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IRS TO REQUIRE DISCLOSURES OF UNCERTAIN TAX POSITIONS

By Samuel A. Mitchell and Peter H. Winslow

For the last three years since the FIN 48 accounting interpretation became effective,[1] corporate tax departments and professionals have been concerned that the increased financial accounting disclosures would lead to more Internal Revenue Service (IRS) scrutiny of the uncertain tax positions and attempts by the IRS to gain access to tax accrual workpapers that contain confidential descriptions and analysis of the positions. The IRS takes the position that it has the right to compel disclosure of confidential tax accrual workpapers under the leading Supreme Court case,[2] but it has chosen as a matter of administrative practice to request the workpapers only in certain limited circumstances in which taxpayers invest in abusive tax shelter transactions. The policy of restraint is described in Announcement 2002-63,[3] and the Internal Revenue Manual,[4] and is based on competing objectives: that routine disclosure of accrual workpapers would provide a disincentive for accurate and candid financial reporting analysis, but limited disclosure for tax shelters would provide an incentive not to enter into abusive transactions.

Since the adoption of FIN 48, various IRS officials have publicly stated that the IRS is reconsidering its policy of restraint under Announcement 2002-63 in light of FIN 48, suggesting that transparency should be the principal objective in a voluntary compliance tax system. In the meantime, the IRS has engaged in significant litigation in which taxpayers asserted the work product doctrine and other grounds in an attempt to protect workpapers the IRS sought in tax shelter cases. The concerns about the IRS's intentions came to a head recently when the First Circuit Court of Appeals ruled in favor of the IRS and against the taxpayer in *United States v. Textron*,[5] ruling that the IRS should have access to the company's tax accrual workpapers.[6]

It turns out that concerns about the IRS's intentions have been well-founded. The IRS announced in January that taxpayers with assets in excess of $10 million will be required to disclose their uncertain tax positions on a schedule attached to their tax returns. Taxpayers will be required to disclose details of each position (*e.g.,* tax years affected), the rationale for the position, the reason the position is uncertain, and the amount of federal income tax that would be due if the position were disallowed by the IRS on examination. Moreover, taxpayers will be required to disclose certain positions regardless of whether they have established reserves for the positions under FIN 48. This means that taxpayers will have to disclose the positions for which they did not establish a reserve because they intend to litigate the matter or because they believe that the IRS as a matter of administrative practice will not raise the issue.[8] Commissioner of Internal Revenue Douglas Shulman has said that the IRS's goal in requiring the schedule is to reduce the time spent selecting taxpayers and issues for audit.

Under the new disclosure regime, the IRS should have a roadmap to uncertain tax positions identified by the taxpayer and a gauge to evaluate the materiality of each position. The gauge will be crude, and frequently unreliable, because the required disclosure will be the maximum tax assessment possible without any consideration of the merits of the issue. Commissioner Shulman has said that the IRS only expects to require concise information and no information concerning the strengths or weaknesses of the uncertain positions, although the announcement seems to suggest that the IRS may want more detail notwithstanding the Commissioner's comments. The IRS states that it is still abiding by its policy of restraint in Announcement 2002-63, and therefore is not asking for the taxpayer's evaluation of the merits of each issue or the actual amount the taxpayer has reserved for financial accounting purposes for each issue. Nevertheless, the disclosure will require descriptions of matters that are highly confidential, including reasons why each issue is uncertain, the Internal Revenue Code sections that potentially apply, and other detailed information. Attorney-client privilege and work product issues inevitably will arise if the IRS disclosure requests are too broad.

Under the current law, taxpayers generally are not required to report detailed descriptions of particular items on their tax returns unless they have determined that they have less than substantial authority for the position, the item has been

designated as an abusive tax avoidance transaction, or the item falls within some other specific disclosure requirement, such as the requirement to describe differences between book and tax treatment. Unlike these existing disclosure requirements, which are backed by penalties for failure to disclose, there is no specific penalty for a taxpayer's failure to disclose uncertain tax positions on a tax return. As a result, the IRS is considering whether it can extend any existing penalties to this situation and whether to seek new legislation imposing penalties for failure to make the disclosures. An IRS official also has stated that a penalty for filing an incomplete schedule might apply, but it is unclear what this penalty may be.[9] If the IRS determines that an imposition of a specific monetary penalty is problematic, it is likely to resort to a procedural "penalty" for failure to provide the schedule, such as more vigorous audits of non-compliant taxpayers.

