Rev. Proc. 2022-39: Collaboration Salvages Special Penalty-Avoidance Rules for Large Entities

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I. Introduction

The Internal Revenue Service ("IRS") has recently suffered several attention-grabbing court defeats, primarily for exceeding its authority, ignoring procedures mandated by Congress, and excluding the public from the rule-making process. These losses center on the Administrative Procedures Act ("APA"), a longstanding law that generally requires agencies, like the IRS, to follow a three-step procedure when issuing guidance. They must notify the public about the proposed rulemaking, allow interested persons to provide input by submitting comments or participating in hearings, and feature in the final rule an explanation of its "basis and purpose."

This article describes the *normal rules* for filing a qualified amended return ("QAR") with the IRS to avoid penalties, as well as the *special rules* for large corporations and partnerships. In doing so, the article chronicles the evolution of the special rules, from their introduction in 1985 to their modification in 1994, and their salvation in 2022 thanks to extensive public input and the IRS's willingness to listen. This article concludes that, aside from being required in many situations, adhering to the APA or similar procedures is a good practice for the IRS, taxpayers, and the tax system as a whole.

II. Post-Filing Corrections—General Rules

One must first understand the normal QAR rules in order to appreciate the special rules applicable to certain large corporations and partnerships.

A. Overview of Relevant Rules

In situations where a tax underpayment is attributable to one of several things, the IRS generally can assert an accuracy-related penalty.[1] The standard penalty is 20 percent of the underpayment amount.[2]

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In the case of an *individual* taxpayer, an "underpayment" generally means the difference between the tax liability that the taxpayer reported on his Form 1040 (*U.S. Individual Income Tax Return*) and the tax liability that should have been reported if the taxpayer had correctly completed his Form 1040.[3] For instance, where the taxpayer's true tax liability was $100,000 but he only reported $80,000 on his Form 1040, then the IRS ordinarily could assert a penalty of $4,000 (*i.e.*, a $20,000 tax understatement multiplied by 20 percent).[4]

The courts have ruled in each instance that the IRS disregarded the mandatory three-step procedure or otherwise surpassed its authority.

An obscure mechanism exists whereby taxpayers can eliminate the tax "underpayment" *after* filing the original Form 1040 with the IRS. Enter the QAR. In essence, if an individual taxpayer files a Form 1040 and later realizes that it showed a tax underpayment, he has a limited opportunity to submit a QAR to rectify the situation proactively and avoid penalties. The taxpayer obtains the benefit in the following manner: The tax liability shown on the original Form 1040 is deemed to include the amount of additional tax reflected on the subsequent QAR.[5] Modifying the basic example above, if the taxpayer filed a Form 1040 showing a tax liability of $80,000 but subsequently submitted a QAR indicating a revised liability of $100,000, then no "underpayment" would exist, and the IRS would thus have no grounds for asserting an accuracy-related penalty.

The purpose of the original QAR rules was "to encourage voluntary compliance by permitting taxpayers to avoid accuracy-related penalties by filing a [QAR] before the IRS begins an investigation of the taxpayer or the promoter of a transaction in which the taxpayer participated."[6]

B. Meeting the QAR Parameters

One of the biggest challenges for taxpayers, of course, is convincing the IRS and the courts that the Form 1040X (*Amended U.S. Individual Income Tax Return*) they filed constitutes a QAR.[7] The IRS has modified the standards over time because it believed the earlier version of the rules might "encourage taxpayers to delay filing [QARs] until after the IRS has taken steps to identify taxpayers as participants in potentially abusive transactions."[8] In other words, the IRS wanted to "discourage the wait-and-see approach of some taxpayers."[9]

A Form 1040X will *not* be a QAR, *unless* the taxpayer files it *before* any of the following[10]:

- The date on which the IRS contacts the taxpayer concerning a civil examination or criminal investigation with respect to Form 1040.[11]
- The date on which the IRS contacts "any person" concerning a tax shelter promoter investigation under Code Sec. 6700 for an activity with respect to which the taxpayer claimed any tax benefit on Form 1040 directly, or indirectly through an entity, plan, or arrangement.[12]
- In the case of items attributable to a pass-through entity (*e.g.*, partnership, subchapter S corporation, estate, trust, regulated investment company, real estate investment trust, or real estate mortgage investment conduit), the date on which the IRS first contacts the passthrough entity in connection with the civil examination of the relevant return, such as Form 1065 (*U.S. Return of Partnership Income*).[13]
- The date on which the IRS serves a Summons relating to the tax liability of a person, group, or class that includes the taxpayer with respect to an activity for which the taxpayer claimed any tax benefit on his Form 1040, directly or indirectly.[14]
- The date on which the IRS announces a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction, and the taxpayer participated in the listed transaction during the relevant year.[15]

An expanded set of criteria applies in situations involving "undisclosed listed transactions," which means transactions that are the same as, or substantially similar to, a listed transaction, and that were not revealed to the IRS on Form 8886 (*Reportable Transaction Disclosure Statement*).[16]

C. Sample Court Decisions

Taxpayers often face challenges in convincing the courts that what they filed with the IRS constitutes a QAR. Here are just a few examples. In *Perrah v. Commissioner*, the Tax Court rejected QAR status because Forms 1040X were filed with the Service Center after the IRS had commenced an examination of the taxpayer.[17] Likewise, in *Wilkerson v. Commissioner*, the Tax Court refused to classify Forms 1040X as QARs when the taxpayer filed them with the Appeals Office after the IRS issued a Notice of Deficiency

and after the taxpayer filed a Petition with the Tax Court.[18] Finally, in *Bergmann v. Commissioner*, the Tax Court held that the taxpayer had not filed QARs, because, by the time Forms 1040X reached the IRS, it had already started a promoter investigation and issued Summonses related to the pertinent transactions and years.[19]

III. Authority to Modify QAR Rules

Despite the strict rules described above for satisfying the QAR standards, the IRS Commissioner has the authority to make exceptions. The regulations state the following in terms of administrative flexibility: "The Commissioner may by Revenue Procedure prescribe the manner in which the rules ... about [QARs] apply to particular classes of taxpayers."[20] The following segment of this article explains how the Commissioner has exercised this authority for many decades when it comes to large entities.

