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Much Uncertainty About Uncertain Tax Positions

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By: *Robert D. Probasco*[1]

Internal Revenue Service (the "Service" or "IRS") Commissioner Douglas Shulman stunned his audience at the January 26th annual meeting of the New York State Bar Association Tax Section with the disclosure of a new proposal, spelled out in Announcement 2010-9[2] (the "Announcement") released the same day. The Service plans to require certain large businesses to report "uncertain tax positions" on a new schedule filed with their annual tax returns.

Shulman explained the proposal as intended to increase efficiency: "Today, we spend up to 25 percent of our time in a large corporate audit searching for issues rather than having a straightforward discussion with the taxpayer about the issues." The Service believes that the new disclosure requirement will "help us prioritize selection of issues and taxpayers for examination." Rather than relying on auditors to identify items that might be in error, the proposal will require taxpayers to affirmatively point out the weak points in their returns, those that are most susceptible to challenge. As a result, the Service will be able to collect more taxes with fewer resources.

The Service subsequently issued Announcement 2010-30[3] on April 19, 2010, with a draft of the proposed Schedule UTP, Uncertain Tax Positions Statement, and related instructions. The draft schedule and instructions clarify some of the mechanical aspects of the new requirement but still leave many open issues and questions.

The Background – Financial Statement Reserves

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 ("FIN 48").[4] FIN 48 establishes a two-stage process of determining whether the taxpayer must establish a tax reserve. In the first step, the taxpayer must reserve 100% of the tax position unless it is more likely than not, based on the technical merits, that the position reported on the return would be sustained if the taxpayer litigated the issue to the court of last resort.[5] This determination is based on application of relevant legal authorities to the facts and circumstances and presumes that the Service audits the return and has full knowledge of all relevant information.[6] If the Service's past administrative practices and precedents, in its dealings with the taxpayer or similar enterprises, are widely understood, those are considered as well.[7] Thus, even if a tax position is technically incorrect, the taxpayer would not have to reserve 100% of it if the Service's practice is to allow it when and if examined.[8]

If a tax position is more likely than not correct, the second step in the FIN 48 process is the determination of how much, if any, of the tax benefits must be reserved in the taxpayer's financial statements. The taxpayer must reserve any amount of the total tax benefit in excess of the largest amount that is greater than 50% likely of being realized upon ultimate settlement with the Service.[9] Unless the probability is greater than 50% that the Service would concede the entire amount at issue, a reserve would be required for the financial statements. The second step in the FIN 48 process takes into account the likelihood that the taxpayer will settle rather than litigate. That

determination is based on the amount the taxpayer would ultimately accept in a settlement with the Service, and therefore may well be less than 100% of the tax benefit even though it is more likely than not that the taxpayer would prevail in full by litigating.[10]

Thus, the taxpayer generally must establish a reserve in its financial statements for part or all of the tax benefit from the position unless it is more likely than not that the Service would *fully concede* the issue prior to litigation. Although Appeals normally will not demand concessions based on "nuisance" value, it is unlikely that the Service will fully concede the issue unless it assesses the probability that the taxpayer would prevail in litigation as at least 80%. (This is consistent with our understanding of the "should" degree of confidence at which accounting firms typically do not require a reserve for financial reporting purposes.) With some exceptions, therefore, the taxpayer has to establish a reserve in its GAAP financial statements for the position unless it is more likely than not that the Service would conclude it had no reasonable basis (roughly less than a 20% chance of success) for contesting the position taken on the return.

FIN 48's requirements apply only to items that are material with respect to the financial statements. The definition of a tax position also depends on the level of detail at which individual items are aggregated into a "tax position." FIN 48 addresses the level of aggregation through a concept described as "unit of account" and defined as follows:

> The appropriate unit of account for determining what constitutes an individual tax position . . . is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used . . . shall consider the manner in which the enterprise prepares and supports its income tax return and the approach the enterprise anticipates the taxing authority will take during an examination.[11]

The taxpayer's financial statements do not show the amount of reserve by individual tax position, only an aggregate amount. Taxpayers routinely prepare supporting documentation for the tax reserves that show such detail. These "tax accrual workpapers" normally contain not only a description of the relevant facts but also identification of potential Service arguments, legal analysis, and assessment of the risks and most likely settlement amount. The tax accrual workpapers could provide the Service not only with a list of the most vulnerable positions to audit but also negotiating leverage from knowing the taxpayer's evaluation of the strength of its case.

