NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON ANNOUNCEMENT 2010-9

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Report No. 1208

NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON ANNOUNCEMENT 2010-9[1]

I. Introduction

This report ("Report") comments on Announcement 2010-9 (the "Announcement") released by the Internal Revenue Service (the "Service") on January 26, 2010. The Announcement states that the Service intends to institute a new requirement that certain taxpayers attach to their annual tax returns a schedule providing what the Announcement refers to as information regarding the taxpayer's "uncertain tax positions" (the "Schedule").[2]

The Commissioner of Internal Revenue, Douglas H. Shulman, unveiled the Announcement in a speech at the NYSBA Tax Section's Annual Meeting (the "Shulman Speech").[3] The Shulman Speech and the Announcement emphasized that the Service is seeking input from taxpayers and tax practitioners about the proposed Schedule, including its precise contents and certain other matters, such as the penalties for noncompliance.

The Commissioner announced that the Service was exploring ways to achieve three objectives with respect to the payment of taxes and the audit process: certainty, consistency, and efficiency for the Service and for taxpayers—objectives that largely depend on transparency. Although the Service has previously taken smaller steps in pursuit of

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[1] The principal drafter of this Report was Marcy Geller. Substantial contributions were made by Peter Blessing, Christian Miller, Elliot Pisem, Danny Salinas, Bryan Skarlatos and Diana Wollman. Helpful comments were received from Kim Blanchard, Peter Canellos, Robert Cassanos, Peter Connors, Michael Farber, Victor Gatti, Edward Gonzales, David Hardy, David Hariton, Vadim Mahmoudov, Gary Mandel, David Miller, Andrew Needham, Erika Nijenhuis, Deborah Paul, Eschrat Rahimi-Laridjani, Leah Robinson, David Schnabel, Michael Schler, Jodi Schwartz, David Sicular, Eric Sloan, Linda Swartz, Mario Verdolini, and Kirk Wallace.

[2] Announcement 2010-9 (Jan. 26, 2010).

[3] Douglas H. Shulman, Commissioner of Internal Revenue, New York State Bar Association Taxation Section Annual Meeting in New York City (Jan. 26, 2010).

transparency, as in the use of disclosures for listed and reportable transactions,[4] this proposal would represent a quantum leap in that direction.

The United States has a self-assessment system of taxation but, for various reasons including the complexity of the tax system, the Service requires a rigorous audit function to promote accurate reporting and payment of taxes due. The Shulman Speech notes that a large proportion of tax audit resources is used just to identify issues that merit review and that the Service is under constant pressure to run itself more efficiently. At the same time, certain financial accounting standards have tightened and created guidelines for tax reserve information that are intended to result in some level of consistency of financial data. An approach drawing on this information along the lines set forth in the Announcement, while a sweeping departure from existing compliance practice for taxpayers generally, potentially would go a significant way towards addressing the issues identified by the Commissioner, and we believe the announced goal of increasing transparency is sound.

This Report responds to the Service's request for comments. Part II of this Report summarizes our comments and suggestions. Part III provides background, including a summary of the current law with respect to self-reporting and disclosure, penalties, and privilege. Part IV provides a detailed description of the Announcement, and Part V includes a detailed discussion and our comments and suggestions.

We understand that a draft Schedule may be released as early as April and look forward to commenting more specifically at that time.

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[4] See, for example, *infra* note 19 and accompanying text discussing disclosure requirements for tax shelters.

II. Summary of Comments and Suggestions/Recommendations

We have set forth in this Report comments for the Service to consider when drafting the Schedule and related Instructions.[5] In summary, we recommend that the Service:

A. General Considerations for Implementation

(1) Conduct a study involving selected voluntary participants (*e.g.*, from the Compliance Assurance Program ("CAP")), if available, to field test the Schedule using, *e.g.*, the 2009 tax year. We believe that an empirical analysis of the way the proposal would operate in practice is an important component of our assessment of the proposal.

(2) Establish a centralized unit at the National Office to monitor and administer the proposal, information collected on the Schedules, and issues of taxpayer compliance, as well as to train agents in the proper use of the information (and prevent its potential misuse by overzealous agents or by agents who may confine their inquiry to scheduled positions).

B. Disclosure Requirements by Taxpayers

(3) In the case of reporting positions that the Service has a general administrative practice not to examine, provide that disclosure is required only for those positions identified by the taxpayer independently, without an affirmative duty of inquiry under the Schedule preparation process in its financial reporting (*i.e.*, only those items identified independently of the process) and eliminate from this additional disclosure requirement items of immaterial risk or immaterial amount.

(4) Confirm that positions for which a taxpayer provides for no reserve (without taking into consideration its expectation to litigate or financial reporting immateriality thresholds) are not required to be disclosed.

(5) Confirm that disclosure requirements will automatically incorporate any changes to the applicable standards under FIN 48 (defined below) and successor provisions (or other applicable accounting standards and successor provisions) except to the extent the Service provides otherwise. In addition, clarify which accounting standard is applicable when a taxpayer has financial statements prepared under more than one standard. Further, monitor closely whether large US reporting companies will become subject to International Financial Reporting Standards at a time when such standards have not adopted rules for uncertain tax positions analogous to those under US generally accepted accounting principles and consider

[5] Internal Revenue Service Large and Mid-Size Business Division ("LMSB") Commissioner Heather Maloy publicly stated that the regulations were likely to be "bare bones," with most of the disclosure requirements fleshed out in the Schedule and related Instructions.

what the results for the proposal would be if such convergence is not achieved.

(6) Confirm that taxpayers need only provide a statement identifying in one or more sentences each uncertain tax position (*i.e.*, the issue(s) and factual context involved). We believe this would sufficiently convey the basis of the position and the fact of uncertainty without the Service "getting into the heads of taxpayers as to the strengths or weaknesses of their positions."[6] The reporting should be designed to minimize the need for a taxpayer to craft responses reflecting subjective legal judgments. The form should, to the fullest extent possible, provide for check boxes for the taxpayer to identify relevant information.

(7) Provide that the presentation of positions may be tailored to the information which is readily derived from the information required to be disclosed on a taxpayer's financial statements. For example, specify that taxpayers may categorize their positions in accordance with the "unit of account" method (or other similar procedure of categorizing) used in determining their reserves.[7]

(8) Eliminate the requirement that the taxpayer specify the maximum amount of potential United States income tax exposure for each uncertain tax position. Instead, we recommend that the Service adopt a "threshold" standard, relying on relatively few baskets based on a range of amounts.

(9) Exclude uncertain tax positions that are below a threshold and are, therefore, immaterial.

(10) Confirm that the Schedule applies only to uncertain tax positions that affect a taxpayer's income tax liability.

(11) Limit disclosures on the Schedule to uncertain tax positions reflected in items realized in the current tax year plus current year changes to amounts reserved in respect of items realized in a prior year. Provide guidance as to which collateral tax positions need not be disclosed in future years.

(12) Provide guidance to taxpayers as to which related party needs to file the Schedule and which financial statement reserves are the ones required to be disclosed.

C. Which Taxpayers Are Required to Disclose

(13) Confirm that pass-through entities and non-profit organizations are subject to the Schedule requirements, but only to the extent such entities themselves have

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[6] *See supra* note 3.

[7] *See infra* Part V.B(4)

reserves for uncertain income tax positions.

(14) Provide that the $10 million threshold be determined by rules similar to those for Schedule M-3.

D. Penalties.

(15) Clarify whether failure to file the Schedule will be considered failure to file a tax return under Section 6651.

(16) Consider the enactment of a specific penalty for a taxpayer's failure to file the Schedule or adequately disclose items on the Schedule, but applicable only to intentional failures.

E. Privilege and Work Product Immunity Issues

(17) Confirm that the disclosure required on the Schedule is not intended to override any otherwise applicable Rules of Privilege (as defined below), and that claims of privilege may continue to be asserted to the same extent permitted under current law. At the same time, the Service could indicate its belief that, in whole or part, the information sought by the Schedule would not be protected by the Rules of Privilege.

(18) Provide that in any case in which taxpayers provided the information sought on the Schedule, whether or not such information is in fact protected by the Rules of Privilege, the provision of such information is not, and the Service will not assert that the provision of such information is, a "subject matter waiver" with respect to any confidential communications or other matters that are otherwise protected by the Rules of Privilege.

III. Description of Current Law

A. Reporting Requirements and Penalties

Compliance under the United States federal income tax system rests on two pillars—self-assessment of tax by taxpayers and audit by the Service.

The regime of both civil and criminal penalties encourages accurate self-assessment.[8] The Code provides for a variety of civil and criminal penalties in order to deter noncompliance, including the following:

- Penalties for underpayments and understatements of tax, such as those imposed by sections 6662[9] and 6662A,[10] which have been amended to restrict and, sometimes, eliminate defenses based on factors such as "reasonable cause";[11]
- Penalties for failure to file a required tax return, or failure to complete the return sufficiently;[12]
- Criminal penalties for willfully failing to file a tax return, which carries a misdemeanor charge;[13]

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[8] Penalties are not restricted to taxpayers, and some are aimed at their advisors. For example, § 10.35 of "Circular 230" provides tax advisors with detailed guidelines for issuing tax opinions. If such guidelines are not met, an attorney may be subject to sanctions under § 10.37 of Circular 230.