IV. Post-Filing Corrections—Special Rules

Some large entities, as determined by the size of their gross revenue, assets, or other criteria, were unable to file QARs for logical reasons. The main impediment was that they were subject to the Coordinated Examination Program, which featured continuous audits by the IRS, year, after year, after year. The audits essentially never ended, with years and issues overlapping. As explained above, an amended return for a particular year ordinarily will *not* be considered a QAR, *unless* the taxpayer files it *before* the IRS contacts the taxpayer concerning a civil examination of the relevant year.[21] Large entities exposed to constant scrutiny by the IRS were prohibited, for all practical purposes, from filing QARs. The IRS recognized this conundrum and took steps to address it. The multi-decade evolution follows.

A. Rev. Proc. 85-26

The IRS began by issuing Rev. Proc. 85-26. Its objective was to introduce a "special procedure" for taxpayers exposed to the Coordinated Examination Program to report additional tax liabilities *or* make adequate disclosure of an item to the IRS in order to obtain automatic waiver of penalties imposed under former Section 6661 for "substantial understatements of income."[22]

The IRS noted in Rev. Proc. 85-26 that a QAR generally means an amended return filed before the IRS contacts a taxpayer about an examination. When it came to taxpayers falling within the Coordinated Examination Program, the IRS realized that such a standard was inappropriate because it examined *all* returns and it was unclear whether a statement submitted to the Revenue Agent at the start of an examination constituted a QAR.[23] Therefore, the IRS created new rules for large taxpayers suffering continuous examinations pursuant to the Coordinated Examination Program.

Rev. Proc. 85-26 established that large entities could file a written disclosure statement with the Revenue Agent within a certain period, and such a statement would constitute a QAR under certain conditions. First, the taxpayer had to file the statement within 10 days of the earliest of receipt of the examination notice, the first meeting with the Revenue Agent, or the first written request from the IRS for information in connection with the examination.[24] Second, the statement had to reference Rev. Proc. 85-26, adequately describe the nature and amount of all items that would result in adjustments to the original tax return, and be signed under penalties of perjury.[25] As long as the written statement met all requirements, tax liabilities declared and items described in the statement would be treated as shown on a QAR.[26]

Rev. Proc. 85-26 applied to returns whose original due date was January 1, 1983, or later.[27]

B. Rev. Proc. 94-69

Congress later repealed or amended the relevant penalty provisions, so the IRS needed to update the protections for large entities subject to the Coordinated Examination Program. It did so by publishing Rev. Proc. 94-69.

The new IRS guidance indicated that large entities subject to the Coordinated Examination Program could avoid certain accuracy-related penalties by providing a written statement to the Revenue Agent within 15 days of a request.[28] The statement had to reference Rev. Proc. 94-69, adequately describe the nature and amount of all items that would result in adjustments to the original tax return, and be signed under penalties of perjury.[29] The IRS elaborated on the description parameters this go around. It stated that the description of an item would be adequate only if it contained information that "reasonably may be expected to apprise the [IRS] of the identity of the item, its size, and the nature of the possible dispute." For instance, a statement about certain items that the taxpayer originally deducted as current expenses but should have capitalized would be adequate only if the statement "refers to specific accounts and amounts recorded in invoices or journal entries."[30] Rev. Proc. 94-69 explained that all items adequately disclosed in a timely written statement

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would be considered additional tax liabilities reflected on a QAR.[31]

The effective date of Rev. Proc. 94-69 was October 31, 1994.[32]

C. Cases and Rulings about Disclosure

Court cases and IRS rulings addressing substantive issues related to post-filing disclosures by large taxpayers under Rev. Proc. 85-26 or its replacement, Rev. Proc. 94-69, are scarce. Here are a few.

Intertan, Inc. v. Commissioner dealt with a penalty for an alleged tax understatement of approximately $5 million related to foreign tax credits.[33] The taxpayer in that case filed its Form 1120 for the relevant year, the IRS later began an audit, and the taxpayer swiftly provided the Revenue Agent a letter referencing Rev. Proc. 94-69 and its position regarding foreign tax credits ("Disclosure Letter"). The IRS raised several arguments for asserting penalties, including that the taxpayer failed to adequately disclose its position on the initial Form 1120, because it did not enclose a Form 8275 (*Disclosure Statement*), or in the subsequent Disclosure Letter, because it did not supply sufficient information to notify the IRS of the nature of the actual or potential dispute. The taxpayer conceded that it never submitted Form 8275, but disagreed with the IRS' characterization of the Disclosure Letter. The Tax Court sided with the IRS, holding that the Disclosure Letter, "by failing to disclose *all the steps of the disputed transaction*, did not provide information that reasonably could have been expected to apprise the IRS" of the long list of actions taken to achieve the desired tax result.[34]