The Service has a "policy of restraint," however, that limits the circumstances under which it will request the taxpayer's tax accrual workpapers. Currently, the Service's policy[12] is to request tax accrual workpapers:

- If the tax return claims any tax benefit from a listed transaction that was properly disclosed, only the tax accrual workpapers pertaining to that listed transaction.
- If the tax return claims any tax benefit from a listed transaction that was not properly disclosed, or benefits from multiple investments in a listed transaction (whether disclosed or not), all tax accrual workpapers.
- In unusual circumstances when additional facts are required for a specific identified issue but could not be obtained from the taxpayer's other records or from available third parties.

When the Service does request tax accrual workpapers, the request may lead to fierce disputes and litigation when the taxpayer asserts privileges against disclosure.[13]

This is the background against which the Service issued the Announcement. Speaking at the March 5th meeting Federal Bar Association Section on Taxation Tax Law Conference, IRS Chief Counsel William Wilkins explained that the proposed disclosures were not an outgrowth of a recent favorable court decision concerning the application of privileges to requests for tax accrual workpapers. Instead, he characterized it as a natural result of the accounting rules regarding companies' tax reserves, such as FIN 48. The information now being sought is available. Because the Service doesn't consider the information to be privileged, there is no reason not to ask for it.

The Proposal

What Positions Would Be Reported

The Announcement and the draft instructions for Schedule UTP define uncertain tax positions as:

- Positions for which the taxpayer or a related entity has recorded a reserve in its financial statements under FIN 48 or other generally accepted accounting standards;
- Positions for which a tax reserve is not required because the taxpayer expects to litigate (and win) the position; and
- Positions for which a tax reserve is not required because the taxpayer has determined that the Service has an administrative practice not to challenge the position.

The instructions for Schedule UTP indicate that it would be based on the same materiality and level of aggregation ("unit of account" in FIN 48) standards as used in the financial statements. Thus, the items reported should be the same as those recorded in the company's reserves for financial accounting.[14] For uncertain tax positions for which no reserve was recorded (because the taxpayer intends to litigate or determined the Service has an administrative practice not to challenge the position), the Service apparently intends taxpayers to apply the same materiality and level of aggregation standards.

Who Would Be Required to Report

The business taxpayers subject to the requirement are those with total assets in excess of $10 million, with one or more positions of the type required to be reported on the new schedule. It includes taxpayers who prepare financial statements themselves, or are in included in the financial statements of a related entity, if the financial statements determine United States federal income tax reserves under FIN 48 or other accounting standards. For now, the requirement is limited to corporations that file Forms 1120, 1120 F, 1120 L, or 1120 PC.

Timing and Transition Rules

Taxpayers would be required to file Schedule UTP starting with 2010 tax returns filed in 2011. The schedule has different sections to list uncertain tax positions for the current year and for prior years and the instructions include timing and transition rules.

- Uncertain tax positions taken in tax years beginning before December 15, 2009 need not be reported regardless of whether or when a reserve was recorded.[15]
- If the taxpayer makes the decision to record a reserve at least 60 days before filing a tax return, the uncertain tax position must be reported on that tax return. It will be reported on Schedule UTP either in Part I (if the position was taken in that year's tax return) or Part II (if the position was taken in an earlier year's tax return).
- If the taxpayer makes the decision to record a reserve less than 60 days before filing a tax return, the taxpayer has the option to report it on Schedule UTP either on that tax return or the return for the next tax year.
- A taxpayer takes an uncertain tax position in each year for which there would be an adjustment to a line item on that return if the position is not sustained. Thus, some uncertain tax positions will be taken in multiple years. The taxpayer is required to report the uncertain tax position once and only once for each year in which it takes the position.

What Would Be Reported

Taxpayers would report, for each uncertain tax position:

- The primary Internal Revenue Code sections relating to the tax position, to a maximum of three.
- Indication whether the uncertain tax position relates to a timing difference, and whether the difference is temporary or permanent.
- The EIN of a pass-through entity, if the corporation's tax position relates to a tax position of the pass-through entity.
- Indication whether the tax position is one for which no reserve is recorded because of the Service's administrative practices.
- The maximum tax adjustment, or a ranking of those items that are valuation or transfer pricing tax positions.
- A concise description of the tax position, including:
    - A statement that the positions involves an item of income, gain, loss, deduction, or credit against tax.
    - A statement whether the position involves a determination of the value of any property or right or a computation of basis.
    - The rationale for the position.
    - The reasons for determining the position is uncertain.

