

IRS Wants a Roadmap: Proposes Broad Disclosure of Uncertain Tax Positions on Returns and Guts Restraint Policy on Tax Accrual Workpapers

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On January 26, the Internal Revenue Service (IRS) announced its intention to require corporate taxpayers to disclose all uncertain tax positions on a new schedule to be attached to the yearly tax return. Under the current proposal, corporate taxpayers would be required to state the maximum amounts of potential tax liabilities as well. Announcement 2010-9 (Announcement) sets forth the proposal and requests comments by March 29, 2010. The Announcement describes, but does not attach, a proposed schedule to be added to Form 1120 and other unspecified business tax returns. The full text of Announcement 2010-9 can be found at <http://www.irs.gov/pub/irs-drop/a-10-09.pdf>.

The Announcement indicates that the IRS intends the schedule to be filed by business taxpayers with total assets in excess of \$10 million. The requirement would extend to a taxpayer that prepares financial statements, or that is included in the financial statements of a related entity that prepares financial statements, if such taxpayer or related entity determines its U.S. federal income tax reserves under FIN 48¹ or other accounting standards² relating to uncertain tax positions involving U.S. federal income tax. The IRS does not define the term “uncertain tax positions,” but the Announcement provides instances where the requirements would apply even though no tax reserve exists, as discussed below. Thus, the IRS requirements go beyond FIN 48 or other reserve requirements.

The proposal is prospective in application, and would apply to all tax returns filed after the date the schedule is released in final. The Announcement indicates the IRS intends to finalize the new schedule “as quickly as possible” and requests comments to be submitted by March 29, 2010. While a due date on April 1st might be more appropriate, this timing indicates the IRS is serious about proceeding with this schedule on an expedited basis.

Maximum Amounts for Each Issue to Be Disclosed

¹ FIN 48 is an interpretation issued in June 2006 by the Financial Accounting Standards Board (FASB) of FASB Statement No. 109. FASB is an independent board that determines the generally accepted accounting principles (or GAAP), which is applicable to both public and private companies in the preparation of their financial statements. FASB itself has no enforcement authority. However, the Securities and Exchange Commission requires public companies to follow GAAP, and may bring an enforcement action against any public company that fails to follow GAAP.

² Such as the International Financial Reporting Standards or country-specific, generally accepted accounting standards.

Taxpayers would be required to state on the new schedule “the maximum amount of potential federal tax liability attributable to each uncertain tax position.” Thus, even though the amount of a potential tax liability recorded in a reserve is less than the maximum amount due to risk adjustments under financial accounting rules, the IRS is requiring that taxpayers report the full potential liability *without regard* to a risk adjustment.³

There is no materiality requirement. The Announcement broadly states that the schedule to Form 1120 will require a description of each uncertain tax position “for which the taxpayer or a related entity has recorded a reserve in its financial statements.” Literally, this language suggests that even if a very small reserve is recorded for a given tax position (for example, 10%), the tax position must be described on the schedule.

Valuing such maximum potential exposures is inherently problematic in various areas of the law and will certainly produce inconsistent results. For example, what is the maximum amount of potential federal tax liability that should be ascribed to a marketing intangible for a potential IRS adjustment under section 482? Anyone familiar with transfer pricing disputes under section 482 is well versed in the wide variances that can occur between the IRS and taxpayers with respect to income attributable to intangible property. For a recent example of such divergence of opinion, see *Veritas v. Commissioner*, 133 T.C. No. 14 (December 10, 2009) (in which the IRS issued a notice of deficiency asserting a \$2.5 billion adjustment to the taxpayer’s buy-in amount in an IRC section 482 cost-sharing structure).

Some Tax Positions That Are Not Reserved Must Still Be Disclosed

The Announcement states that certain tax positions that are not reserved must still be disclosed on the schedule, if the reason for not recording a reserve is “because (i) the taxpayer expects to litigate the position, or (ii) the taxpayer has determined that the Service has a general administrative practice not to examine the position.” Under FIN 48, it is possible to conclude that a tax position meets the “more likely than not” threshold based on an administrative practice. The Announcement effectively states that if the tax position would require a reserve if administrative practice could not be taken into account, then it must be disclosed. Also under FIN 48, it is possible to conclude that no reserve should be recorded because the taxpayer does not expect to settle but expects to win in litigation. The Announcement effectively states that if a reserve would be recorded on the assumption that a settlement would be entertained by the taxpayer, then the tax position must be disclosed.

Description of Uncertain Tax Position to Be Reported

The new schedule will require “a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements.” The description must include “a rationale for the position and a concise general statement of the reasons for determining that the position is an uncertain tax position.” The Announcement lists six additional requirements that the description must contain, including:

³ The Announcement further states that “the schedule will require a taxpayer to specify for each uncertain tax position the entire amount of the United States federal income tax that would be due if the position were disallowed in its entirety on audit.”

- The Code sections “potentially implicated” by the position
- Identification of the taxable year(s) at issue
- A statement indicating whether the position involves an item of income, gain, loss, deduction, or credit against tax
- A statement that the position involves a permanent exclusion of any item, the timing of that item, or both
- A statement whether the position involves a determination of the value of any property or right
- A statement whether the position involves a computation of basis

Workpaper Policy of Restraint Gutted

The Announcement indicates that the IRS will continue the policy of restraint with respect to tax accrual workpapers. The proposal, however, reduces the policy of restraint to a ghost-like state since core information will be on the tax return if the proposal goes through. Further, much of the relevant information that might have enjoyed benefit under the restraint policy will be quickly ascertained via targeted Information Document Requests (IDRs). The stated purpose of the proposed requirements regarding uncertain tax return positions is to assist the IRS to quickly and efficiently identify significant tax issues underlying the tax return, so that the IRS’s resources can be better focused. Not surprisingly, the Announcement references FIN 48, but fails to recognize that FIN 48 results in a determination of an accounting position. In contrast, the new IRS proposal results in a qualitative description of a tax return position.

The Announcement is clearly a reflection of the IRS’s emboldened attitude following its victory before the First Circuit in *United States v. Textron Inc.*, No. 07-2631 (1st Cir. Aug. 13, 2009). That decision, which has been widely criticized, is being appealed to the U.S. Supreme Court.

The Announcement requests comments concerning the contents of the schedule. Interestingly (although not surprisingly), the issues that the IRS is “particularly interested” in receiving comments on do not include the topic of whether the proposed schedule should be used in the first place.

Proposed Effective Date

The IRS intends to require filing of the new schedule for uncertain tax positions to be made with returns filed after the release of the schedule.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis Tax Practice attorneys:

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