In a Field Service Advisory, the IRS tackled the question of whether audit personnel should agree in writing at the beginning of an examination that a taxpayer has adequately disclosed an item for purpose of Rev. Proc. 85-26. It explained that (i) no requirement exists under the law, regulations or otherwise for the IRS to stipulate to the adequacy of disclosure at the outset, (ii) the IRS cannot determine whether a taxpayer has sufficiently described the "nature" of an item until it does its own examination of the facts and law, and (iii) signing a written agreement about the adequacy of a particular disclosure before conducting an examination would cause the IRS to "sacrifice its right to impose a penalty if the disclosure is misleading or incomplete."[35]

The IRS addressed in a Program Manager Technical Advice whether a disclosure is adequate for purposes of Rev. Proc. 94-69 if it omits the "precise amounts" of the particular items, supplying instead adjustments to the total amount reported on the relevant line of Form 1120. The IRS noted that one reason for introducing the revised standards in Rev. Proc. 94-69 was that some large taxpayers previously were filing "disclosure statements that were too general for the [Revenue Agent] to adequately identify the items that the taxpayer knows have not been given the proper tax treatment." The IRS further indicated that Rev. Proc. 94-69 does not contain any exceptions to the adequate disclosure mandate. However, the IRS acknowledged that it has a certain degree of flexibility in terms of the period during which a taxpayer must accomplish adequate disclosure, because Rev. Proc. 94-69 permits extensions in situations where reasonable cause exists. The IRS thus concluded that, in cases where fixing the amount of an item requires a time-consuming computation, the IRS should permit taxpayers "sufficient time and take a liberal approach to the time limitations."[36]

The proper year in which to claim an interest expense was the key issue in a later Chief Counsel Advice. A large taxpayer under examination filed an adequate disclosure pursuant to Rev. Proc. 94-69 with the Revenue Agent in 1994, which caused a tax increase (and related interest charges) with respect to its Form 1120 for 1988. The taxpayer took the position that the interest was accruable in 1994, that is, the year in which it made the disclosure. The IRS disagreed. It concluded that the taxpayer's liability for the interest on the "agreed" tax issues and liabilities for 1988 was not "fixed and determinable" in 1994. The audit was a long, multi-year affair, involving several adjustments and amended returns. The IRS ruled that the interest amounts pertaining to 1998 were not deductible until the taxpayer and the IRS entered into a formal agreement encompassing all changes.[37]

D. Foreshadowing by Tax Professionals

Potential changes to the special QAR rules for large taxpayers were on the horizon in 2015. The annual report by Internal Revenue Service Advisory Council ("IRSAC") for that year discussed the future of Rev. Proc. 94-69 in light of the IRS' announcement that it intended to cease continuous examinations of large entities as a compliance technique.[38] IRSAC recommended that the IRS "develop a new procedure to preserve the benefits of Rev. Proc. 94-69 and, indeed, possibly expand them to a broader group of taxpayers that [while not subject to perpetual examination] could respond positively to an incentive for self-correction."[39]

Why did IRSAC make this suggestion? It speculated that taxpayers that discover an error after the fact while, say, preparing a tax return or a financial statement for a later year, would have "no incentive to correct or even disclose it" were it not for the type of penalty relief offered by Rev. Proc. 94-69.[40] Indeed, given the uncertainty of penalty abatement, combined with the costs and administrative burdens of filing a formal QAR and corresponding returns at the state and foreign levels, the number and quality of proactive corrections by taxpayers would decline, warned IRSAC.[41]

E. IRS Considers Elimination of Special Rules

Time passed and things changed, including the manner in which the IRS conducted examinations of large entities. The Coordinated Examination Program ended, and the IRS replaced it in 2019 with the Large Corporate Compliance ("LCC") program. It expanded its approach to the Large Partnership Compliance ("LPC") program soon thereafter. The most significant alteration was that continuous examinations disappeared under the two new programs. The IRS began selecting taxpayers for examination based on "risk profiles" and "data analytics" instead of their size.[42] The IRS explained that "[w]hile a small number of taxpayers may be examined in multiple consecutive years due to consecutive selection," the LCC and LPC programs are *not* premised on the assumption that large entities will be examined continuously.[43]

In light of the disappearance of continuous examinations of large entities and the creation of the LCC and LPC programs, the IRS considered eliminating the special procedures in place for decades thanks to Rev. Proc. 85-26 and, later, Rev. Proc. 94-69. The IRS observed that such procedures were only available to a small group of large entities, they created a disparity among taxpayers in terms of what they must do to achieve penalty relief, and they did not support the broader tax administration effort to improve the accuracy and reliability of original returns.[44] Moreover, emphasized the IRS, *all* taxpayers (including large entities) can file a QAR before an examination begins, make adequate disclosures to the IRS using Forms 8275, Forms 8275-R (*Regulation Disclosure Statement*), and Schedules UTP (*Uncertain Tax Position Statement*), and submit informal Claims for Refund to Revenue Agents within 30 days of the start of an audit to rectify any issues.[45]

The IRS asked the public to comment on the proposed eradication of the special penalty-avoidance procedures.[46] Interestingly, in seeking input from the public, the IRS warned that commentators should be mindful of the reasons the IRS noted for potential withdrawal of the special procedures, consider the existing avenues utilized by all taxpayers for making adequate disclosures to the IRS, and "not merely request a continuation of the [special] treatment under Rev. Proc. 94-69."[47]

F. Public Input Galore

Several groups took the IRS up on its offer to comment on the proposed deletion of the special procedures for certain large entities set forth in Rev. Proc. 94-69.