In a follow-up announcement, the IRS has stated that the schedule will apply to calendar-year 2010 returns and fiscal year returns that begin in 2010.[10] The follow-up announcement clarifies that the schedule will not be required for 2009 returns and requests comments on its implementation. The comments are due to be submitted by June 1, 2010.[11]

It is difficult to overstate the significance of the new disclosure requirements. The disclosures could change the way taxpayers think about adopting uncertain tax positions (particularly those that do not satisfy the more-likely-than-not FIN 48 threshold). On the other hand, the IRS's behavior on audit possibly could change, with agents more reluctant to waste their effort examining issues that the taxpayer and outside auditors already have determined are not uncertain.

END NOTES

1 FIN 48 (FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109) became effective for most publicly traded taxpayers for fiscal years beginning after December 15, 2006. The interpretation is now codified at FASB Accounting Standards Codification subtopic 740-10, *Income Taxes*. FASB ASC 740-10.

2 *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

3 2002-2 C.B. 72.

4 IRM 4.10.20.3.1.

5 *United States v. Textron*, Inc., 577 F.3d 21 (1st Cir. 2009). Petition for certiorari filed with the Supreme Court on Dec. 24, 2009, No. 09A361.

6 For a discussion of the Textron case before the appeal, *see What Does Textron Mean for Preserving the Confidentiality of Tax Accrual Workpapers?*, 4 *TAXING TIMES* 20 (May 2008).

7 Announcement 2010-9, 2010-7 I.R.B. 408.

8 Under FIN 48, taxpayers must hold a 100 percent tax reserve for positions which do not satisfy the more-likely-than-not-to-prevail (MLTN) standard. For uncertain positions on which taxpayers have determined that they are more likely than not to prevail in court, a tax benefit is recognized for the largest amount that is greater than 50 percent likely to be realized on ultimate settlement. Many taxpayers do not hold any reserve under the FIN 48 interpretation for MLTN positions which they intend to litigate if challenged and do not intend to entertain a settlement. Additionally, the interpretation does not require a reserve for issues that the IRS has determined as a matter of administrative practice that it will not examine.

9 J. Coder, "LMSB Commissioner Fields Questions on Reporting Uncertain Tax Positions," *Highlights & Documents* 941, 942 (Tax Analysts Feb. 23, 2010).

10 Announcement 2010-17, 2010-13 I.R.B. 515. The Announcement states that the schedule will be released in draft form in April, 2010. Note that the draft schedule had not been released as of the final deadline for submitting this article.

11 This is a 60-day extension of the comment period announced in Announcement 2010-9, *supra*.

DISALLOWED INTEREST REDUCES EARNINGS AND PROFITS IN THE CURRENT YEAR

By Stephen Baker

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A corporation determines if a distribution is a dividend to its shareholders by reference to Earnings and Profits ("E&P"). There is little legislative or administrative guidance relative to the computation of E&P, yet corporations face E&P calculation questions frequently in the ordinary course of business. Each item of revenue or expense may impact E&P. One such item that impacts E&P is interest on indebtedness. What happens when that interest is not deductible? Revenue Ruling 2009-25 addresses that question.[1]

Section 163[2] generally allows a deduction for interest paid or accrued on indebtedness within the taxable year.[3] However, section 264(a)(4) generally disallows a deduction for any interest paid or accrued on any indebtedness with respect to one or more life insurance policies or any endowment or annuity contracts owned by the taxpayer covering any individual.[4] Even though disallowed as a deduction, the interest has still been paid or accrued on a policy, endowment or annuity, and, consequently, there will be a reduction to E&P for the interest. On Sept. 8, 2009, the Internal Revenue Service ("Service") released Rev. Rul. 2009-25,[5] addressing the proper timing

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