Practice

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The IRS Takes a Controversial Position on Uncertain Tax Positions

On January 26, 2010, the IRS issued Announcement 2010-9, which bears the title "Uncertain Tax Positions Policy of Restraint."[1] Immediately controversial, the preliminary statement to Announcement 2010-9 states that the IRS "is considering changes to reporting requirements regarding certain business taxpayers' uncertain tax positions in order to improve tax compliance and administration."[2] While IRS officials have stated, since the issuance of Announcement 2010-9, that the proposed changes are not intended to alter the IRS's long-standing "policy of restraint" concerning tax accrual workpapers, in fact the proposed changes raise serious concerns that the principles underlying that policy will be severely undermined.

The changes proposed in Announcement 2010-9 have given rise to other concerns as well. The IRS has already received a number of comments concerning the Announcement, and more are expected. The comment period, originally set to have ended in late March, has now been extended to June 1, 2010.

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The Information to Be Reported

At its core, Announcement 2010-9 states that the IRS "is developing a schedule that will require certain filers to provide information about their uncertain tax positions that affect their United States federal income tax liability."[3] As described in Announcement 2010-9, the proposed new schedule is to be filed with Form 1120 corporate income tax returns or other business tax returns. It is expected to require "(i) a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements and (ii) the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to

the taxpayer's risk analysis regarding its likelihood of prevailing on the merits)."[4] In addition, Announcement 2010-9 states that "uncertain tax positions will include any position related to the determination of any United States federal income tax liability for which a taxpayer or a related entity has not recorded a tax reserve because (i) the taxpayer expects to litigate the position, or (ii) the taxpayer has determined that the IRS has a general administrative practice not to examine the position."[5]

Announcement 2010-9 states that the schedule will require "a concise description of each uncertain tax position in sufficient detail so that the IRS can determine the nature of the issue."[6] While noting that the "sufficiency of a description will depend on the taxpayer's particular facts and the nature of the underlying transaction," Announcement 2010-9 anticipates that the required description "will include the rationale for the position and a concise general statement of the reasons for determining that the position is an uncertain tax position."

> Thus Announcement 2010-9 will impose burdens on taxpayers beyond what they are required to do under FIN 48 or other accounting standards.

"Uncertain Tax Positions" Under Announcement 2010-9

The fundamental issue raised by the IRS's proposed changes is the definition of uncertain tax positions. Announcement 2010-9 takes as a starting position the requirements of FASB Interpretation No. 48, commonly known as "FIN 48."[7] In Announcement 2010-9, however, the IRS goes beyond both the scope and reach of FIN 48.

Under FIN 48, entities that prepare their financial statements in accordance with U.S. generally accepted accounting principles (GAAP) must record a reserve for uncertain tax positions. To make this determination, the entity must identify each of its individual tax positions, and determine whether each position is more likely than not to be sustained upon examination by the IRS or other taxing authority. Following such analysis, the entity may recognize the amount of tax benefit that it determines may be realized upon any settlement with the relevant taxing authority or, if the entity intends to litigate the position and concludes that it will prevail in litigation, it may recognize the full amount of the tax benefits from the individual tax position under consideration. Potential tax liability, including interest and penalties, that cannot be recognized under this analysis must be accrued and a reserve must be established.

A public company with uncertain tax positions is required to provide an extensive footnote detailing information concerning its tax reserves, while other entities will need to set out less detailed information to comply with GAAP. In conclusory terms, Announcement 2010-9 states that "many taxpayers" are required by FIN 48 "to identify and quantify uncertain tax positions taken in the return for financial accounting purposes."[8] The Announcement similarly observes that taxpayers "not subject to FIN 48 may be subject to other requirements regarding accounting for uncertain tax positions," noting "[f]or example, taxpayers may be subject to other generally accepted accounting standards, including International Financial Reporting Standards (IFRS) and country-specific generally accepted accounting standards."[9]

On its face, however, the schedule anticipated by Announcement 2010-9 would go far beyond the requirements of FIN 48. For example, under FIN 48, when a taxpayer that determines that, if challenged by the IRS, it will litigate and expects to prevail as to a tax position, that taxpayer is not required to set up a reserve for that position and accordingly will not need to meet FIN 48's reporting requirements. As proposed in Announcement 2010-9, the anticipated schedule may require detailed disclosure of such a taxpayer's position.