Deloitte directed several points at the IRS. It explained, for instance, that many changes that should be made after filing the original return are due primarily to external factors over which taxpayers have little or no control, including statutory and regulatory changes. It further argued that the current rules in Rev. Proc. 94-69 enhance compliance and promote transparency between taxpayers and the IRS during audits. It also pointed out that, even with the elimination of the Coordinated Examination Program, many large entities will still be targets of continuous audits based on their "risk profiles," and they will need special procedures.[48]

> *This article shows that compliance with the APA, adherence to the Policy Statement, or utilization of other forms of advance, meaningful exchanges of ideas between interested parties and the IRS can lead to positive results.*

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Mindful of the IRS' admonition not to merely request a continuation of the current treatment afforded to certain large entities under Rev. Proc. 94-69, the American Bankers Association provided a list of observations and recommendations. It first explained that the LCC program is relatively new, it is unclear at this point how many large entities will suffer continuous examinations, and waiting for more data before eliminating or replacing Rev. Proc. 94-69 would be prudent. The group further underscored that the Tax Cuts and Jobs Act, in conjunction with legislation introduced in connection with the Coronavirus pandemic, "have resulted in historic levels of

implementation guidance" in this "complex and dynamic environment." Consequently, more taxpayers than ever will need to rectify issues with the IRS, before or at the start of examinations. The American Bankers Association also highlighted that taxpayers have no legal duty to amend inaccurate or incomplete original returns, and they might not do so without the benefit of efficient, favorable procedures like those in Rev. Proc. 94-69. Finally, the organization indicated that many large entities subject to the LCC or LPC programs make investments in entities formed to syndicate low-income housing, new market, historic rehabilitation, and other tax credits. Due to the nature of these investments, the entities generating the credits often must make significant adjustments to their original returns, which flow to and affect thousands of investors. The special procedures in Rev. Proc. 94-69 allow the entities to provide the IRS, and the upstream partners, efficient, timely, and accurate updates after the original filings.[49]

KPMG took things a step further, not just suggesting preservation of Rev. Proc. 94-69, but rather an expansion of it "to a broader class of taxpayers" and "to the full range of large taxpayers that identify errors and seek to come forward to voluntarily correct them." KPMG identified several significant developments affecting tax administration since the IRS issued Rev. Proc. 94-69 a quarter century earlier: generally accepted accounting principles demand more detail and controls; business operations have gotten more complex with the use of multi-tier structures and international transactions; and tax compliance has become extremely complicated because of the constant issuance of new laws, formal and informal IRS guidance, case law, *etc.* These developments, explained KPMG, make it "even more difficult now to establish with certainty one true and correct tax liability at the time the original federal income tax return is filed." KPMG acknowledged that all taxpayers, including large entities, can avoid penalties by filing formal QARs. It underscores, however, that this triggers an obligation to file amended foreign, state, and local returns, which can be extremely costly and burdensome for entities operating in multiple jurisdictions. Finally, KPMG emphasized that most experienced Revenue Agents already exercise their discretion and use common sense when they decide not to penalize taxpayers who voluntarily bring errors or omissions to their attention amid an audit. KPMG suggested that these "best practices of wise tax administration and prudent case management should be adopted ... in the form of published guidance applicable to a broad range of taxpayers and not just those who have historically benefited from the technical application of Rev. Proc. 94-69."[50]

A coalition of tax and business associations banded together to supply observations to the IRS about the potential obsolescence of Rev. Proc. 94-69. They, like KPMG, suggested not just retaining the current special procedures, but "potentially expanding the population of taxpayers eligible for [their] use beyond those taxpayers under consecutive or continuous examination." The group pointed out that many large entities must file tax returns in dozens of states, such that the elimination of Rev. Proc. 94-69 would impose heavy state compliance burdens. The group then told the IRS that it was not a good time for a change, considering that the Tax Cuts and Jobs Act caused widespread and drastic changes to the tax laws, it took the IRS a long time to issue guidance implementing parts of the law, and additional direction is still needed. Finally, with respect to the notion that Rev. Proc. 94-69 creates disparities among taxpayers in terms of penalty relief, the group suggested that, if uniform treatment is the IRS' goal, "the better way to reduce the disparity would be to expand the population of taxpayers eligible for [Rev. Proc. 94-69], not eliminate it."[51]

Some individual tax practitioners expressed their opposition to the potential withdrawal of the special procedures for large businesses. Consistent with the groups discussed above, the practitioners urged the IRS to expand coverage of the special procedures to all large taxpayers, not only those forming part of the LCC or LPC programs. They raised several points in support of their position, including that a safe harbor is needed now more than ever with the enactment of the Tax Cuts and Jobs Act and various laws addressing the Coronavirus, the trickle of regulations and other administrative guidance from the IRS, and the fact that taxpayers are "continuing to digest" the recent major changes. The practitioners also underscored that not only large taxpayers, but also the IRS, has heavily relied on Rev. Proc. 94-69 for decades to deal with tricky compliance questions and drastic rule alterations. Drilling down on this point, the practitioners provided a long list of regulations, Announcements, Notices, and Revenue Procedures in which the IRS expressly cited possible use of the special procedures.[52]