Maximum Tax Adjustment

One of the primary concerns of tax practitioners has been the computation of the maximum tax adjustment (MTA). It was not clear exactly how that should be determined to provide the most

useful information to the Service without providing risk assessment information. The Announcement, for example, requested input on whether the amount reported should be only for the tax period for which the return is filed or for all tax periods to which the position relates, and whether the determination should take into account net operating losses or excess credits. In addition, while the MTA might be determined in some instances simply from the effect of totally disallowing a deduction or loss, in other situations the maximum adjustment might be indeterminate. This might occur, for example, with many valuation or transfer pricing issues. If the taxpayer values something too high, the MTA might be based on changing the value of $0. If the taxpayer obtains a tax benefit from valuing something too low, however, there may be no logical or clear answer to the maximum value on which the MTA might be based.

The Service has resolved most of these issues, for now, in the draft Schedule UTP and instructions. The MTA is determined on an annual basis. For tax positions other than valuation or transfer pricing tax positions, the MTA is: (1) the total amount of an item of credit; and/or (2) the total amount of items of income, gain, loss, or deduction multiplied by an effective tax rate of 35%. Interest and penalties are not included, and items may not be offset other than by other items relating to the same tax position.

For valuation and transfer pricing tax positions, the Service provided another approach. Taxpayers are not required to report a specific amount as with other positions. Instead, the taxpayer reports the relative ranking of all valuation positions and the relative ranking of all transfer pricing positions. The taxpayer has a choice of basing the ranking on either: (a) the amount recorded as a reserve in the financial statements; or (b) the estimated adjustment to tax liability, computed as described above, if the tax position is not sustained. The taxpayer need not disclose the method chosen or the relative amounts used to rank the positions.

Concerns and Open Issues

The Service requested comments on the proposal by June 1, 2010, and has stated that there may be further changes based on those comments or as the proposal evolves. There are several open issues or areas of concern to many taxpayers and tax practitioners. Some of the most significant are as follows.

Practical Effect

Tax positions are uncertain for a number of reasons. As Commissioner Shulman recognized in recent comments to the Tax Executives Institute Midyear Conference, these reasons may include ambiguity in the law and a lack of public guidance on issues. An uncertain tax position may, and often will, simply reflect the taxpayer's honest effort to apply the tax law correctly rather than an aggressive interpretation of the law in the face of contrary guidance or caselaw. Often, the correct resolution will be no adjustment at all. It is clear from public pronouncements that top management at the Service understands this and does not intend that Exam automatically propose adjustments for all listed positions. However, there is reason for concern whether management's expectations will translate into reality.

Under FIN 48, the taxpayer generally must establish a reserve in its financial statements for part or all of the tax benefit from the position unless it is more likely than not that the Service would *fully concede* the issue prior to litigation. Service personnel will know, simply from the fact that a position is listed on the schedule, that the taxpayer determined it probably would have to concede at least a partial adjustment if the Service challenges the position. These positions will appear to be easy sources of additional tax collections, based on the taxpayers' own assessments. Also, Congress, the Executive Branch, the media, and the general public may not have the same understanding as the Service that an uncertain tax position is often completely proper, and they could react negatively to a perception that uncertain tax positions are not always challenged. It seems unlikely that Exam and Appeals would develop issues and analyze positions in the same manner as before, in the face of the changed circumstances and foreseeable pressures. There is a significant potential for overly aggressive use of the additional information provided, in a manner inconsistent with management's expectations, that could strain the Service's resources for handling taxpayer protests and litigation. Communicating management's expectations regarding use of the additional information alone may not be enough to avoid this potential disruption. Significant efforts to provide extensive training, align incentives, and monitor performance will be critical to the successful implementation of this program.

It will also be necessary to quickly and efficiently identify and resolve common issues. Exam may have enough published guidance and other authority to resolve many of the uncertain tax positions but other positions may be uncertain because of the lack of such authority. A thoughtful review and evaluation of the latter may require extensive coordination at National Office. As with other issues identified in the field, such coordination will help avoid wasteful duplication of effort and promote consistency. Depending on the volume of disclosures, however, the amount of time and effort required may well increase significantly.

It is not clear whether the Service has the administrative capacity to use the additional information appropriately. Given the potential difficulties and disruption from implementation of this new requirement, some practitioners have recommended that the Service give serious consideration to delaying implementation until it can conduct a pilot program to test how the process translates from theory to practice.