"Certain Taxpayers" Under Announcement 2010-9

The introductory paragraphs of Announcement 2010-9 state that the IRS intends that the new schedule will be filed "by a business taxpayer with total assets in excess of $10 million if the taxpayer has one or more uncertain tax positions of the type required to be reported on the new schedule."[10] The Announcement states that this will include taxpayers who prepare financial statements or who are included in the financial statements of related entities, if the taxpayer or related entity determines its income reserves under FIN 48 or other accounting standards relating to uncertain U.S. income tax positions.[11]

Thus Announcement 2010-9 will impose burdens on taxpayers beyond what they are required to do under FIN 48 or other accounting standards. As an example, FIN 48 draws a distinction between the reporting requirements of public companies and other entities. As contemplated by Announcement 2010-9, the anticipated schedule will apparently impose its detailed reporting requirements on a broader segment of businesses.

The Potential Undermining of the Policy of Restraint

Announcement 2010-9 states: "Except as described in this Announcement, the IRS intends to retain the existing policy of restraint for requesting tax accrual workpapers."[12] It is difficult to see, however, how the proposed changes in Announcement 2010-9 will not work to undermine that policy. Indeed, the Announcement itself goes on to say that the IRS "will continue to review the policy and to consider additional modifications … as appropriate or necessary to ensure it obtains complete and accurate information regarding a taxpayer's uncertain tax positions on a timely basis."[13]

In recent years, the IRS has made strategic modifications to its policy of restraint, and has seen its efforts to summons tax accrual workpapers become the subject of heated litigation.

The IRS's longstanding policy of restraint states that the IRS will seek tax accrual work papers only in "unusual circumstances."[14] In setting out this "policy of restraint," the Internal Revenue Manual defines "tax accrual work papers" as "those audit work papers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities … and to footnotes disclosing those tax reserves on audited financial statements."[15] The Internal Revenue Manual defines "unusual circumstances" in the following manner:

- A specific issue has been identified by the examiner for which there exists a need for additional facts.
- The examiner has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue.
- The examiner has sought a supplementary analysis (not necessarily contained in the work papers) of facts relating to the identified issue and the examiner has performed a reconciliation of the taxpayer's Schedule M-1 or M-3 as it pertains to the identified issue.[16]

Examiners are instructed to seek tax accrual work papers only when "factual data cannot be obtained from the taxpayer's records or from available third parties, and then only as a collateral source for factual data." They are further instructed to limit such requests "to the portion of the work papers that is material and relevant to the examination."[17]

The IRS's policy of restraint did not arise, nor does it exist in a vacuum. In setting out its policy of restraint, the IRS cites to the Supreme Court's decision in *Arthur Young & Co.*[18] for the proposition that tax accrual workpapers are generally not privileged, but then recognizes that such material may include "information on whether there was reliance on outside legal advice" and "an assessment of the taxpayer's position and potential for sustention."[19]

In recent years, the IRS has made strategic modifications to its policy of restraint, and has seen its efforts to summons tax accrual workpapers become the subject of heated litigation. Specifically, in Announcement 2002-63, the IRS set out an exception to its policy of restraint with regard to "listed transactions" or so-called abusive tax shelters.[20] The IRS will routinely request the portion of tax accrual workpapers that relate to the listed transaction in examinations involving returns filed after July 1, 2002, that claim tax benefits of a listed transaction or a substantially similar transaction and disclose the transaction as such on the return. When a listed transaction is not disclosed on the return, the IRS will routinely request the complete tax accrual work papers. When there are multiple listed transactions disclosed on the return, the IRS will exercise its discretion in determining whether to seek the complete tax accrual work papers.[21]

The IRS recently prevailed in *Textron*[22] before the First Circuit in an action to enforce a summons for tax accrual workpapers. The *Textron* decision, however, has been highly criticized, and the taxpayer's petition for *certiorari* to the U.S.