[9] The penalty rate is 20%, but that rate is doubled to 40% for an underpayment attributable to a "gross valuation misstatement." The penalty is imposed on the portion of an understatement of tax resulting from one or more of five specified causes, including negligence and substantial understatements.

[10] The penalty rate is 20%, but the rate is increased to 30% for any reportable transaction understatement where the taxpayer fails to meet the requirements of section 6664(d)(2).

[11] For example, section 6664(d) provides that a "reasonable cause" defense is unavailable to the penalty for "reportable transaction understatements" imposed by section 6662A unless a number of highly restrictive conditions are met, and no other defense exists to that penalty.

[12] Section 6651(a). In some cases, the omission of required information from a return that is in fact filed may cause the taxpayer to be considered to have failed to file a return for purposes of these penalties. *See, e.g.*, Beard v. Comm., 82 T.C. 766 (1984) (return is sufficient if it contains enough information to calculate tax liability, honest and reasonable attempt to comply with tax law, purports to be a return, and is executed under penalty of perjury); Schroeder v. Comm., 291 F.2d 649 (8th Cir. 1961) (taxpayer subject to penalties for failure to file a return where only information included was net income and tax due); GCM 38057 (stating the Service's position that failure to include the annual statement described in Treas. Reg. § 1.6012-2(c)(1) would subject the taxpayer to section 6651(a)(1) penalties).

[13] Section 7203. Violations are classified as a misdemeanor subject to imprisonment for not more than one year and fines up to $25,000 for an individual or $100,000 for a corporation (in addition to other penalties that may apply). Courts have held that a document that does not contain information relating to a taxpayer's income and deductions from which a tax can be computed is not a "return." *See, e.g.*, United States v. Goetz, 746 F.2d 705 (11th Cir. 1984).

- Penalties for failing to file information returns, such as Forms 8886 (relating to reportable transactions)[14] and Forms 8918 (relating to material advisors for reportable transactions).[15]

Congress and the Service periodically introduce new tools to facilitate the audit process and to give the Service more insight into potential taxpayer noncompliance. Among these tools are:

- The requirement that a taxpayer seeking relief from penalties under section 6662(d)(2)(B)(ii) generally must make disclosure on Forms 8275 and 8275-R.[16]
- The requirement that a partner in a partnership taking a position inconsistent with a Schedule K-1 received from the partnership must generally make disclosure on Form 8082.[17]
- The requirement that many business taxpayers must reconcile, in detail, differences between their reported taxable income and their income as computed for financial reporting purposes on Schedule M-3.[18]
- The requirement that a taxpayer who has "participated" in a "reportable transaction" must file Form 8886 (Reportable Transaction Disclosure

[14] Sections 6707 and 6707A.

[15] Section 6708.

[16] Treas. Reg. § 1.6662-4(f)(2).

[17] *See* Treas. Reg. § 301.6222(b)-1(a).

[18] *See* Rev. Proc. 2004-45 (Jun. 7, 2004).

Statement)[19] and that a "material advisor" with respect to such a transaction must file Form 8918 (Material Advisor Disclosure Schedule).[20]

The Service also has certain targeted tools such as tiered issues[21] and mandatory information document requests[22] requiring taxpayers to produce documents aiding it in the audit process.

However, notwithstanding the addition of new penalties and audit tools, since the 1980s the Service has exercised what it calls a "policy of restraint" with respect to request for a taxpayer's documentation, or tax accrual workpapers, regarding its uncertain tax positions.[23] Only in limited circumstances will the Service request all of a taxpayer's tax accrual workpapers. One such case is when the Service determines that "tax benefits from multiple investments in listed transactions are claimed on a return, regardless of whether the listed transactions were properly disclosed."[24] This was the case in *Textron*, discussed below.[25]

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[19] Treas. Reg. § 1.6011-4. Examples of reportable transactions include "listed transactions," "confidential transactions," "transactions with contractual protection," and "loss transactions."

[20] Treas. Reg. § 301.6111-3(d)(1).

[21] *See* IRS Large and Mid-Size Business Division Announcement, Industry Issue Focus (Mar. 12, 2007); *see also* IRS LMSB Rules of Engagement, 4.51.1.

[22] *See* Langdon, Memorandum to IRS LMSB Division, Abusive Tax Shelters Mandatory Information Document Requests (Jan. 29, 2002) (approving a standardized information document request form to be used in obtaining appropriate information regarding "listed transactions").

[23] *See* Announcement 84-46 (Apr. 30, 1984); United States v. Arthur Young & Co., 465 U.S. 805 (1984); Announcement 2002-63 (Jun. 17, 2002). For further discussion of tax accrual workpapers, see *infra* note 28 and accompanying text.

[24] Announcement 2002-63.

[25] U.S. v. Textron, 507 F.Supp. 2d 138 (D.R.I. 2007), *rev'd* 553 F.3d 87(1st Cir. 2009), *petition for cert. filed*, 78 USLW 3375 (Dec. 24, 2009) (NO. 09-750).

B. Financial Reporting and FIN 48

Domestic business entities, including C and S corporations, partnerships, limited liability companies, REITs, RICs, and certain trusts, often prepare financial statements in accordance with United States generally accepted accounting principles ("US GAAP") promulgated by the Financial Accounting Standards Board ("FASB"); foreign taxpayers often use the International Financial Reporting Standards ("IFRS") or their local country's "GAAP" ("local GAAP"). In order for financial statements to provide an accurate reflection of the financial position of the reporting entity, US GAAP and many other accounting standards require the reporting entity to make an assessment of potential liabilities and to record certain of those amounts on their statement ("reserves").

The rules for reflecting potential income tax liabilities[26] under US GAAP are set out in Financial Accounting Standards Board Interpretation No. 48 ("FIN 48").[27] Taxpayers generally prepare workpapers, referred to as "tax accrual workpapers,"[28] that document how the company applied FIN 48 to arrive at the amounts reflected as a reserve with respect to income taxes on their financial statements.

FIN 48 requires a taxpayer to assess uncertain tax positions it has taken that create a tax benefit—for example, a taxpayer must assess whether it was entitled to claim each deduction and credit reported on its tax return, was entitled to characterize as capital gain, instead of ordinary income, each item as to which a capital gain benefit is claimed, was entitled to omit from income each item it failed to report, and so forth. With respect to each

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[26] Reserves for non-income taxes are determined under FAS 5. *See infra* note 91 and accompanying text.

[27] All references to FIN 48 throughout this paper refer to the income tax rules as codified at FASB ASC 740-10. For a more detailed discussion, see *infra* notes 29-42 and accompanying text.

[28] For a discussion of the different types of tax workpapers prepared by companies, see *Textron*, 507 F.Supp. 2d at 142-43.

such position a two-step process is undertaken pursuant to which the taxpayer (i) determines whether the tax benefit may be "recognized" and, if so, (ii) "measures" the amount that may be so recognized.[29]

No benefit related to a tax position may be recognized in the financial statements unless the position is more likely than not to be sustained based solely on its technical merits.[30] Specifically, there must be more than a fifty-percent likelihood that the position would be sustained upon examination by the relevant tax authority, including resolution of any related appeals or litigation.[31] The "technical merits" of a tax position derive from sources of authority in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law), and past administrative practices of the Service and their applicability to the facts and circumstances of the tax position.[32]

Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.[33] The determination of what constitutes an individual tax position (the unit of account) is a matter of professional judgment based on the level at which the entity accumulates information to support the tax return and the level at which it expects tax authorities to address the issues during an examination.[34] In making this

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[29] FASB ASC 740-10-05-6. Tax positions that are "highly certain" are not covered under FIN 48's two-step recognition process, but are generally substantiated through a taxpayer's processes and controls.

[30] *Id.*

[31] *Id.* at 25-6.

[32] *Id.* at 25-7(b)

[33] *Id.* at 25-7(c).

[34] *Id.* at 25-13.

determination, management must evaluate the manner in which it prepares and supports its income tax return.[35]

As a second step, upon determination that a position permits recognition, the amount recognized is measured as the largest amount of tax benefit that is greater than fifty percent likely to be realized upon settlement with a taxing authority that has full knowledge of all relevant information.[36] To make this determination, the amounts and probabilities of the outcomes that could be realized upon settlement are taken into account.[37] Once at "more likely than not," if the taxpayer intends to litigate and expects to win, the full amount of tax benefits can be recognized.

Positions that fail the "more likely than not" standard, or the amounts not recognized under the measurement step, are "unrecognized tax benefits."[38] Unrecognized tax benefits may be recorded as a current or noncurrent liability account (based on expected time of payment), or a reduction in deferred tax assets.[39] Additionally, interest and penalties must be accrued on the unrecognized tax benefit based on the relevant tax law.[40]

FIN 48 requires companies to include extensive footnote disclosure in their financial statements. A public entity[41] must disclose all of the following at the end of each annual reporting period presented:

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[35] *Id.*

[36] *Id.* at 30-7.

[37] *Id.*

[38] The difference between the benefit in the tax return and the amount reflected in the financial statements. *Id.* at 25-6, 25-8, 25-16, & 25-17.

[39] *Id.* at 45-11, 45-12 & 45-12.