Privilege and Waiver

The proposed disclosure requirement appears to be intended as a *de facto* compromise in requesting sensitive information from taxpayers. Schedule UTP requires less information that is available in tax accrual workpapers. However, the proposal still creates serious concerns regarding privilege and waiver. The Service concludes that the information sought is not protected by privilege but many taxpayers and tax practitioners disagree. In particular, there could be serious questions about whether the work-product doctrine applies to the information requested. That privilege illustrates some specific objectionable aspects of the proposal.[16]

The Supreme Court first articulated the work-product doctrine in *Hickman v. Taylor*,[17] and the Advisory Committee incorporated it into the Federal Rules of Civil Procedure in 1970.[18] It generally protects from discovery "documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative."[19] Although that protection

may be overcome on a showing of substantial need, courts are directed to "protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative."[20] In *Upjohn Co. v. United States*,[21] the Supreme Court recognized that the protection is much stronger with respect to such opinion work-product[22] and some courts have held that the protection is nearly absolute.[23]

Schedule UTP primarily focuses on factual information about tax positions, rather than opinion work product often contained in tax accrual workpapers, such as the analysis of possible arguments and an overall assessment of the relative strength of the position and the hazards of litigation. However, there are aspects of the information requested that arguably constitute opinion work product.

First, the inclusion of a tax position on the schedule does not disclose the taxpayer's *exact* risk assessment, but it does demonstrate that the taxpayer assesses the risk as high enough that the Service probably would not fully concede the issue. This is a limited disclosure but arguably it is still opinion work product. Second, and more important, the proposal requests "a concise general statement of the reasons for determining that the position is an uncertain position." Similarly, the draft instructions include, as part of the concise description in Part III of the schedule, "the reasons for determining the position is uncertain." It is difficult to interpret this as asking for anything other than the taxpayer's assessment of the relative weaknesses of that position, since that assessment drives the decision to record a reserve for an uncertain tax position. All three examples given in the draft instructions are consistent with this interpretation that the Service is requesting the taxpayer's "conclusions, opinions, or legal theories," that is, opinion work product.

Taxpayers have legitimate concerns about the disclosure of opinion work product as well as the possibility that the Service could later argue that the disclosures constitute broad subject matter waivers of any privilege. The possibility of waiver is particularly troublesome as the waiver, if it is such, would result automatically from the required disclosures. This could essentially eliminate the privilege altogether for any such uncertain tax positions. In the context of requests for tax accrual workpapers, taxpayer concerns over privilege and waiver often lead to costly and time-consuming litigation to resolve the dispute. Although the proposed disclosures are less intrusive than a request for tax accrual workpapers, they are also being directed at a much larger population of taxpayers. As the proposal is structured, there is a significant possibility of dramatic increases in government resources required to litigate privilege disputes.

There are several possible changes to the proposal that could alleviate most taxpayers' concerns. First, the Service might confirm that the government will not take the position that the disclosures constitute a broad subject matter waiver of any privileges to which the taxpayer is entitled and that the disclosure requirements do not alter the otherwise applicable law relating to such privileges. This may be the Service's intent but taxpayers would be reassured by a formal commitment.

Second, a change to the Service's policy of restraint regarding tax accrual workpapers would be appropriate. In various public statements, Service personnel have stated that the Service would not, as a result of the new program, modify the policy of restraint to request additional tax accrual workpapers in circumstances other than those now authorized. That is, the Service will not

request tax accrual workpapers based solely on the disclosures on Schedule UTP. This is welcome news but it would be appropriate for the Service to further restrict the circumstances in which tax accrual workpapers are requested. Specifically, the Service should explicitly modify the policy of restraint to prohibit such workpaper requests of any taxpayer that complies with the new disclosure requirement. Although the Service may need additional facts about some of the uncertain tax positions, those can easily be obtained through normal channels in the course of the audit once the position has been identified. The only other information in the tax accrual workpapers would be the taxpayer's analysis and risk assessment. Under ordinary circumstances, there is no legitimate purpose for the Service to have that information.

Third, the Service should eliminate from the information to be disclosed the "concise general statement of the reasons for determining that the position is an uncertain tax position" or "reasons for determining the position is uncertain." If the reasons are factual in nature and unknown to the Service, such a request may be appropriate, but the information likely can be obtained as easily through normal channels during the audit rather than on the proposed schedule. If the reasons are legal in nature, they arguably fall within the realm of opinion work product. In addition, in the experience of most taxpayers and tax practitioners, once the Service has the relevant facts it has no difficulty identifying the arguments that could be used to challenge a tax position. This information adds minimal value to the Service while raising significant privilege concerns for the taxpayer and therefore should not be requested.

Some taxpayers and tax practitioners are making such recommendations to the Service. Whether the proposal will be modified accordingly remains to be seen.

Penalties

The Announcement stated that the Service "is also evaluating additional options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure of the required information regarding its uncertain tax positions. One option being considered is to seek legislation imposing a penalty for failure to file the schedule or to make adequate disclosure." It is still unclear whether the Service will seek a new penalty, rather than relying on existing penalties, and how any new penalty might be designed.

