acknowledgment, as required by section 170(f)(8), is obtained from the donee or-

ganization. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds \$500, attach a properly completed Form 8283, *Noncash Charitable Contributions*, to the return.

(e) Casualty and Theft Losses: Complete Form 4684, *Casualties and Thefts*, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section, the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.01(1)(e) must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or non-deductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, *Compensation of Officers*, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section does not apply to "golden parachute" payments, as defined under section 280G. This section will not apply to the extent that remuneration paid or incurred exceeds the \$1 million-employee-remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Differences in book and income tax reporting.

(a) Form 1120, Schedule M-1, *Reconciliation of Income (Loss) per Books With Income per Return*, and

(b) Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More*, Form 1120: Column (b), *Temporary Difference*, and Column (c), *Permanent Difference*, of Part

II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

The information provided reasonably must be expected to apprise the Service of the nature of the potential controversy concerning the tax treatment of the item. If the information provided does not so apprise the Service, a Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, must be used to adequately disclose the item (see Part II of the instructions for those forms).

Note: An item reported on a line with a pre-printed description, shown on an attached schedule, or "itemized" on Schedule M-1 may represent the aggregate amount of several transactions producing that item (i.e., a group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business). In some instances, the potentially controversial item may involve a portion of the amount disclosed on the schedule. The Service will not be reasonably apprised of the potential controversy by the amount disclosed. In these instances, the taxpayer must use Form 8275 or Form 8275-R regarding that portion of the item.

The combining of unlike items will not constitute an adequate disclosure.

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, *International Boycott Report*. Schedule A, *International Boycott Factor* (section 999(c)(1)); Schedule B, *Specifically Attributable Taxes and Income* (Section 999(c)(2)); and Schedule C, *Tax Effect of the International Boycott Provisions*, must be completed when required by their instructions.

(b) Treaty-Based Return Position: Transactions and amounts under section 6114 or section 7701(b) as disclosed on Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*.

(5) Other:

(a) Moving Expenses: Complete Form 3903, *Moving Expenses*, and attach to the return.

(b) Employee Business Expenses: Complete Form 2106, *Employee Business Expenses*, or Form 2106-EZ, *Unreim-*

bursed Employee Business Expenses, and attach to the return. This section does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on the trip.

(c) Fuels Credit: Complete Form 4136, *Credit for Federal Tax Paid on Fuels*, and attach to the return.

(d) Investment Credit: Complete Form 3468, *Investment Credit*, and attach to the return.

SEC. 5. REQUEST FOR COMMENTS

The Service invites comments from the public on issues relating to Schedule M-3 in section 4.01(3). In particular, the Service requests comments addressing whether the adjustments to arrive at line 11, Part I of the schedule, *Net income (loss) per income statement of includible corporations*, may provide an adequate

disclosure, and whether the condition that the Internal Revenue Service be apprised of the nature of the potential controversy is necessary for the Schedule M-3. Written comments should be submitted by June 30, 2005, to CC:PA:LPD:RU (Rev. Proc. 2004-73), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered between the hours of 8 a.m. and 4 p.m., Monday through Friday to CC:PA:LPD:RU (Rev. Proc. 2004-73), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, D.C. Alternatively, comments may be submitted electronically via e-mail to the following address: "Notice.Comments@irscounsel.treas.gov" using the subject line "Rev. Proc. 2004-73." All comments will be available for public inspection.

SEC. 6. EFFECTIVE DATE

This revenue procedure applies to any return filed on a 2004 tax form for a taxable year beginning in 2004, and to any return filed on a 2004 tax form in 2005 for a short taxable year beginning in 2005.

SEC. 7. DRAFTING INFORMATION

The principal author of this revenue procedure is John Moran of the Office of the Associate Chief Counsel, Procedure & Administration (Administrative Provisions & Judicial Practice Division). For further information regarding this revenue procedure, contact Branch 2 of the Administrative Provisions & Judicial Practice Division at (202) 622-4940 (not a toll-free call).