[40] *See id.* at 25-56, 25-57, & 30-29.

[41] All other entities are required to disclose only items (3) through (5). *Id.* at 50-15 & 50-15A.

1. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:

a. The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period

b. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period

c. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities

d. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations

2. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate

3. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position

4. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:

a. The nature of the uncertainty

b. The nature of the event that could occur in the next 12 months that would cause the change

c. An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made

5. A description of tax years that remain subject to examination by major tax jurisdictions.[42]

In sum, taking into account the above requirements (i) with respect to positions that are below "more likely than not," the taxpayer must be fully reserved, and (ii) for positions

[42] *Id.*

at or above "more likely than not," reserves may be required as determined under the measurement step discussed above, and some positions, after the measurement step, may not have any reserves.

C. Taxpayer Privileges and Immunities

The privileges most affected by the disclosures proposed by the Announcement are the attorney-client privilege, the tax-practitioner privilege, and the work product doctrine (collectively, the "Rules of Privilege"). The attorney-client privilege, as it applies in the federal tax context, is a creature of federal common law. The tax-practitioner privilege was created as a privilege between federally authorized tax practitioners and their clients, and it mirrors the attorney-client privilege in most respects.[43] The work product doctrine, like the attorney-client privilege, is governed by federal common law,[44] although it also is codified in Fed. R. Civ. Proc. 26(b)(3) for purposes of discovery proceedings in federal courts.

The attorney-client and tax-practitioner privileges protect confidential communications between an attorney or a tax practitioner and his or her client that are made for the purpose of obtaining legal advice. There is some ambiguity over the extent to which these privileges apply to communications relating to the preparation of a tax return and the extent to which the filing of a return waives the privilege.[45] These ambiguities are, however, beyond the scope of this report.

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[43] 26 U.S.C. §7525. The main differences between the attorney-client privilege and the tax-practitioner privilege are that the tax-practitioner privilege applies only to non-criminal tax proceedings brought in federal court by or against the United States, applies only with respect to tax advice and it does not apply to any communication in connection with the promotion of a tax shelter.

[44] Hickman v. Taylor, 329 U.S. 495 (1947).

[45] *See, e.g.*, Pease-Wingenter, Does the Attorney-Client Privilege Apply to Tax Lawyers: An Examination of the Return Preparation Exception to Define the Parameters of Privilege in the Tax Context, 47 Washburn L.J. 699 (2008). There is also ambiguity about whether and the extent to which the filing of a tax return waives a privilege for advice regarding the return. *Id.*

The work product doctrine protects disclosure of documents and other tangible things prepared in anticipation of litigation.[46] There are many questions regarding the scope of the work product doctrine that are decided differently in different circuits, not answered at all in some circuits, or remain unsettled for different reasons. Some of these unsettled questions include (i) whether an audit or administrative hearing (*i.e.*, a Service Appeals conference) constitutes litigation for purposes of the doctrine, (ii) what constitutes "anticipation of litigation" in this context. (iii) the required connection between the anticipated event and the document at issue, and (iv) what constitutes a waiver of the protection (*e.g.*, showing to the attest auditor). Although these issues, as with those concerning the attorney-client privilege, are beyond the scope of this report, we urge the Service to clarify that the proposed Schedule should in no way be read as an attempt to interject an answer into the current debate regarding these ambiguities.

IV. Description of Announcement

The Announcement states that the proposed Schedule will require any "business taxpayer" with assets in excess of $10 million to disclose its "uncertain tax positions" if (i) the taxpayer prepares financial statements or is included in the financial statement of a "related entity" under Sections 267(b), 318(a) or 707(a), and (ii) the taxpayer or related entity has one or more "uncertain tax positions" of the type required to be reported on the Schedule. The Schedule will apply only to positions with respect to United States federal income taxes and not to positions with respect to excise, withholding, or estate taxes.

[46] See *Hickman*, 329 U.S. at 508-14; *see also* Fed. R. Civ. Proc. 26.

Three types of uncertain tax positions will require disclosure: (i) those for which the taxpayer or related entity has established a reserve under FIN 48 or other accounting standards, (ii) those for which no reserve is established because the taxpayer expects to litigate the issue and ultimately prevail, and (iii) those for which no reserve is required because the taxpayer has determined that the Service has a general administrative practice not to examine them.

The Announcement contemplates that the Schedule will require disclosure of the following with respect to each uncertain tax position: (i) a concise description of each uncertain tax position, and (ii) the maximum amount of potential federal tax liability that would be due if the position were disallowed (reflecting all changes to items of income, gain, loss, deduction, or credit).

The Announcement states that the concise description of each uncertain tax position must include the following information: (i) the Code sections potentially implicated by the position, (ii) the taxable year or years to which the position relates, (iii) whether the position involves an item of income, gain, loss, deduction, or credit against tax, (iv) whether the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both, (v) whether the position involves a determination of the value of any property or right, (vi) whether the position requires a computation of basis (together (i) – (vi), the "Six Enumerated Items"),[47] (vii) the rationale for the position, and (viii) a statement of the reasons for determining that the position is an uncertain tax position.

The Announcement provides that the adequacy of the disclosure will depend on the "particular facts and the nature of the underlying transaction." Further, the Announcement

[47] We do not discuss each of the Six Enumerated Items in this report. However, we do provide comments regarding the maximum liability in Part V.B(5).

states that the Service is "evaluating additional options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure" and that it may "seek legislation imposing a penalty for failure to file the schedule or make adequate disclosure."

The Schedule would not require disclosure of a taxpayer's tax accrual workpapers, nor would it require a taxpayer to disclose the amount of its reserve for any item. Commissioner Shulman explained that the reason the Service is asking for the maximum amount of the potential liability was in order to avoid asking taxpayers for the specific reserve amounts.

V. Discussion and Comments on Proposal

The Announcement states that the Schedule under development by the Service will require certain filers to provide information about uncertain tax positions that affect their United States federal income tax liability. IRS LMSB Commissioner Heather Maloy has explained that the Service welcomes comments from practitioners and taxpayers with respect to any specific issues involved in implementing the requirement that taxpayers provide the Schedule, including the issues enumerated in the Announcement, and, in that spirit, we offer the comments set out below.[48]

In his January 26, 2010 speech, Commissioner Shulman said that the Announcement was designed to "to improve transparency . . . so that [the Service could] achieve . . . objectives of certainty, consistency and efficiency."[49] The Commissioner noted that the Service auditors spends up to 25% of their time searching for issues to audit—time that

[48] *See supra* note 5

[49] *See supra* note 3.

could be better spent examining those issues and discussing and resolving them with taxpayers. He stated his belief that the audit system would work more efficiently if the Service had access "to more complete information earlier in the process regarding the nature and materiality of a taxpayer's uncertain tax positions."[50] Furthermore, he explained that his goals with respect to requiring the Schedule are (i) efficiency—to cut down the time it takes to find issues and complete an audit, to help [the Service] prioritize its selection of issues and taxpayers for examination, and bring large case audits into compliance and hold them there by keeping taxpayers compliant "with strategies that are less time and resource intensive than the traditional audit process," (ii) certainty—to allow a taxpayer that is transparent with the Service to get certainty at the time its return is filed, and (iii) consistency—to maintain consistent treatment across taxpayers.[51] Moreover, Commissioner Shulman stated his belief that the new proposed Schedule will not "be adding substantial new work or burden on taxpayers" because these taxpayers "are already required to establish tax reserves for uncertain tax positions in determining their financial-statement income under United States or foreign accounting standards, such as FIN 48."[52]

We agree that these objectives are very important and acknowledge the boldness of the proposal.[53] The Tax Section strongly endorses the goal of transparency. Also to be weighed in evaluating the proposal, however, are, for example: the effect that tying tax

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[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] We have inquired among attorneys practicing in other countries, many of which are significant trading partners with the United States, and to our knowledge an approach along these lines is at most infrequently encountered. On the other hand, we note the general trend towards greater fiscal transparency in many countries, and that the goal of transparency motivates the proposal. *See* OECD, "Public Sector Transparency and the International Investor" (2003).

reporting to financial reporting may have on the financial reporting process; the tools currently available to the Service and the Service's need for, and ability to sensitively and usefully employ, potent new weapons; the burdens that would be imposed on taxpayers; inconsistent treatment among taxpayers; and the intersection with the Rules of Privilege. We discuss these below in part V.A. below.

In devising an appropriate disclosure regime, a pivotal issue is whether the tax system should embrace tax disclosure tied to financial statements, or whether other approaches to achieving greater transparency should be considered. A clear majority of our Executive Committee, while acknowledging that there are serious concerns, would support adoption of a disclosure system tied to financial statement reserves. A significant minority of the Executive Committee voices caution based on concerns relating to the effect of the Announcement's approach on the financial reporting process (see Part V.A(1) below) and the objective and subjective inconsistencies that are unavoidable under such an approach (see Part V.A(4) below), and believe that alternative proposals should be considered.[54]

We believe that the announced goal of increased transparency which underlies the proposal is sound and that, assuming sensitive and careful implementation, this goal could be achieved through a general disclosure approach such as is incorporated in the proposal.