The Tax Executive Institute ("TEI") called the IRS' proposed elimination of the special procedures in Rev. Proc. 94-69 "surprising and quite disappointing" because the largest and most complex business taxpayers have relied on them for decades to efficiently self-correct errors, thereby enhancing the notion of sound tax administration. The TEI, calling on practical experience from its thousands of members working in tax departments, provided extensive comments. Among other things, the TEI

emphasized that things have not changed all that much for large taxpayers with the introduction of the LCC and LPC programs. Such taxpayers are "under continuous scrutiny" by the IRS, they are subjected to "comprehensive examinations as a matter of course, not as a matter of exception," and "they remain and expect to remain under actual, continuous audit for each open taxable year." The TEI also challenged the idea underpinning the potential elimination of Rev. Proc. 94-69, which is that its special procedures cause large taxpayers to be less diligent in preparing tax returns. According to the TEI, that premise is "patently false" and ignores the reality that large taxpayers always do their best to file complete and accurate returns because of the obligation to sign returns under penalties of perjury, desire to avoid enormous costs and burdens associated with filing multiple amended returns, exposure to exhaustive financial audits by Big Four firms each year, a duty to disclose uncertain tax positions, and more. The TEI also provided several examples of adjustments that large taxpayers routinely reveal to Revenue Agents at the start of examinations pursuant to Rev. Proc. 94-69, which are triggered by events beyond their control. These include evolving laws, regulations, court cases, and other guidance, particularly as they relate to the new international regime created by the Tax Cuts and Jobs Act. Based on the preceding thoughts and several others, the TEI encouraged the IRS to maintain the special rules under Rev. Proc. 94-69 in their current form. If the IRS were unwilling to do so, the TEI proposed several alternatives, one of which was keeping in place the existing rules for large taxpayers that have been audited for at least three of the past five years.[53]

The Tax Section of the American Bar Association ("ABA") added its two cents. It began with the notion that eliminating Rev. Proc. 64-69 would not lead to increased accuracy of original tax returns because the types of errors later disclosed by large entities through the special procedures "are not known (and are not discoverable) at the time the original tax return is filed." The ABA offered several specific examples in support of this statement. Next, the ABA explained why the normal mechanisms available to *all* taxpayers for rectifying errors and omissions, such as filing a separate QAR each time an adjustment is identified or submitting informal Claims for Refund at the start of an examination, are inadequate for entities subject to the LCC and LPC programs. The ABA then argued that the existing mechanisms under Rev. Proc. 94-69 provide a "practical solution" for large entities exposed to continuous or nearly continuous examinations. The ABA ultimately lobbied for maintaining the *status quo*. If that were not feasible, it supported either the development of an "objective category" of large entities subject to the LLC or LPC programs that could continue operating under Rev. Proc. 94-69 or allowing all large entities to utilize the existing special procedures.[54]

G. IRS Makes New Rules a Priority

The IRS indicated in late 2021 that issuing "special rules" for QARs filed by certain large corporations was a "priority."[55]

H. IRS Seeks Comments on New Draft Form

Approximately 18 months after seeking public input on the proposed elimination of the special procedures under Rev. Proc. 94-69, the IRS issued a new draft Form 15307 (*Post-Filing Disclosure for Specified Large Business Taxpayers*) and asked for thoughts.[56] In doing so, the IRS intimated that it had heard and agreed with many of the earlier points made by stakeholders. The news release accompanying the new draft Form 15307 stated the following:

> While we no longer have a continuous audit program, there is nonetheless a small subset of taxpayers who will likely be in some form of continuous audit posture with [the IRS] because of the nature of their transactions and return filings. For this narrow group of taxpayers, some form of the disclosure process that existed under Rev. Proc. 94-69 may be appropriate ... In addition to refining the scope of who is eligible for this special disclosure process, [the IRS] will be standardizing the process for making these disclosures so that eligible taxpayers and Revenue Agents are working with consistent guidelines around what constitutes an adequate disclosure.[57]

I. Rev. Proc. 2022-39

The people spoke, and the IRS listened. After reviewing public comments, the IRS determined that modified special penalty-avoidance procedures are appropriate for large taxpayers "whose tax posture is likely to result in *near annual examinations*."[58] The IRS memorialized these procedures in Rev. Proc. 2022-39.

Only "eligible taxpayers" can utilize the new procedures. They consist of taxpayers selected for examination under the LCC or LPC program whose income tax returns for at least four of the preceding five taxable years were, or are, subject to audit.[59]

Rev. Proc. 2022-39 indicates that, for purposes of avoiding accuracy-related penalties, the IRS will treat a completed Form 15307 as a QAR under certain conditions. Namely, taxpayers must provide Form 15307 to the examination team after they filed the original, inaccurate tax return and within 30 days of the date of a written request from the IRS.[60] Taxpayers must adequately describe in a statement attached to Form 15307 all items that would result in one or more adjustments to the original tax return, which means "information that reasonably may be expected to apprise the IRS" of the items, their amounts, and the nature of potential disputes with the IRS.[61] Moreover, taxpayers must show the increase or decrease of taxable income or tax credits, as applicable, for all items. Taxpayers, however, need not supply the IRS with a recalculation of the total tax liability for each year affected.[62]

The IRS warns of consequences for "inadequate disclosures." It explains that disclosures based on incomplete information or unreasonable assumptions, or those that are otherwise contrary to the mandates of Rev. Proc. 2022-39 and Form 15307, will result in taxpayers not benefiting from penalty protection.[63] The IRS further admonishes that taxpayers generally cannot net adjustments; they must address each item separately.[64]

J. Final Version of Form 15307

The IRS released the final version of Form 15307 the same day that it issued Rev. Proc. 2022-39, which makes sense. The Instructions to the new Form 15307 offer several examples regarding what constitutes adequacy or inadequacy in this context, at least from the IRS' perspective:[65]