Supreme Court has been supported by several amicus briefs.[23]

As even the IRS has recognized in formulating its policy of restraint, the concern raised when the IRS seeks tax accrual workpapers is that such workpapers will contain or reflect the legal advice given by tax professionals, or the analysis of counsel in anticipation of litigation with the IRS. In *M. Adlman,*[24] the Second Circuit denied enforcement of an IRS summons, holding that the work product immunity protects materials prepared "because of" litigation, and not just those materials prepared "for use" in litigation. In *Roxwothy,*[25] the Sixth Circuit followed the holding in *Adlman* to conclude that tax accrual work papers were protected work product. Thus the First Circuit's decision in *Textron* stands in contradiction of the precedent in the Second and Sixth Circuits.

As in its policy of restraint, the IRS in Announcement 2010-9 cites to the decision in *Arthur Young* and goes further, contending that its current proposal does not require disclosure of a taxpayer's risk assessment or tax reserve amounts, "even thought the IRS can compel the production of this information through a summons."[26] Setting aside for current purposes this controversial position, Announcement 2010-9 raises a number of issues concerning its potential impact on the attorney-client privilege, tax practitioner privilege, and work product immunity.

It is in the very nature of setting up reserves for contingent tax liabilities that an assessment must be done on some level as to the extent and strength of legal authority for a particular return position, and thus attempts by the IRS to seek information concerning such reserves should tread carefully so as not to invade privileged communications or the mental impressions of counsel. In startling contrast, the information that is proposed to be sought by Announcement 2010-9 would, for example, cover not only those items that are subject to tax reserves, but also those positions for which the taxpayer in fact anticipates litigation.[27] Moreover, Announcement 2010-9, by its current terms, would require disclosure of "the rationale for the position and a concise general statement of the reasons for determining that the position is an uncertain tax position."[28] Rather than carefully delineating information that is and properly should be protected by the attorney-client privilege, tax practitioner privilege and work product immunity, the proposal in Announcement 2010-9 would seem to trample over any concerns for these fundamental legal principles.

The Issues Posed by the IRS in Announcement 2010-9

There are many open issues raised by Announcement 2010-9. A number of those issues were raised by the IRS in the Announcement itself, and may give insight into the direction that the IRS is considering. Specifically, in Announcement 2010-9, the IRS sought comments generally, and in particular on the following questions:

1. How the maximum tax adjustment should be reflected on the schedule so that it provides the IRS with an objective and quantifiable measure of each reported tax position (*e.g.,* specific dollar amount or by appropriate dollar ranges)
2. What alternative methods of disclosure of the amount at issue would allow the IRS to identify the relative importance of the uncertain tax positions
3. Whether the calculation of the maximum tax adjustment should relate solely to the tax period for which the return is filed or to all tax periods to which the position relates, and whether net operating losses or excess credits should be taken into account in determining the maximum tax adjustment
4. How the related entity rules should be applied
5. Whether the scope of the Announcement should be modified regarding the uncertain tax positions for which information is required to be reported (*e.g.,* positions for which no tax reserve has been established because the taxpayer determined the IRS has a general administrative practice not to examine the position)
6. Whether transition rules should be used or criteria modified to either include or exclude certain businesses taxpayers (*e.g.,* the proposed threshold of $10 million total assets)
7. How the new schedule should address taxpayers that initially did not record a reserve for an issue, but in later years do record a reserve
8. Whether the list of information proposed to be included should be modified, including whether certain information should be requested in some circumstances upon examination rather than with tax return[29]

The Issues Subsequently Raised by the IRS in Announcement 2010-17

In Announcement 2010-17, the IRS acknowledged that it had already received a number of comments concerning Announcement 2010-9, and that the release of the proposed draft schedule and implementing instructions may facilitate the comment process.[30] Accordingly, the IRS extended the comment period to June 1, 2010, with the expectation that a draft schedule would be made available in early April. As part of Announcement 2010-17, the IRS also invited comments on the following additional issues:

- Do the disclosures required by the new schedule duplicate those required by other forms, thus making forms, such as the Form 8275 and 8275-R, unnecessary or redundant in some circumstances?
- What type of uncertain tax positions should be reported by passthrough entities and tax-exempt entities?
- How should uncertain tax positions be reported in various related entity contexts, such as how members of a consolidated group for financial statement or tax return purposes or entities that are disregarded for federal tax purposes should report uncertain tax positions?[31]

The IRS also clarified that it intends to require that the new schedule be filed with returns for calendar year 2010 and for fiscal years that begin in 2010.[32]

Other Concerns Raised by Announcement 2010-9

As noted, the comment period is ongoing. We respect that the IRS gives careful consideration and due regard to comments that it receives. Announcement 2010-9, however, represents a significant and far-reaching change in reporting requirements, and comments and criticisms deserve heightened regard. In addition to the threat to the attorney-client privilege, tax practitioner privilege and work product immunity, and the potential for further undermining of the policy of restraint, a number of other concerns arise. For example, as even the IRS notes, it is a fair question whether, in light of other reporting schemes, whether this added reporting requirement is even necessary, or whether it is unduly burdensome or redundant in many circumstances.

Moreover, while the IRS proposes this added reporting requirement in the name of efficient tax enforcement, it risks the opposite result: The IRS may find itself inundated with both requests for specific guidance, so as to eliminate the uncertainty of positions pre-filing, or it may find that many taxpayers over-report uncertain positions for any of a number of strategic reasons. The tax system surely does not need another reporting requirement that increases paperwork to an extent that it fails as a useful enforcement tool.

There are other uncertainties in the broad language of Announcement 2010-9 that may become clearer with the proposed schedule and with other IRS responses to the comments that are being made. There is also considerable concern about the impact of the proposal on certain types of entities, and specific tax issues. At a minimum, so significant a change in reporting requirements needs clarity in its terms, and more careful consideration of its potential impact. As proposed, Announcement 2010-9 has far-reaching potential. The IRS may be well-advised to take this proposal more slowly, to start more narrowly and to heed the concerns that many have raised.

Endnotes

1 Announcement 2010-9, IRB 2010-7, 408 (Feb. 16, 2010), *Uncertain Tax Positions—Policy of Restraint.*
2 *Id.*
3 *Id.* In a subsequent announcement extending the comment period, the IRS stated its expectation that a draft schedule would be released by early April; the schedule was not available prior to the submission date for this column.
4 *Id.*
5 *Id.*
6 *Id.*
7 *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109,* also contained in Accounting Standards Codification subtopic 740-10, *Income Taxes* (hereinafter "FIN 48.")
8 Announcement 2010-9, *supra* note 1.
9 *Id.*
10 *Id.*
11 *Id.*
12 *Id.*
13 *Id.*
14 IRM §4.10.20.3(2).
15 IRM §4.10.20.2(1).
16 IRM §4.10.20.3.1(2).
17 IRM §4.10.20.3.1(1).
18 *Arthur Young & Co.*, SCt, 84-1 USTC ¶9305, 465 US 805.
19 IRM §4.10.20.2(2)(A).
20 Announcement 2002-63, 2002-2 CB 72; *see* IRM §4.10.20.3.2(1).
21 *Id.*
22 *Textron Inc.*, CA-1, 2009-2 USTC ¶50,574, 577 F3d 21.
23 The *Textron* decision has been criticized by the authors of this column, among others. *See* K. Keneally and C. Rettig, Practice, *Textron and Work Product Immunity: A Misguided Decision*, J. Tax Practice & Procedure, Oct.–Nov. 2009.
24 *M. Adlman*, CA-2, 98-1 USTC ¶50,230, 134 F3d 1194, 1202.
25 *P.J. Roxworthy*, CA-6, 2006-2 USTC ¶50,458, 457 F3d 590, 593-94.
26 Announcement 2010-9, *supra* note 1.
27 *Id.*

ENDNOTES

[28] *Id.*
[29] *Id.*
[30] Announcement 2010-17, IRB 2010-13, Mar. 5, 2010, *Extension of Time to Submit Comments on Announcement 2010-9 Regarding Reporting Uncertain Tax Positions, Draft Schedule, and Implementation Date.*
[31] *Id.*
[32] *Id.*