Other Disclosure Requirements

The draft instructions state that taxpayers need not file Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, for any tax positions disclosed on Schedule UTP.[24] The Service has not, as yet, addressed whether Schedule UTP might also replace other disclosure requirements, such as Form 8082, Notice of Inconsistent Treatment, or Form 8886, Reportable Transaction Disclosure Statement, or Schedule M-3. More importantly, the Service has not yet addressed whether listing an item on Schedule UTP will be considered adequate disclosure for purposes of various penalties or statute of limitations provisions, including:

- Accuracy-related penalties, Section 6662(d)(2)(B)(ii)(I)
- Reasonable cause exception for reportable transaction understatements, Section 6664(d)(2)(A)

- Extension of statute of limitations for undisclosed listed transaction, Section 6501(c)(10)
- Extension of statute of limitations for substantial omission of income, Section 6501(e)(1)(A)(ii)
- Extension of statute of limitations for substantial omission of income, Section 6229(c)(2)[25]

The purpose of most such provisions is to encourage sufficient disclosure for the Service to decide whether to examine an item. Clearly, listing an item on Schedule UTP will frequently, if not always, prompt the Service to consider additional investigation and provide the Service with fair warning of questionable items on the return. Listing a tax position on Schedule UTP should be considered "adequate disclosure" for the above and similar provisions seems entirely appropriate.

Conclusion

The effect of the proposed requirement remains unclear. The Service is still awaiting comments and considering changes. Even when the requirement is finalized, some experience with it will be necessary to determine how taxpayers implement it and how the Service uses the new information. At this point, though, it appears likely to be the most significant transformation in years of the tax reporting process and the relationship between the Service and taxpayers.

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[1] Mr. Probasco practices law with Thompson & Knight, LLP in Dallas, Texas.
[2] 2010-7 I.R.B. 408. The Service subsequently issued Announcement 2010-17, 2010-13 I.R.B. 515, to extend the deadline for comments and request input on three additional questions.
[3] 2010-19 I.R.B. ___.
[4] As a result of the FASB codification project, the relevant portions of FIN 48 are now contained in FASB ASC 740-10.
[5] FIN 48 ¶¶ 6, A2.
[6] *Id*. ¶ 7.
[7] *Id*. ¶ 7.b.
[8] Examples are at *id*. ¶¶ A12-A15, including a policy under which assets that cost less than $2,000 are deducted immediately rather than being capitalized.
[9] *Id*. ¶ 8.
[10] If the taxpayer determines that it will not accept anything less than a full concession by the Service, and will litigate if necessary, it may avoid the need to establish a tax reserve for that position for financial reporting. However, as discussed below, such positions would still be reported under the Service's new proposal.
[11] *Id*. ¶ 5.
[12] Announcement 2002-63, 2002-2 C.B. 72; I.R.M. 4.10.20 (Jul. 12, 2004).
[13] *See, e.g., United States v. Textron*, 553 F.3d 87 (1st Cir. 2009), *petition for cert. filed*, 78 U.S. Law Weekly (Dec. 24, 2009) (No. 09-750).
[14] In public pronouncements, Service management has denied any intention to second-guess taxpayers' decisions regarding the reserves in their financial statements.
[15] This also applies to tax years beginning on or after December 15, 2009, if the tax year ends before January 1, 2010.

[16] Although the following discussion focuses on the work-product doctrine, taxpayers and tax practitioners have similar concerns about other privileges.
[17] 329 U.S. 495 (1947).
[18] This provision governs discovery proceedings in federal court, but the work-product doctrine is not limited to that context. Courts have also analyzed it in IRS summons enforcement actions.
[19] Fed. R. Civ. P. 2b(b)(3)(A).
[20] Fed. R. Civ. P. 26(b)(3)(B).
[21] 449 U.S. 383 (1981).
[22] *Id*. at 401-2. "[W]e think a far stronger showing of necessity and unavailability by other means . . . would be necessary to compel disclosure" of such opinion work-product.
[23] *See In re Grand Jury Subpoena*, 220 F.R.D. 130, 145 (D. Mass. 2004) and cases cited therein.
[24] These forms are used for items or positions not otherwise adequately disclosed, in order to avoid accuracy-related penalties.
[25] Although this section does not specifically mention adequate disclosure as an exception to the extension of the statute of limitations, the Service has interpreted it in that manner. *See* FSA 199925016 and cases collected in *CC&F Western Operations Limited Partnership v. Comm'r*, 273 F.3d 402 (1st Cir. 2001).