> **Example.** *Inadequate Disclosure*. Company, a Subchapter C Corporation that files a consolidated tax return, is a taxpayer subject to the LCC program. During the relevant year, Company's subsidiary, Sub-Company, begins to accrue an expense for a general litigation reserve on a monthly basis. Company does not review the accrued expense during the preparation of its Form 1120 (*U.S. Corporation Income Tax Return*) for the relevant year, and does not recognize a Schedule M-3 adjustment for the accrued expense. After filing its Form 1120, Company determines that the accrued expense does not meet the all-events test under Section 461 and the corresponding regulations. The total accrued expense reported on the balance sheet is $5 million and no portion of this accrual has ever been adjusted on Schedule M-3. Company files Form 15307 to correct the item, showing a single disclosure for an "Expense Deduction" increasing taxable income by $5 million. This adjustment was described as "Correction of incorrect treatment of an accrued expense." This written statement is an *inadequate disclosure* because Company has not provided a detailed explanation of the disclosure, nor has it provided any of the necessary facts or circumstances for the IRS to understand the nature and implication of the disclosure.[66]

> **Example.** *Adequate Disclosure*. Same facts as the preceding example, except Company's Form 15307 described the adjustment as follows: "Subsequent to filing its Form 1120, Company found that its subsidiary, Sub-Company, was recognizing for tax purposes an accrued expense for a litigation reserve. This reserve is a general fund and is not specific to any pending or ongoing litigation. Upon review, it was determined that this reserve does not meet the all-events test under Section 461(h)(4) and the corresponding regulations. No portion of the reserve was adjusted for on a prior year tax return. Therefore, the full balance of the reserve, $5 million, is reversed and recognized as a current year adjustment." This is *adequate disclosure* of Company's circumstances and adjustments.[67]

> **Example.** *Unacceptable Netting of Adjustments*. Company, a Subchapter C Corporation that files a consolidated return, is a taxpayer subject to the LCC program. During the relevant year, it mistakenly capitalized and depreciated $200,000 of items ordinarily treated as deductible repairs and maintenance. Company claimed $100,000 of additional first-year depreciation and $20,000 of regular depreciation on its Form 1120. After filing Form 1120, Company discovered $1 million of 15-year property eligible for additional first-year depreciation that it did not previously claim. Therefore, Company files Form 15307 to correct the items, showing a single disclosure for an "Additional Expense" reducing taxable income by $580,000. Company supplied the following description of the adjustment: "Correction of incorrect treatment of deductible repairs and maintenance as depreciable property and correction of additional first-year depreciation for the current year." This is an *inadequate disclosure* because Company has inappropriately netted the repairs and maintenance with the additional first-year depreciation adjustments.[68]

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Example. *Adequate Disclosure of Late Flow-Through Data*. Entity is a partnership subject to the centralized partnership audit rules, is participating in the LPC program, and is an investor in certain flow-through entities. During the relevant year, Entity does not receive timely final Schedules K-1 from some of those flow-through entities in which it is an investor. As a result, Entity makes a good faith effort to reasonably estimate the income and expense items from the flow-through entities and files Form 1065, enclosing Form 8082 (*Notice of Inconsistent Treatment or Administrative Adjustment Request*) to notify the IRS that it is filing inconsistently with those partnerships for which it did not receive timely Schedules K-1. After Entity filed its Form 1065, it receives the delinquent Schedules K-1. It realizes that the net passthrough income shown on the original Form 1065 was understated because of the delinquent Schedules K-1. Therefore, Entity files a Form 15307 describing the changes for each of the delinquent Schedules K-1. This is *adequate disclosure* by the Entity, and the conclusions with respect to adequacy of disclosure would be the same if Entity had instead been a corporation instead of a partnership.[69]

V. Recent IRS Policy Statement

A few months *before* the IRS sought public comments about the potential elimination of the special procedures in Rev. Proc. 94-69, the IRS published a Policy Statement on the Tax Regulatory Process ("Policy Statement").[70] It thereby declared its commitment to a regulatory process that encourages public participation, features transparency, offers fair notice, and follows the law. The IRS explained in the Policy Statement that the APA process "allows the public to participate before any final rule becomes effective," "ensures that all views are adequately considered," and "enables the public to apprise the government of all relevant information or to alert the government to consequences that it may not foresee." The IRS also acknowledged in the Policy Statement that the "best practice" for rulemaking by agencies, like the IRS, is to adhere to the notice-and-comment procedure established by Congress in the APA.

The Policy Statement covered various topics, among them the appropriate use by the IRS of so-called "Subregulatory Guidance." The IRS says this term encompasses Revenue Rulings, Revenue Procedures, Announcements, and Notices, all of which fall *below* regulations in the hierarchy of tax authorities.

The Policy Statement indicated that "sound tax administration" sometimes necessitates the use of "less formal guidance" to efficiently advise the public about matters. For instance, Subregulatory Guidance supplies taxpayers with "much-needed clarity and certainty concerning the legal interpretation that the IRS intends to apply." The Policy Statement underscored the importance of restraint, though. It explained that the IRS *cannot* use Subregulatory Guidance to modify existing law or to create new law. In this regard, the Policy Statement assured taxpayers that the IRS "will not argue that Subregulatory Guidance has the force and effect of law."

VI. Conclusion

As mentioned in the introduction to this article, the IRS has recently found itself on the losing end of several judicial decisions focused on the APA. The courts have ruled in each instance that the IRS disregarded the mandatory three-step procedure or otherwise surpassed its authority.[71] This article shows that compliance with the APA, adherence to the Policy Statement, or utilization of other forms of meaningful exchanges of ideas between interested parties and the IRS can lead to positive results. Examples are the issuance of Rev. Proc. 2002-39, publication of new Form 15307, and continued use of the special rules for QARs by large taxpayers in the future.

