

Expert Q&A on Proposed Disclosure of Uncertain Tax Positions

In a surprising and controversial move, the IRS recently announced a proposal to require disclosure of uncertain tax positions by certain taxpayers on a new schedule to their US federal income tax returns. PLC reached out to Jim Browne of Strasburger & Price LLP for an examination of the proposal and its likely impact on companies.



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Jim is a Tax Partner at the law firm of Strasburger & Price, LLP and is also a certified public accountant. Jim advises clients on the US income tax aspects of domestic and international business transactions. He also has a particular interest in FASB Interpretation No. 48 (Accounting for Uncertainty in Income Taxes) (FIN 48). Formerly, Jim served as chief tax officer for several large publicly traded multinational companies and was a partner in a “Big 4” accounting firm.

What is the new IRS proposal for annual reporting of uncertain tax positions?

On January 26, 2010, the IRS issued Announcement 2010-9, which proposes annual reporting of uncertain tax positions by certain business taxpayers on a new schedule to be attached to their US federal income tax returns. This requirement would apply to business taxpayers that:

- Have assets in excess of \$10 million;
- Issue (or are included in) financial statements prepared according to US generally accepted accounting principles (GAAP) and FASB Interpretation No. 48 (Accounting for Uncertainty in Income Taxes) (FIN 48), or according to other accounting standards that include requirements for accounting for uncertain tax positions (including International Financial Reporting Standards); and
- Have one or more reportable uncertain tax positions.

A reportable uncertain tax position is any position related to the determination of US federal income tax liability for which either:

- A reserve (meaning, a liability accrual) is established under FIN 48 or other accounting standard; or
- No reserve has been established either because the taxpayer expects to litigate the position or because the taxpayer has determined that the IRS has a general administrative practice not to examine the position.

It appears that only positions that are material for GAAP purposes would be reported, but this is not entirely clear.

The schedule would require a description of each reportable uncertain tax position and the maximum amount of potential

US federal income tax liability that would result if the position were disallowed in its entirety on audit, taking into account all tax items affected by the disallowance of the position. The IRS does not provide any guidance on how the maximum tax liability is determined, and has asked for comments on this issue.

Why is it being proposed now? Was it expected?

The IRS is under intense Congressional pressure to close the “tax gap” (the gap between what should be collected under the tax laws and what is being collected). The proposal follows on the heels of full implementation this year of FIN 48 for most issuers of financial statements prepared according to US GAAP. The IRS knows that taxpayers subject to FIN 48 and similar accounting rules must prepare detailed financial accounting workpapers listing their uncertain tax positions and calculating accruals for the potential disallowance of those positions. The IRS reasons that it would be simple for these companies to prepare the new schedule using the information gathered for financial reporting purposes. The IRS can then use this information to prioritize areas to audit in the tax return, streamlining the audit process and enhancing tax collections.

The proposal came as a complete surprise to tax practitioners. The issue whether the IRS can get access to a taxpayer’s financial accounting workpapers related to its uncertain tax positions (so-called “tax accrual workpapers”) has been the subject of significant recent litigation, with one such case (*United States v. Textron, Inc.*) currently on appeal for review by the US Supreme Court. Most practitioners expected that the IRS would have deferred any major policy decisions on requesting the workpapers, or the information contained in them, until the law in this area had become more settled.

How is the IRS proposal different from FIN 48 disclosure? Would it create significant incremental compliance burdens?

There are two main differences. First, FIN 48 provides for highly aggregated disclosures of amounts accrued for uncertain tax positions, with the express intent of avoiding having the disclosures constitute a road map to a company's individual tax exposures. The IRS proposal would require a disaggregated disclosure of each individual uncertain tax position. Second, FIN 48 disclosures reflect the taxpayer's assessment of the technical merits of the position and likely resolution of any dispute. The IRS schedule would disclose only the maximum potential tax liability for each issue, without any qualitative information regarding the relative merits of the positions.

The IRS expects that the proposed schedule would not create significant compliance burdens for taxpayers because the information for the schedule should be readily available in the taxpayer's financial accounting workpapers. However, the calculation of the maximum tax amount for each individual issue could create incremental burdens for taxpayers. There is also a piling on aspect to this proposal given that several other reporting requirements and penalties already apply to some uncertain tax positions (such as the disclosure rules for reportable transactions and transactions lacking substantial authority). The proposed schedule also has the potential to misdirect IRS audit resources to issues having large maximum exposure amounts but relatively low levels of uncertainty.

Would the IRS proposal impact the IRS's policy of restraint in requesting discovery of tax accrual workpapers?

The IRS states that it will retain its current policy to not request tax accrual workpapers during audits except in specified limited circumstances, but cautions that it will continue to review the policy. Despite these assurances, the IRS policy of restraint would be of limited continuing comfort to taxpayers if the IRS proposal is implemented. Under the proposal, only the taxpayer's risk assessments and accrual calculations would remain within the policy of restraint. And even those items seem to be at risk, as one has to wonder how the IRS can verify compliance with the new reporting requirements without inspecting the tax accrual workpapers.

Could the IRS proposal be impacted by a reversal in the *Textron* case?

The First Circuit Court of Appeals ruled in *Textron* that the IRS could get discovery of the company's tax accrual workpapers and supporting legal analysis, rejecting the company's claim that the workpapers were protected under the work product doctrine. The First Circuit held that the documents must be prepared "for use" in litigation to be protected. *Textron*

has filed an appeal with the US Supreme Court, arguing in part that the standard of review adopted by the First Circuit conflicts with the standard adopted by the other circuits.

If the Supreme Court grants certiorari in *Textron* and holds that tax accrual workpapers are protected from discovery, the IRS's proposed schedule could run afoul of that holding. The IRS will likely argue that its proposal is not affected by the *Textron* appeal because the schedule would request only factual information, and would not require disclosure of the taxpayer's risk assessments or accrual calculations (matters that may reflect the company's or its counsel's judgment). The assertion that the information requested by the schedule is purely factual information or is otherwise discoverable is debatable.

What is the potential impact of the IRS proposal?

In addition to the compliance burdens referenced above, the IRS proposal would end whatever is left of the audit lottery for affected taxpayers. Consequently, large companies may be less likely to take aggressive tax positions or engage in transactions with uncertain tax results, and are likely to significantly expand their reporting of items under existing tax return disclosure rules. Companies might also have to reassess their existing accruals for uncertain tax positions in light of the disclosure requirement. Interest in early issue resolution programs — such as pre-filing agreements, advance pricing agreements and the compliance assurance program (CAP) — is likely to increase as companies seek to eliminate or minimize their list of uncertain tax positions. If states or other countries enact similar disclosure requirements, the impact could be much broader.

Are there any proposed penalties or sanctions for failure to comply with the IRS proposal?

The IRS proposal is being issued under the general IRS authority to require filing of tax returns, so there are no specific penalties. However, the IRS is considering asking Congress to pass legislation establishing specific penalties for failure to comply with the disclosure requirements. One possible sanction that would not require legislative action is to rescind the policy of restraint on requesting tax accrual workpapers for any taxpayer that fails to make adequate disclosure as required by the schedule.

Any additional thoughts?

The IRS is accepting comments on the proposal through March 29, 2010. The IRS then intends to issue regulations and make the proposal effective for tax returns filed after release of the new schedule. I encourage affected companies to promptly review their FIN 48 workpapers to assess the potential impacts of this proposal, and to then take an active role in the comment process, either directly or through industry groups.