Below we first discuss the policy considerations that we believe should be taken into account when preparing the Schedule and its Instructions. We then address technical issues

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[54] One example suggested is to require disclosure of (i) any material tax return position that the taxpayer determined not to be "more likely than not" to prevail on the merits, (ii) any material tax return position that the taxpayer determined to be at least "more likely than not" on the merits but is contrary to a published position of the Service (e.g., a Revenue Ruling), and (iii) any material tax return position that is taken because it follows a general administrative practice of the Service.

raised by the Announcement, including recommendations for clarifications and changes that we believe the Service should consider when preparing its notice of proposed rulemaking, Schedule, and related Instructions.

A. Policy Considerations

(1) Effect on Communication with Auditors and Advisors

Some have expressed concerns that requiring the Schedule would have a chilling effect on the relationship business entities have with their auditors and tax advisors, and specifically, that taxpayers would put more pressure on their auditors to limit the items required to be reserved under FIN 48 and that tax advisors would be pressured to increase the strength of their opinions to avoid a FIN 48 reserve with respect to such issues.[55] It does seem clear that compliance with the proposal would require taxpayers to effectively concede large chunks of territory allowed them under the policy of restraint, and, thus raises the issues that motivated the adoption of that policy.

Although we readily believe that auditors and tax advisors will confront pressures (as they already do) to prepare strong opinions to either avoid reserving the position under US GAAP or disclose the position to the Service, we note that there are reasons why one might reasonably conclude that they would perform their professional and ethical responsibilities with the same diligence even if the proposal were adopted. For example, auditors and tax professionals (including in-house personnel) already face substantial criminal penalties, civil liability, and professional discipline (from state regulatory authorities, professional organizations, and Treasury's Office of Professional Responsibility) for failure to act

[55] *See, e.g.*, Wilkins Discusses Need for Uncertain Tax Position Reporting, 2010 Tax Notes Today 41-2 (Mar. 3, 2010).

properly in the computation and reflection of a taxpayer's FIN 48 reserves on its financial statements.[56]

The Supreme Court addressed a similar issue in *United States v. Arthur Young & Co.*,[57] in which it was argued that the absence of a work-product immunity for tax accrual workpapers prepared by independent auditors in the course of compliance with federal securities laws would tempt corporations to withhold from their auditors "certain information relevant and material to a proper evaluation of its financial statements."[58] The Court rejected this concern, stating that "the auditor is ethically and professionally obligated to ascertain for himself . . . whether the corporation's contingent tax liabilities have been accurately stated" and that "the independent auditor's obligation to serve the public interest assures that the integrity of the securities markets will be preserved, without the need for a work-product immunity for accountants' tax accrual workpapers."[59]

Nevertheless, we do believe that the Service should reflect seriously on the concerns of conflicting objectives and pressures on financial audit professionals that led to the policy of restraint following the *Arthur Young* case and that arise again under the approach described in the Announcement.

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[56] *See* §§ 10.50-10.52 of Circular 230. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), also provides additional control over the behavior of auditors and attorneys in this regard as well.

[57] 465 U.S. 805 (1984).

[58] *Id.* at 818.

[59] *Id.* at 819. *Accord,* United States v. Textron, 553 F.3d 87 (1st Cir. 2009), *rev'g* 507 F. Supp. 2d (D.R.I. 2007), *petition for cert. filed*, 78 USLW 3375 (Dec. 24, 2009) (NO. 09-750) ("the compulsion of the securities laws and auditing requirements assure that [Textron's workpapers] will be carefully prepared, in their present form, even though not protected ...."); United States v. El Paso, 682 F.2d 530 (5th Cir. 1982), *aff'g* 49 A.F.T.R.2d 82-380 (S.D.Tex 1981) (reasoning, two years before the Supreme Court's Arthur Young decision: "The powers of the SEC suffice to ensure that companies will comply with law."). Although each of these cases involved a demand for production of workpapers on audit, we do not think that fact meaningfully distinguishes them for this purpose.

Does the Service Need, and Can It Make Effective Use of, the Information?

The Service already has powerful tools for motivating disclosure of issues and identifying important issues, and for demanding information in respect thereof. These are described briefly in Part III.A of this Report. This has caused some to ask whether the Service is not already sufficiently and appropriately equipped with information and suggest that the Service should focus on better training its agents and using the considerable devices available to it.

Further, the Service has, in recent years, increased the type and degree of disclosure required from taxpayers. Substantial time delays between the provision of information to the Service and the Service's examination of that information has caused some to be concerned that the burden to the taxpayer is borne upfront without proper confirmation that the information will be very useful to the Service. It is unclear to what extent previously added disclosure requirements have positively affected efficiency and compliance. Some commentators have noted that other forms of disclosure, such as Forms 8275, 8082, and 8886, can fail to trigger an examination of the issues disclosed, even if the disclosed transaction involves large amounts of money, the Service could reasonably take a contrary position, and the taxpayer undergoes audit.

In the case of Schedule M-3, the jury is still out. For taxable years beginning in 2006, the Service implemented the most current version of Schedule M-3, which requires taxpayers to identify and detail their book-tax differences.[60] Because taxable years for which new Schedule M-3 was required are just beginning to be examined by the Service, the value of this information to the Service's audit process is not yet known.

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[60] IRS News Release 2006-114 (Jun. 20, 2006).

The information sought by the Service in the Schedule differs from, for example, the Schedule M-3 regime in that it targets specific items of tax uncertainty, which should make it more useful in theory and more used in practice. The Schedule resembles in this respect, though on a vastly different scale, the "tax shelter reporting" regime, which is also intended to target specific tax issues—reportable and listed transactions the Service believes require additional attention during its audit review because of the potential for tax abuse. We believe that the information contained in the Schedule can be used efficiently and productively by the Service.

We recommend that the Service put in place a framework so that the new information is best used to achieve the Commissioner's stated objectives of efficiency, consistency, and certainty, given that the burden placed on taxpayers can only be justified to the extent that the information on the Schedule helps the Service achieve these goals. There should be some clear sense of the amount of information that will be generated and that it will not be overwhelming, in order that the information that is collected can be automatically processed and used effectively to target taxpayers and transactions, consistent with the stated rationale.

To this end, it would seem to us particularly useful for the Service (if it has not already) to engage in empirical research using real case studies, or even engage in a pilot program, with certain (willing) participants, perhaps from the CAP.[61] Given that the proposal is not expected to be implemented prior to years beginning after January 1, 2010,[62]

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[61] We understand from statements of Chief Counsel Williams Wilkins reported in the press that the Service plans to continue and expand the CAP. Wilkins Describes Uncertain Tax Positions Under New Program, Highlights & Documents, March 11, 2010, 1379, 1380. Participants in the CAP already disclose reserved positions.

[62] As well as tax returns relating to the 2010 calendar year. Announcement 2010-17.

we strongly suggest that the Service conduct such a study in respect of, for example, 2009 taxable years of taxpayers, if any, which agree to participate.

We also recommend that the Service create a unit in the National Office to monitor information collected under the Schedule and coordinate the use of the Schedule by examining agents.[63] This would include providing detailed guidance to field agents as to the proper use of the information provided on the Schedule.[64] We are concerned that Examination may tend to use the information as a checklist to assert deficiencies by rote. For example, overzealous agents may propose deficiencies in respect of strong scheduled positions that are not entirely clear in order to seek what amounts to a nuisance settlement. There also is the risk that Examination may tend to overly focus on the Schedules, which would be inequitable to reporting taxpayers as compared with non-reporting taxpayers, and from the Service's standpoint may have the negative effect of tending to leave unscheduled issues unexamined. We recommend that the National Office monitor and reassess the value of this disclosure over time to make sure the information is being used effectively, efficiently, and properly.[65]

We note that the proposal could offer the opportunity to improve the examination process. For example, the Service should use it to offer faster audit resolution to taxpayers. Similarly, to the extent material issues are disclosed that affect a broad class of taxpayers,

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[63] Compare the program instituted for listed transactions. *See* IRS Audit Technique Guide, Abusive Tax Shelters and Transactions (released May 24, 2005).

[64] We note that Chief Counsel Wilkins has acknowledged that this is something that must be done. Wilkins Describes Uncertain Tax Positions Under New Program, Highlights & Documents, March 11, 2010, 1379, 1380.

[65] In this regard, we recommend that the Service periodically reconsider all of the disclosure requirements imposed on taxpayers, and to the extent such requirements are ineffective, duplicative, or unduly burdensome such requirements should be eliminated. Indeed LMSB Commissioner Maloy stated that the Service hoped to reduce some other filing requirements upon adoption of the Schedule. *See supra* note 5.

the Service could provide guidance to all taxpayers with respect to such issues. We believe that taxpayers are entitled to reap such benefits to compensate for the burdens imposed by the proposal.

(2) Burden on Taxpayer

We, like others, have concerns that the Schedule as currently described would impose too great a burden. To be of value the Schedule must not only provide information to the Service that can be put to effective use, it must also minimize the costs of compliance imposed on taxpayers. To the extent the Schedule would request only information that a taxpayer prepares for its financial reporting under US GAAP, including FIN 48, the Announcement arguably meets this cost-benefit test by not asking a taxpayer to prepare or disclose information to the Service that the taxpayer does not already have on hand.

