Daily Journal
VERDICTS & SETTLEMENTS
FRIDAY, MARCH 17, 2017

To Disclose Or Not To Disclose On Your Tax Return

By Robert W. Wood

Tax preparers and tax advisers talk a lot about "disclosure." Tax people use the term as if it is something you sometimes *have* to do. People rarely talk about it as a *good* thing.

So, what is disclosure anyway?

Put simply, disclosure is more than the usual listing of income or expense. It is just extra explanation. Without knowing exactly why, most people do not want to "disclose" unless they must. Discretion and privacy sound better. They may not even know what disclosure is, but it sounds like extra work, or extra risk.

Besides, disclosure also sounds like it exposes you to extra audit risk, which it can. Extra audit attention is the last thing anyone wants. Ironically, though, disclosure can actually reduce risk in some cases. One big question about disclosure is what this extra explanation is, and how much extra to offer.

How much extra varies considerably, not only in legal requirements but also in practice. Let's start by discussing why to disclose in the first place. Sometimes the Internal Revenue Service says it is 'required,' though the real requirement is in the IRS penalties you might attract if you fail to disclose and are audited.

A prime example of disclosure is when there is a debatable point about an item you are claiming, where your tax authorities don't meet a minimum IRS standard. You might be claiming legal expenses for a fight with your siblings over an heirloom. Can you deduct those expenses as investment legal expenses, or are they just personal?

Or, you might be claiming that you had an ordinary loss rather than a capital one when some stock became worthless. Maybe you settled a legal case in 2016 and had the money in your trust account, but claim it isn't 2016 income as you didn't withdraw it until 2017. There are almost infinite circumstances in which disclosure could be required.

The IRS wants disclosure if you do not have at least "substantial authority" for your tax position. For example, imagine you are writing off the cost of getting your law degree. Almost all the case law is *against* that deduction because a law degree qualifies you for a new profession. So, if you claim it anyway on your taxes — and you want to avoid penalties if the IRS disallows it — you must disclose it.

You do so because your position is weak, and you are pointing out to the IRS that you are claiming it nevertheless. Yes, that sounds like you are asking for the IRS to audit you or to disallow the deduction. Technically, you do not *have* to disclose. But disclosing is a way to get out of penalties.

Besides, most tax return preparers will not file your return in such a case without it. Fortunately, disclosure can also prevent the IRS from extending the usual three-year statute of limitations on audit. If a taxpayer omits more than 25 percent of his or her gross income on a return, the IRS doesn't just get the usual three years to audit.

Instead, the IRS gets to audit for up to six long years. However, in determining the amount of gross income omitted from a return, the IRS will count what you disclosed, even if you say it isn't taxable. So, this is one more way you can help yourself by disclosing.

A big reason to disclose is penalties. There is a penalty for a substantial understatement of income tax, and the IRS threshold for what is 'substantial' is low. An individual who understates his tax by more than 10 percent or $5,000, whichever is greater, can end up with this penalty. One way to avoid or reduce it is to adequately disclose the relevant facts. All you need is a relatively low-level reasonable basis for your tax position, and your disclosure.

How to Disclose

So, if you need to or want to disclose, how do you do it? The classic way, which the IRS clearly prefers, is by form. There are two disclosure forms, Form 8275 and Form 8275-R. We can dispense with Form 8275-R, because that form is for positions that contradict the law. If you need to file a Form 8275-R, get some professional advice, possibly from more than one source!

Form 8275 (without the R) is another matter. These are common forms, and they are commonly filed. Vast numbers of tax returns attaching Form 8275 are not audited. Plainly, such a form does not automatically trigger an audit. But how much detail to provide is another matter.

In the hundreds of these forms I am asked to review, rarely have I not cut down what the taxpayer or tax return preparer is proposing to say. Some people go on for pages and even send attachments. I have seen many proposed Forms 8275 that are long-winded arguments about the law, all in capital letters and citing many cases.

That is not appropriate material for a disclosure, nor are attachments. I have seen proposed Forms 8275 that attach full legal agreements or excerpts. Don't! If the IRS wants your legal settlement agreement or purchase contracts, the IRS will ask for them. In short, going overboard in a disclosure is usually unwise.

You are required to disclose enough detail to tell the IRS what you are doing. But keep it short and succinct. Can you omit Form 8275 and instead disclose in a footnote to your return? The answer depends. According to the IRS, Form 8275 is required to avoid the substantial understatement penalty, unless the item is listed as an exception in Revenue Procedure 2016-13.

There, the IRS lists some things that must be disclosed on Form 8275, rather than on the tax return itself or a white paper disclosure. A white paper disclosure is usually a footnote to the tax return. Many tax returns contain many such items.

Obviously, they are generally much less noticeable than an IRS Form 8275. Since the facts and the particular issue matter, it is appropriate to get professional advice about the particular disclosure. However, don't think of disclosure as necessarily a *bad* thing. Often, a properly prepared disclosure will save you time, money, and angst.

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*