ENDNOTES

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1 Code Sec. 6662(a).

2 Code Secs. 6662 and 6662(b). The penalty increases to 40 percent in certain cases, like when the underpayment is the result of a "gross valuation misstatement." *See* Code Sec. 6662(h).

3 Code Sec. 6664(a); Reg. §1.6664-2(a). The definition of "underpayment" is considerably more complicated, but a simplified and abbreviated version suffices to make the critical points in this article.

4 Code Sec. 6664(c)(1). Penalties would not apply if the "underpayment" is due to "reasonable cause" and the taxpayer acted in good faith.

5 Reg. §1.6664-2(c)(2).

6 T.D. 9186 (March 2, 2005), Preamble, Background.

7 To follow the evolution of the QAR criteria, *see* T.D. 8381 (December 31, 1991), Notice 2004-38, IRB 2004-21, 949 (May 24, 2004), T.D. 9186 (March 2, 2005), and T.D. 9309 (January 9, 2007).

8 T.D. 9186, IRB 2005-13, 790, Preamble, Explanation of Provisions, Background.

9 *Id.*

10 Reg. §1.6664-2(c)(3)(i). The ability to eliminate an underpayment by filing a QAR disappears where the position taken on Form 1040 triggering the underpayment was fraudulent in the first place. *See* Reg. §1.6664-2(c)(2).