Careful consideration, however, should be given to disclosure of information that deviates from the breadth or level of specificity required under the taxpayer's applicable accounting standard. The proposal asks for certain information on the Schedule that is not already prepared under FIN 48 (or other accounting standards), including disclosure in respect of positions that the Service has a policy not to examine, the maximum amount of such potential liability, the rationale for the taxpayer's positions, and the reasons for the uncertainty as to the tax position. This information would take additional time for taxpayers to prepare and would not necessarily be useful to the Service. We discuss below in more detail certain of the proposed requirements of disclosure and recommend eliminating or reducing the amount of information required,[66] and eliminating other duplicative disclosure

[66] *See infra* Part V.B(3).

requirements to ameliorate any additional burden to the taxpayer and encourage compliance.[67]

(3) Inconsistent Treatment of Taxpayers

The proposal incorporates certain systemic inconsistencies in its treatment of taxpayers. We discuss below at Part V.B.9 the fact that the proposal would affect only taxpayers that maintain reserves for uncertain tax positions for purposes of audited financial statements. We discuss below at Part V.B.2 the further inconsistency that results from the fact that IFRS and FIN 48 have very different approaches to uncertain tax positions, and are not static. Finally, we note that the process of determining reserves itself is laden with subjectivity, and hence inconsistency, because it necessarily is based on the judgments of taxpayers and their advisors and is affected by the risk profiles of taxpayers, the nature and size of their businesses, and so forth.

(4) Interaction of the Announcement and Taxpayer Privileges

The Announcement does not expressly require disclosure of information regarding how the taxpayer determined its tax reserves or information that might include confidential communications between the taxpayer and its attorneys and/or federally authorized tax practitioners. As discussed above, there is significant ambiguity regarding the extent to which such information would be protected from disclosure by the Rules of Privilege. Because the Announcement does not specifically address the interplay between the Announcement and these Rules of Privilege, we infer that the Service is not purporting to override,[68] and is not asking Congress to override,[69] any existing Rules of Privilege in

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[67] *See infra* Part V.B.

[68] This is consistent with reported statements of Chief Counsel Wilkins. *See supra* note 64.

requiring such disclosure. This would be consistent with the approach adopted by the Service in Treasury Regulation section 301.6112-1(e)(2), which recognizes that the Code's requirement that a "material advisor" prepare, maintain, and furnish to the Service lists of "advisees" does not preclude the advisor from claiming application of the Rules of Privilege to matters within their scope.

The precise scope of the Rules of Privilege is the subject of frequent litigation between taxpayers and the Service. It would not be surprising if circumstances arose in which a taxpayer reasonably could argue that a disclosure proposed to be required by the Announcement would require disclosure of a matter protected by the Rules of Privilege. Or, in the absence of guidance, a taxpayer reasonably might feel compelled to assert the Rules of Privilege as a defense against disclosure in accordance with the Announcement to avoid a claim by the Service that the taxpayer had waived the Rules of Privilege as to underlying workpapers and communications. For example, *Textron* raises an issue regarding whether the work product doctrine protects certain information contained in tax-accrual workpapers from disclosure in the context of a Service summons enforcement proceeding.[70]

Even when a colorable claim of privilege could be asserted, however, many taxpayers will not want to incur the expense of asserting and, ultimately, litigating every legitimate claim of privilege that may arise in connection with compliance with the proposed disclosure requirements, and it is certainly in the interest of the Service that the Schedule lead to disclosure rather than to litigation. It would be undesirable for concerns regarding

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[69] We do not believe that the Service has been granted the authority by any existing legislation to modify the Rules of Privilege as they currently apply to information sought on tax return disclosures and other materials filed with the Service.

[70] United States v. Textron, 507 F.Supp. 2d 138 (D.R.I. 2007), *rev'd,* 553 F.3d 87 (1st Cir. 2009), *petition for cert. filed*, 78 USLW 3375 (Dec. 24, 2009) (NO. 09-750).

potential "subject matter waiver" to force taxpayers to assert claims of privilege that they would not otherwise make.[71]

Accordingly, we recommend that the Schedule and any accompanying instructions expressly state that the disclosure required on the Schedule is not intended to override any otherwise applicable Rules of Privilege, and that claims of privilege may continue to be asserted to the same extent permitted under current law. At the same time, the Service could indicate its belief that, in the vast majority of cases, the information sought by the Schedule would not be protected by the Rules of Privilege. In addition, the Service should clarify that, whether or not certain information is in fact covered by the Rules of Privilege, the disclosure of such information pursuant to the Announcement does not constitute a "subject matter waiver" with respect to any confidential communications or other matters that are otherwise protected by the Rules of Privilege, and, furthermore, the Service will not argue to the contrary in any administrative or judicial proceeding.

B. Technical Matters Raised by the Announcement

(1) Uncertain Tax Positions Conforming to Accounting Standards

As we understand the Announcement, three categories of positions on a return will be considered "uncertain tax positions" that must be disclosed on the Schedule: (i) positions for which a reserve is actually reflected on the taxpayer's financial statements, (ii) positions for which a taxpayer has not recorded a reserve because the taxpayer expects to litigate the position, and (iii) positions for which the taxpayer has not recorded a tax reserve because the

[71] Fed. R. Evid. 502 provides specific rules governing waiver of the attorney-client privilege and work product protection. However, those rules only govern disclosures made in judicial or administrative proceedings and would not apply to disclosures made on a Federal income tax return.

taxpayer has determined that the Service has a general administrative practice not to examine the position even though there is a technical violation of tax law.

In his speech, Commissioner Shulman stated that "[the Service] is asking for a list that the taxpayer has already prepared for financial reporting purposes."[72] Although much, if not all, of the information described in the Announcement is likely to have been developed by a taxpayer with respect to each position for which a tax reserve is actually reflected on its financial statements, the same may not be true with respect to a position in one of the latter two categories, and certain information relating to the positions may not be readily available to the taxpayer.[73]

(a) Expects to Litigate

If a taxpayer is "highly certain" that it would prevail in audit or litigation relating to an uncertain tax position, then no reserve is required.[74] This is true regardless of the taxpayer's actual intent to litigate. On the other hand, if a taxpayer who would otherwise be required to provide a tax reserve for an uncertain tax position (because of the expected outcome on audit) determines that it intends to litigate if challenged, and that if it litigates it expects to win, then likewise, no reserve is required. However, we understand from the Announcement that the second category, where a taxpayer expects to litigate and win, would be required to be listed on the Schedule, whereas the first category would not be required to

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[72] *See supra* note 3.

[73] Taxpayers subject to the CAP (a program pursuant to which the Service invites certain large taxpayers to be audited on a real-time basis) are required to confirm under penalties of perjury that they have disclosed to their auditors all tax reserves under FIN 48 and that there are no tax positions that would require reserves to be reported but that have not been disclosed to the Service. However, even this disclosure does not include all the supplementary information that will be required by the Schedule. *See* Announcement 2005-87 (Dec. 8, 2005).

[74] Indeed, such positions are not considered uncertain tax positions and, therefore, not subject to the two-step process under FIN 48.

be listed. We therefore ask that the Service confirm that the requirement to list positions for items that "taxpayer expects to litigate" includes only those items that are at or above "more likely than not" but for which no reserves have been set up on the financial statements solely because the taxpayer expects to litigate the position through trial and expects to win; conversely, if no reserve would be required on the financial statements because of the technical merits of the position regardless of an intention to litigate if necessary, such item should not be required to be listed on the Schedule.

Once the Service distinguishes the two categories discussed above, we recommend that the Service provide guidance to taxpayers concerning how they should demonstrate the category into which their uncertain tax positions fall. In many cases, a taxpayer's books and records include a discussion of whether the taxpayer intends to litigate the position and, if so, whether the taxpayer would likely prevail. However, we do not believe the discussion alone should signal that the taxpayer did not reserve "solely" because it intends to litigate the position. We request guidance from the Service as to how taxpayers should document this distinction.

(b) Administrative Practice

The second addition to the FIN 48 (or other accounting standards) definition of "uncertain tax positions" would require a taxpayer to include on its Schedule each item not reserved because the taxpayer has determined that the Service has a general administrative practice not to examine the position even though there is a technical violation of tax law. Under FIN 48, the "more likely than not" threshold may be reached if a company can establish that its tax position is consistent with widely understood "past administrative

practices and precedents of the taxing authority in its dealings with the entity or similar entities."[75]

Commissioner Shulman stated that the Schedule is intended to "add efficiency to the process [so that the Service can] cut down the time it takes to find issues and complete audits . . . [and] to help [the Service] prioritize selection of issues and taxpayers for examination."[76] We believe that requiring taxpayers to attempt to identify and list items that have been previously ignored on audit (probably by taxpayers as well as the Service), places a burden on taxpayers while making the list less useful to the Service, as it will detract from time available for significant issues and increase the time required to complete audits.[77] It would seem difficult to administer a distinction between positions for which a taxpayer actively considered and "determined" that the Service had a general administrative practice of non-examination and positions for which taxpayers and the Service followed past practice. We therefore recommend that that Service reconsider the requirement to list as uncertain tax positions all those positions that the Service has a general administrative practice not to examine. The positions required to be disclosed should, we believe, be limited to those identified by the taxpayer without an affirmative duty of inquiry under the Schedule preparation process.

We also ask the Service to confirm that any items for which a reserve would not have been required under the taxpayer's method of computing tax reserves for financial statement purposes (even if the taxpayer did conclude that the Service has a general

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[75] FASB ASC 740-10-25-7(b); *see also id.* at 55-90 through 55-92.

[76] *See supra* note 3.

[77] *See infra* Part V.B(6)

administrative practice of not examining such positions) are not required to be listed on the Schedule.

(2) Other Accounting Standards

The Announcement applies to taxpayers that prepare financial statements, or are included in the financial statements of a related entity that prepares financial statements, if that taxpayer, or related entity, determines its United States federal income tax reserves under FIN 48 or other accounting standards.

We understand that the IFRS do not currently conform to FIN 48 (required for US GAAP) for uncertain income tax positions and that IFRS do not have a specific standard for uncertain income tax positions.[78] Because IFRS do not have specific guidance governing uncertain income tax positions, taxpayers subject to IFRS and those following US GAAP will often take inconsistent reserve positions for substantially similar issues. We note a recent report that the International Accounting Standards Board ("IASB") plans to address uncertain tax positions, but only after the revision of IAS 37, Provisions, Contingent Liabilities and Contingent Assets, is finalized; and further, the IASB members believe that the result of any amendment would not be to cause IFRS to move closer to US GAAP on uncertain tax positions.[79] In addition to IFRS, there may be other accounting standards that either do not have any (or have a substantially different) requirement to reserve for uncertain tax positions.

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[78] Although not specifically applicable, we understand that most companies subject to IFRS rely on International Accounting Standard 37 ("IAS 37"), which governs contingent liabilities. International Accounting Standard No. 37 (1998) (Provisions, Contingent Liabilities and Contingent Assets).

[79] Stephen Bouvier, IASB Courts Controversy in Decision to Address Uncertain Tax Positions, 52 DTR (Mar. 19, 2010) I-2.

One of the Commissioners' stated objectives is consistency. To the extent taxpayers are subject to different accounting standards, the reporting requirements under the proposal may differ among taxpayers, creating inconsistencies in the disclosure. Taxpayers subject to US GAAP might have significantly more (or less) items disclosed on the Schedule than those subject to IFRS or other local GAAP regimes. The differences in requirements might bias the Service to target certain taxpayers, even though such taxpayers do not merit a higher priority audit. These concerns might be exacerbated if IFRS were made applicable to larger SEC reporting entities.

However, basing the Schedule on a taxpayer's actual financial statement reserves is fundamental to the practical feasibility of the proposal, both from the standpoint of taxpayer burden and taxpayer compliance. Requiring all taxpayers to prepare US GAAP statements for their uncertain tax positions is not an option. Therefore, we request that the Service confirm that the Schedule ties to a taxpayer's reporting requirements under the accounting standards applicable to it, even though different taxpayers may be subject to different disclosure standards. In addition, we recommend that the disclosure requirements automatically incorporate any changes to the standards under the applicable accounting regime or successor provisions to which the taxpayer is subject, except to the extent the Service provides otherwise.

Further, we recommend that the Service clarify which accounting standard applies in situations where different entities of a global business use different accounting standards. For example, if a subsidiary of a multinational conglomerate maintains its accounts under US GAAP, but the parent reports (on a consolidated basis with its subsidiaries) under a different accounting standard, it is unclear which tax reserves serve as the basis for the

Schedule. We recommend that the reserves used for the US subsidiary be the appropriate basis for disclosure to the extent such reserves are subject to US GAAP. Lastly, to the extent the subsidiary creates two sets of financial statements (for example, one under US GAAP and another under a regulatory regime), the Service should specify which reserves should be used.

(3) Concise Statement

The Announcement states that the Schedule will require a concise description of each uncertain tax position in sufficient detail to enable the Service to determine the nature of the issue. "[T]he concise 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." This description would require a taxpayer both to describe the reason(s) that the taxpayer believes its position will be successful and to articulate the arguments against the success of its position. By contrast, under FIN 48, a reporting entity is not required to provide any rationale for its position and is not required to prepare a written explanation of why a position is uncertain.[80]

In determining how much disclosure is necessary, the Service should consider the increased burden to taxpayers of preparing information not required by FIN 48 and should bear in mind Commissioner Shulman's stated goals: keeping the description to "a few sentences that inform [the Service] of the nature of the issue," "cut[ting] down the time it takes to find issues," and, consistent with Service's policy of restraint, to "not require that taxpayers disclose how strong or weak they regard their positions."[81] We have concerns

[80] *See supra* notes 29-42 and accompanying text. A reporting entity must, however, disclose certain possible changes to its positions.

[81] *See supra* note 3.

regarding the extent of disclosure that may be contemplated by the proposed requirements to state the rationale and the reason the position is uncertain.

Requiring a taxpayer with many uncertain tax positions to provide significant information regarding the rationale of each of its uncertain tax positions could be time-consuming, require exercise of significant judgment, require legal advice, and, as a result, be more burdensome than we believe is intended. Further, in the case of close issues, it either may result in overly favorable shading of the position or may cut too close to requiring the taxpayer to disclose the strength of its positions.[82]

We believe that a Schedule that requires a sufficiently precise statement of the legal issue in its factual context, even without further stating a rationale, should be sufficient to highlight the issues that the Service may wish to audit without imposing an undue burden on taxpayers. In fact, the Shulman Speech stated that what would be required is "a list of issues." For example, if a taxpayer deducted rather than capitalized a material amount of cost in respect of certain activity in the current year, the statement might read: "[Type of costs] attributable to [activity] deducted rather than capitalized; (issue whether [long-term benefit]. Section 162 and Treas. Reg. section 1.263(a)-1)." As another example, if a taxpayer took the position that a transaction qualified as a tax-free spin-off without receiving a ruling, the taxpayer might schedule the item as follows: "Pro-rata distribution of subsidiary stock to shareholders treated as tax free under Section 355; (issue of business purpose ("fit and focus"))." If a taxpayer was uncertain whether certain options should be deemed exercised under section 382, the statement might read: "issuance of options treated

[82] Moreover, if significant information regarding the taxpayer's rationale was required, the required disclosure might raise questions of waiver of attorney-client privilege and would, in that event, in most cases lead to the involvement of the taxpayer's outside tax advisors in the disclosure process, giving rise to large and unnecessary legal expenses.

as not exercised for purposes of section 382; (issue whether meets test under Treas. Reg. section 1.382-4(d)). Lastly, if a taxpayer was uncertain whether a debt exchange gives rise to cancellation of indebtedness income the statement might read: "exchange of old debt for new debt does not give rise to cancellation of indebtedness income; (issue whether old debt or new debt is publicly traded. Treas. Reg. § 1.1273-2(f)(4) and (f)(5))." Thus, we recommend that the Service restate the rationale requirement as requiring that a taxpayer need provide a short statement of the issue with applicable Code and regulation citations. We believe that a series of examples in the Instructions illustrating this point would be highly valuable.

The Announcement also states that the concise description of each uncertain tax position will also have to include a concise general statement of the reason for determining that the position is uncertain. We believe that this requirement, to the extent that it might go beyond the type of disclosure we have indicated in the examples above, should not be needed to achieve the Service's objectives and would be contrary to the statement in the Shulman Speech that the proposal "would not require that taxpayers disclose how strong or weak they regard their tax positions" and would not "get in the heads of taxpayers."[83] This requirement does not merely aid the Service in identifying issues but could also affect the substantive resolution of the matter. Accordingly, we recommend that the Service clarify that this requirement would be satisfied by the type of disclosure we have indicated in the examples above.

Finally, we recommend that to the extent possible (*e.g.*, with respect to certain of the Six Enumerated Items), the information be provided by checking a box, in order to ease both

[83] *See supra* note 3.

taxpayer compliance and Service automated processing. Where appropriate, space could be provided for taxpayer clarification at the taxpayer's option.

(4) Unit of Account

Unlike FIN 48, which does not require taxpayers to specify in great detail the different items for which it has set up reserves in its financial statements (other than those that might change significantly over the next twelve months), the Announcement seems to require taxpayers to identify each uncertain tax position. Under FIN 48, accountants use a "unit of account" to determine what constitutes an individual tax position and whether the more likely than not recognition threshold is met. Each enterprise makes its own determination as to whether certain tax positions are similar enough to fall within the same unit of account.[84] We believe that the Schedule is intended to follow this same approach (*i.e.*, allowing taxpayers to make recognition determinations based on the level at which it accumulates information and the level at which it anticipates addressing the issue with the taxing authority), which will lessen any burden associated with the preparation of the Schedule but should not affect its utility. Such an approach would be consistent with the description of the proposal outlined in the Shulman speech, stating that the Service is only asking for information the taxpayer has already prepared. The unit of account would be relevant to the sorting of issues for purposes of the concise description, the granularity of the description, and determining materiality (if the standard therefor were based on units of account).[85]

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[84] FASB ASC 740-10-25-13.