11 Reg. §1.6664-2(c)(3)(i)(A).

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[12] Reg. §1.6664-2(c)(3)(i)(B).
[13] Reg. §1.6664-2(c)(3)(i)(C); The term "passthrough entity" is defined by cross-reference in Reg. §1.6662-4(f)(5).
[14] Reg. §1.6664-2(c)(3)(i)(D)(1).
[15] Reg. §1.6664-2(c)(3)(i)(E).
[16] Reg. §1.6664-2(c)(3)(ii).
[17] *V. Perrah*, 84 TCM 547, Dec. 54,935(M), TC Memo. 2002-283.
[18] *E.V. Wilkerson*, TC Summ. Op. 2004-99 (July 27, 2004).
[19] *J.K. Bergmann*, 137 TC 136, Dec. 58,783 (2011). There are several other cases in which the courts declined to grant taxpayers the benefit of QAR status. *See, e.g., B.L. Perry*, 112 TCM 321, Dec. 60,695(M), TC Memo. 2016-172 (taxpayer filed relevant Form 1040X after the IRS notified her of an examination); *D.J. Planty*, 114 TCM 620, Dec. 61,085(M), TC Memo. 2017-240 (taxpayer filed Form 1040X after the start of examination); *J.D. Scully, Jr.*, 106 TCM 384, Dec. 59,656(M), TC Memo. 2013-229 (taxpayer filed Forms 1040X and otherwise changed tax positions during the trial); *R. Sampson*, 106 TCM 276, Dec. 59,635(M), TC Memo. 2013-212 (taxpayer filed relevant Forms 1040X after the IRS notified him of an examination).
[20] Reg. §1.6664-2(c)(4)(ii).
[21] Reg. §1.6664-2(c)(3)(i)(A).
[22] Rev. Proc. 85-26, 1985-1 CB 580, Section 1.
[23] *Id.*, Section 2.04.
[24] *Id.*, Section 3.01.
[25] *Id.*, Section 3.02.
[26] *Id.*, Section 3.04.
[27] *Id.*, Section 4.
[28] Rev. Proc. 94-69, IRB 1994-44, 17, Section 3.01. The IRS could agree to extend the filing period upon showing of "reasonable cause" by the taxpayer. *Id*.
[29] Rev. Proc. 94-69, IRB 1994-44, 17, Section 3.02.
[30] *Id.*
[31] Rev. Proc. 94-69, IRB 1994-44, 17, Section 3.04. The IRS cautioned that, because of changes in the relevant penalty provisions, a taxpayer must adequately disclose its position and have a "reasonable basis" for such position in order to dodge penalties. *Id*. at Section 4.03.
[32] Rev. Proc. 94-69, IRB 1994-44, 17, Section 7.
[33] *Intertan, Inc.*, 87 TCM 767, Dec. 55,502(M), TC Memo. 2004-1 (Jan. 5, 2004).
[34] *Id.* (emphasis added).
[35] FSA 1018A (Aug. 26, 1993).
[36] Program Manager Technical Advice 2007-00018 (April 17, 1995).
[37] CCA 200521026 (Feb. 22, 2005).
[38] Internal Revenue Service Advisory Council. 2015 Public Report, pg. 108; *See also* Luca Gattoni-Celli, *IRS Advisory Council Urges Care in Business Penalty Assessments*, 2015 Tax Notes Today 224-7 (November 23, 2015); Nathan J. Richman, *LB&I's Audit Process May Hinder Pre-Filing Agreements*, 2015 Tax Notes Today 126-3 (July 1, 2015); Amy S. Elliott, *Departure from Continuous Audits Creates Penalty Avoidance Worry*, 2015 Tax Notes Today 103-1 (May 29, 2015).
[39] Internal Revenue Service Advisory Council. 2015 Public Report, pg. 108.
[40] *Id.*, pg. 110.
[41] *Id.*, pgs. 110 and 111.
[42] Rev. Proc. 2022-39, IRB 2022-49, 507, Sections 2.13 and 2.14; Internal Revenue Service, LB&I Announces Large Corporate Compliance Program, IR-2019-95 (May 16, 2019); Internal Revenue Service, Interim Guidance on Implementation of the Large Corporation Compliance Program, LB&I-04-0419-004 (May 21, 2019); Internal Revenue Service, Interim Guidance on Implementation of the Large Partnership Compliance Pilot Program, LB&I-04-1021-0017 (Oct. 21, 2021).
[43] *LB&I Seeks Comments on Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 161-22 (August 19, 2020); William Hoffman, *IRS Asks Corporations to Weigh In on Penalty Avoidance Procedures*, 168 Tax Notes Federal 1519 (August 24, 2020).
[44] *LB&I Seeks Comments on Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 161-22 (August 19, 2020); William Hoffman, *IRS Asks Corporations to Weigh In on Penalty Avoidance Procedures*, 168 Tax Notes Federal 1519 (August 24, 2020).
[45] *LB&I Seeks Comments on Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 161-22 (August 19, 2020); William Hoffman, *IRS Asks Corporations to Weigh In on Penalty Avoidance Procedures*, 168 Tax Notes Federal 1519 (August 24, 2020).
[46] *LB&I Seeks Comments on Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 161-22 (August 19, 2020); William Hoffman, *IRS Asks Corporations to Weigh In on Penalty Avoidance Procedures*, 168 Tax Notes Federal 1519 (August 24, 2020).
[47] *LB&I Seeks Comments on Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 161-22 (August 19, 2020); William Hoffman, *IRS Asks Corporations to Weigh In on Penalty Avoidance Procedures*, 168 Tax Notes Federal 1519 (August 24, 2020).
[48] *Deloitte Seeks Retention of Admin Relief Procedure for Large Entities*, 2020 Tax Notes Federal Today 205-61 (October 16, 2020).
[49] *Bakers Suggest Update to Guidance on Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 203-17 (October 19, 2020).
[50] *KPMG Seeks Update to, Expansion of Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 205-17 (October 5, 2020).
[51] *Industries Seek Retention of Penalty-Avoidance Procedures*, 2020 Tax Notes Today Int'l 202-19 (October 19, 2020).
[52] Ellen McElroy & Jessica Rodgers, "Rev. Proc. 94-69, IRB 1994-44, 17 Should Be Expanded, Not Withdrawn," Bloomberg Tax Management Memorandum (December 7, 2020).
[53] *TEI Seeks Retention of Penalty-Avoidance Procedures*, 2020 Tax Notes Today Federal 213-22 (October 16, 2020).
[54] *ABA Tax Section Offers Comments on Making Penalty-Avoidance Procedures Obsolete*, 2020 Tax Notes Today Federal 203-16 (October 20, 2020).
[55] Department of the Treasury, 2021-2022 Priority Guidance Plan, September 9, 2021.
[56] Chandra Wallace, *IRS Floats Alternative Form for Penalty Avoidance Disclosures*, 2022 Tax Notes Today Federal 39-5 (February 28, 2022).
[57] *Id.* (from the IRS website cited and linked in the article).
[58] Rev. Proc. 2022-39, IRB 2022-49, 507, Section 2.16 (emphasis added).
[59] Rev. Proc. 2022-39, IRB 2022-49, 507, Section 3.01. Taxpayers who do not qualify, known as "ineligible taxpayers," still have certain remedies for avoiding penalties. Specifically, they can still file a QAR or adequately disclosure their positions to the IRS on Form 8275, Form 8275-R, or Schedule UTP, as appropriate. *See* Rev. Proc. 2022-39, IRB 2022-49, 507, Section 3.02.
[60] Rev. Proc. 2022-39, IRB 2022-49, 507, Section 4.01.
[61] *Id.*, Section 4.02.
[62] *Id.*, Section 4.03.
[63] *Id.*, Section 4.06.
[64] Form 15307 (*Post-Filing Disclosure for Specified Large Business Taxpayers*), Instructions, pg. 3.
[65] Form 15307 (*Post-Filing Disclosure for Specified Large Business Taxpayers*), Instructions, Disclosure Examples, pgs. 3 and 4. The author modified the examples from the IRS to make them more readable.
[66] Form 15307 (*Post-Filing Disclosure for Specified Large Business Taxpayers*), Instructions, Example 1, pg. 3.
[67] *Id.*, Example 2, pg. 3.
[68] *Id.*, Example 3, pg. 3.
[69] *Id.*, Example 5, pg. 4. Taxpayers that receive so-called "push-out statements" should note that the IRS will not accept such statements as part of Rev. Proc. 2022-39, IRB 2022-49, 507 or Form 15307; they will be processed through the normal procedures under the Bipartisan Budget Act. *Id*.
[70] Internal Revenue Service. Policy Statement on the Tax Regulatory Process. March 8, 2019.
[71] *See, e.g., CIC Services, LLC*, DC-TN, 2017-2 USTC ¶50,402, 129 AFTR 2d 2022-1119 (2022); *Mann Construction, Inc.*, CA-6, 2022-1 USTC ¶50,122, 27 F4th 1138 (2022); *Liberty Global, Inc.*, DC-CO, 2022-1 USTC ¶50,134, 129 AFTR 2d 2022-1373 (2022); *GBX Associates, LLC*, DC-OH, 2022-2 USTC ¶50,263, Case No. 1:22cv401, Memorandum Opinion & Order, District Court Ohio, Nov. 14, 2022; *Green Valley Investors, LLC*, 159 TC No. 5, Dec. 62,122 (2022).

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