[85] *See supra* Part V.B(6)

(5) Maximum Amount

In order to avoid requiring taxpayers to disclose their actual risk assessment or tax reserve amounts with respect to uncertain tax positions, the Announcement proposes that taxpayers disclose the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer's risk analysis regarding the likelihood of prevailing on the merits). We commend the Service for this restraint, and understand that the Service is asking for the maximum amount in order to "allocate [its] exam resources appropriately" by effectively and efficiently measuring the materiality of each uncertain tax position.[86] However, we do not believe that requiring taxpayers to provide the maximum amount of potential liability is an appropriate means of meeting this goal for the following reasons.

First, the determination of the maximum of potential liability can be difficult to calculate and sometimes may be impossible. There can be many alternative treatments for a transaction that is reported in a particular way on a return, and each of those can potentially lead to a different liability. For example, if a taxpayer took the position that a credit default swap should not be treated as a notional principal contract subject to the contingent swap regulations,[87] the swap could be recharacterized as an insurance contract, a guarantee, an option, or a notional principal contract subject to the contingent swap regulations. Similarly, it may not be simple for a taxpayer that has deducted an expenditure to determine the precise year-by-year tax consequences of disallowance and capitalization.[88]

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[86] Announcement 2010-9.

[87] Treas. Reg. § 1.446-3 & Prop. Reg. § 1.446-3(g).

[88] *See, e.g.*, Treas. Reg. § 1.263A-1(c)(4) (costs capitalized under section 263A "are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used,

Second, the maximum amount of potential liability may simply be unknowable, for example, in cases involving transfer pricing and valuation generally, especially with respect to intangibles. It seems inappropriate to require taxpayers to assume extreme and unrealistic values, but that may be required (or even insufficient) under a "maximum amount of potential liability" standard.[89]

Third, the information received in response to such a requirement might actually be misleading to the Service, since it may tend to direct the Service's audit efforts toward high dollar amounts, including those associated with relatively low-probability-of-loss positions. This reality also might provide taxpayers the opportunity to divert attention from more uncertain positions.

Finally, positions that relate to a one-year timing difference would be much less significant to the Service in terms of monetary assessments. For example, a taxpayer might have an extremely large uncertain tax position with respect to a deduction that should be taken in the current year or following year. Although the amount of such liability is large, the additional recovery for the Service that is assessed on audit would be limited to one year's interest (and possibly penalties). In these cases, the maximum amount of the position would not be an accurate measurement of the priority of the issue at audit. (This issue also could be addressed by a requirement to identify such a timing difference.)

If a maximum amount calculation is required, the Service would also need to address the other variables that taxpayers may need to consider. For example, would a change in a

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sold, placed in service, or otherwise disposed of by the taxpayer," as determined under "applicable Internal Revenue Code and regulation provisions").

[89] Taxpayers will likely involve their counsel in making these determinations, which could be costly, and, as discussed below, could cause attorneys to become tax return preparers for each uncertain tax position on the return.

tax position (i) cause the taxpayer to become subject to alternative minimum tax, (ii) eliminate previous net operating losses or (iii) subject to additional items of income to tax?

In order to facilitate the efficiency of audits and the effectiveness of the Schedule, we recommend that the Service adopt a threshold (basket) system to help the Service prioritize issues and determine materiality. Such a system would create only a minimal amount of additional work, thereby minimizing the burden on taxpayers. Under such a system, taxpayers could indicate whether the total exposure for each uncertain tax position is above or below a stated amount or percentage. This type of segregation should enable the Service to appropriately target taxpayers and to prioritize audit issues. With respect to a threshold, there are various possibilities by which the Service could segregate positions, including:

1. Dollar Value. Taxpayers could segregate their uncertain tax positions into two or more baskets based on whether the maximum potential liability would be above or below one or more dollar thresholds.

2. Percentage of Revenue or Expense. Taxpayers could segregate their uncertain tax positions with respect to whether the maximum potential liability represents more or less than x% of the taxpayer's aggregate revenues or expenses required to be reported on the return.

3. Percentage of Reserves. Taxpayers could segregate their uncertain tax positions with respect to whether the maximum potential liability represents more or less than x% of the taxpayer's recorded reserves on the taxpayer's financial statements. The Service could require more than two threshold categories (*e.g.*, greater than 10%, between 1% and 10%, less than 1%).

Each of the alternatives has the benefit of alleviating some of the burden from the taxpayer by not requiring them to calculate the exact maximum amount of the potential liability, and each of the alternatives has its own advantages and disadvantages. The first alternative has the benefit of allowing the Service to compare absolute amounts among taxpayers. However, the dollar value of the liability can be misleading when comparing the dollar value against both large and small taxpayers. If the threshold is too low, larger taxpayers would be burdened with items that might not be that material to their tax return. If the threshold is too high, smaller taxpayers might escape review for transactions that should otherwise be subject to audit. Of course, there could be a different schedule of baskets for large taxpayers.

The second alternative, percentage of revenue or expense, has the benefit of measuring materiality based on the size of the particular taxpayer. However, measurement by size would create a greater dollar threshold of materiality for larger taxpayers. This greater threshold might cause larger taxpayers to escape audit on issues the Service focuses on with respect to smaller taxpayers.

The third alternative, percentage of reserves, has the benefit of prioritizing issues for the Service on a taxpayer-by-taxpayer basis. However, this alternative does not provide the Service with the ability to compare taxpayers' uncertain positions on a gross basis across the board because the relative importance of each issue under this alternative will depend on the number of items and the dollar value of such items in the taxpayer's reserve.

Although each of the alternatives has its benefits and detriments, any of them would provide the Service with sufficient information to either target specific taxpayers or target specific positions taken by a particular taxpayer. A statement of the maximum liability

would not create a significant additional benefit for the Service, while it would undoubtedly create additional work for taxpayers. When creating a threshold, it may be relevant to consider whether the threshold should apply on a position-by-position basis or with respect to each "unit of account."

(6) Immaterial Issues

When a company prepares financial statements, all of its uncertain tax positions should be included. However, certain items may not get included as a liability, possibly because the amounts are thought to be insignificant by the company. Upon audit by the accountants, those items may be ignored if the amounts are considered immaterial to the financial statements as a whole. Different levels of materiality are present across taxpayers because of the difference in practice among auditors, internal treasury officers, and the size of the company being audited.

We believe that all items, whether or not deemed immaterial during audit, that are analyzed and identified in the accounting process should be tentatively taken into account in preparing the Schedule subject, however, to a materiality standard to be articulated for purposes of the Schedule. The materiality standard need not be the same for every item or every entity.[90]

The Service could conform a materiality standard to that used by the taxpayer's auditors. To the extent an item was not included in the financial statements, and not required to be included by auditors because it was below their materiality determination, the Service

[90] For an analogy, one might look to the rules under Treasury Regulation section 1.6011-4 for the disclosure of "loss transactions," under which the threshold for disclosure depends on the nature of the taxpayer and the nature of the loss. However, in making the determination as to whether an item is immaterial, the Service would have to take into account whether such item is recurring (in which case the Service may want to use the totality of the item for all open years to assess materiality).

could excuse such item from being disclosed on the Schedule. This would provide for ease of administration. However, taxpayers may have significantly disparate materiality standards, especially given their different sizes, as well as across different auditors, different accounting standards, and different internal controls.

Alternatively, the Service could propose one or more new materiality standards. The Service could differentiate whether items are immaterial for taxpayers based on numerous standards, such as those discussed above with respect to disclosing the maximum amount. Taxpayers could eliminate items that are below a certain dollar value, percentage of revenue or expense, or percentage of reserves. Fairness across taxpayers must be considered, as larger taxpayers will have a higher materiality standard, possibly allowing them to escape audit on issues that smaller taxpayers will face. In composing a materiality standard, the Service should consider whether the standard should apply to each uncertain tax position or to a set of positions that are part of the same "unit of account."

(7) Solely Income Taxes

The Announcement requires taxpayers to schedule information about their uncertain tax positions that affect their "United States federal income tax liability" for which they have tax reserves under FIN 48 or other accounting standards. While FIN 48 provides for reserves only with respect to income taxes, other FASB standards, such as Financial Accounting Standard No. 5 ("FAS 5"),[91] require reserves for non-income taxes such as employment, excise, and withholding taxes.[92]

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[91] Statement of Fin. Accounting Standards No. 5 (1975). All references to FAS 5 refer to the contingent liability rules as codified at FASB ASC 450-20.

[92] FIN 48 relies on FAS 109, which provides that income taxes include domestic and foreign federal (national), state, and local (including franchise) taxes based on income. Statement of Fin. Accounting Standards No. 109 (1992).

Under FAS 5, a company is required to provide a reserve for a contingent liability if it is probable that the company will sustain a loss.[93] Contingent liabilities (including non-income taxes) are segregated into three categories: (i) probable, (ii) remote, and (iii) reasonably possible.[94] Generally, if the liability is probable, then the liability is recorded, and if there is a range of outcomes for the liability, we understand that the company records the low end of the range and might discuss the liability in the commitments and contingencies section of the financial statements.[95] If the liability is remote, then the company is not required to record or disclose the liability. If the liability is more than remote but less than probable, the company must disclose the liability as well as the amount of the exposure if it is able to be quantified.[96] Although there are no specific guidelines with respect to what constitutes probable versus possible, etc., we understand from discussions with accountants that they generally consider a liability probable if there is around a 70% to 80% likelihood of occurrence.

Taxpayers are subject to both FIN 48 and FAS 5, depending on the type of contingent liability (*i.e.*, type of tax). Because the Announcement refers to FIN 48 as the basis for reporting under the Schedule, we understand that only income taxes are intended to be covered and therefore request that the Service confirm this understanding.

We concur with the Service's decision to apply this new and untested form of disclosure to only one class of tax liabilities at this time. In the event that the experience shows that the Schedule is an appropriate and useful tool for the Service, consideration

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[93] FASB ASC 450-20-25-2.

[94] *Id.* at 25-1.

[95] *Id.* at 30-1 & 50-1.

[96] *Id.* at 50-3.

could be given at a future date to possibly extending the disclosure requirements to other taxes.

(8) Current Tax Return Items Only

The Announcement provides that the description for the uncertain tax position must include a description of the taxable year or years to which the position relates. However, this does not specify whether years other than the current taxable year need to be included. We ask the Service to clarify that the Schedule need only disclose uncertain tax positions relating to the current tax return, even though the tax reserves on the financial statements relate to all taxable years for which the taxpayer is still subject to possible audit. Our system of tax reporting relies on an annual accounting; requiring a schedule to cross over more than one accounting cycle would be inconsistent with this annual tax return compliance system. In the interest of an acceptable compliance burden we do not believe that, as a general matter, prior positions not directly relevant to the current return should be annually restated. However, we do believe that to the extent reserves with respect to a position were increased, the Schedule should include the position for the year in which the reserve changed.

Our recommended approach would be to require taxpayer reporting only for any item realized or generated during the taxable year for which disclosure is made. Under such an approach, for example, a valuation or other tax basis position would affect all years in which depreciation or amortization is taken by the company in respect of the asset. Under an alternative approach, the item would be disclosed for only the first year in which the tax basis is determined.

Whether the Service adopts a current year approach for the Schedule, we recommend that the Schedule and Instructions generally should carve out correlative positions (*i.e.*,

positions that derive from the initial uncertain tax position items). Tax positions may indirectly affect earnings and profits or net operating losses, among other things. For example, in general, we do not believe that uncertain tax positions relating to items comprising a net operating loss that is used in the current year but that does not otherwise relate to the current year should be required to be disclosed for the current year. If, however, the uncertain tax position relates to the ability to claim the net operating loss in a particular year (*e.g.*, in the case of a specified liability loss under section 172(f) or a corporate equity reduction interest loss under section 172(h)), then that of course should be required to be disclosed.

(9) Entities Subject to the Announcement

The Announcement provides that the Schedule is to be filed by business taxpayers with total assets in excess of $10 million if the taxpayer or a related party prepares financial statements.

The general tax policy of consistent treatment of taxpayers is not met when only certain taxpayers are required to comply with a disclosure or other requirement and distinctions are not based on the actual tax return positions taken. The inconsistency in this context would be based on the size and financial reporting status of the taxpayer. For example, a large private multinational company may not be required to prepare financial statements and, thus, may fall outside the scope of the Announcement, while a small private company may be subject to the proposed reporting because it is required to prepare financial statements to maintain compliance with its credit agreement covenants. Additionally, there is no reason to believe that large public companies are more or less likely to take aggressive tax positions than large private companies, which might conflict with the Service's goal of efficiently targeting the proper taxpayers.

However, although consistency is an important overriding goal, we note that similar distinctions based on size or other criteria are made in connection with reporting and enforcement of the tax law.[97] Given the Service's understandable wish to avail itself of information that can be accessed, and given the hardship that would burden taxpayers that do not currently prepare financial statements, we agree that the Schedule should only be required by taxpayers, or related parties, that prepare financial statements.

(10) Related Party Issues

The Announcement provides that the Schedule must be filed by any business taxpayer with total assets in excess of $10 million if the taxpayer has one or more uncertain tax positions, and either the taxpayer prepares financial statements or is included in the financial statements of a related entity that prepares financial statements. For purposes of determining whether two parties are related, the Announcement incorporates the related party rules under Sections 267(b), 318(a) and 707(b). Chief Counsel Wilkins stated that "the Announcement is trying to avoid inconsistency in who files a tax return and where financial reporting of a position occurs."[98]

There are circumstances in which the technical taxpayer (*i.e.*, the entity that files the tax return) is not necessarily the same entity that prepares financial statements. In order for the tax reserves in such financial statements to be listed on a Schedule, we agree that a related party rule is necessary. For example, assume a parent and a subsidiary, both US corporations, file a consolidated US tax return, and the subsidiary prepares financial statements in accordance with US GAAP. Although the subsidiary does not itself file tax

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[97] *E.g.*, Schedule M-3 (only applicable to taxpayers with assets over $10 million); Form 8886 (only applicable to loss transactions over a certain threshold); Form 547 (only applicable to interest over a certain threshold).

[98] *See supra* note 55.

returns, we believe that the parent should be required to include the tax reserves of the subsidiary on a Schedule attached to the US consolidated return. Similarly, assume the parent is a foreign corporation that prepares financial statements in accordance with IFRS for itself and the subsidiary, a US corporation, and such financial statements have tax reserves for the subsidiary. We believe that, in this case, the subsidiary should be required to attach a Schedule to its US tax return, listing the uncertain tax positions that were part of the parent's financial statements. We also agree with the Service that such reserves would be listed on the Schedule as such reserves are recorded under IFRS.

However, we believe that the Service needs to clarify the extent to which the related party rule applies. We recommend the following:

First, to the extent a taxpayer's financial information, including tax reserves, are included in the prepared financial statements of a related party, as determined under Sections 267(b), 318(a) and 707(b), and such taxpayer files a US tax return, we recommend that the taxpayer include the tax reserves on the Schedule.

Second, to the extent a taxpayer's financial information, including tax reserves, are included in the prepared financial statements of a related party that files a global income tax return and such taxpayer does not file a US tax return, we recommend that the tax reserves be included on a Schedule prepared by the related party (even if such party is different from the entity that prepared the financial statements).

Third, to the extent a business entity prepares financial statements and such entity is an owner in a pass-through entity, the items listed on the Schedule should include the "allocable portion" of any uncertain tax positions of the underlying pass-through vehicle.

(11) Pass-Through Entities

Although many pass-through entities prepare financial statements in compliance with US GAAP, federal tax liabilities are the responsibilities of the owners of such entities, rather than the entities themselves. As such, although these entities are generally subject to FIN 48 reporting, because they do not generally pay United States federal income tax they do not have uncertain tax positions with respect to United States federal income tax. Based on the scope of the Announcement, our understanding is that, generally, pass-through entities would not be required to prepare the Schedule because such entities do not have FIN 48 reserves with respect to federal income tax, unless there is uncertainty regarding their status as a partnership (for example, under section 7704).

We therefore ask the Service to confirm our understanding that pass-through entities would not be subject to the requirement of filing a Schedule unless such entities have uncertain tax positions with respect to United States federal income tax liabilities for which they are primarily liable.

Many pass-through entities have corporate partners and such partners may themselves be subject to FIN 48 reporting. It is our understanding that to the extent a tax item of a pass-through entity is a material part of the partner's financial statements taken as a whole, the partner is required to scrutinize the item under FIN 48 as if the partner had directly engaged in the underlying activity giving rise to the tax item. Part of that FIN 48 diligence requires the partner to contact the partnership to obtain any relevant information regarding its allocable tax items so as to ensure that the partner is properly establishing reserves for any potentially uncertain tax positions on its financial statements.

We suggest that the Service confirm that the owners of pass-through entities that prepare financial statements are required to include in the Schedule items that relate to their respective interest in the pass-through entity.

One area of uncertainty is whether the diligence required of the partner under FIN 48 (which, as noted, may be tied to a different materiality standard than might be appropriate under the Schedule), and whatever motivation may currently exist for the partnership to cooperate, would be sufficient under the Schedule. In some circumstances a partner may not be aware that a particular tax item allocated to it is in fact an uncertain tax position because, for example, information pertaining to its uncertainty resides at the partnership level. Where this is the case, the Service might consider whether to impose an affirmative duty on the pass-through entity to inform either the partner or the Service about the potentially uncertain tax position, or to incorporate the existing obligations under FIN 48.

We also suggest that the Service provide guidance as to whether the owner in a pass-through entity must take any steps in addition to those required under FIN 48 (which as noted may involve a different materiality standard) to determine whether there are uncertain tax positions with respect to their allocable share of income, gain, loss, or deduction from such pass-through entity.

(12) Tax-Exempt Entities

FIN 48 applies to non-profit organizations to the extent such organizations have uncertain income tax positions. A non-profit organization may have tax reserves to the extent that the organization has unrelated business taxable income or is uncertain of its tax-exempt status.[99] We do not believe there should be any distinction between for-profit and

[99] FASB ASC 740-10-15-2.

non-profit taxpayers. Certain states require non-profit organizations to prepare audited financial statements. For example, under New York law, if the non-profit organization is soliciting charitable contributions in the State of New York (which would include public charities but not most private foundations) and such organization has more than $250,000 in total annual support and revenue, the attorney general's office requires the organization to prepare audited financial statements.[100] Therefore, to the extent a non-profit organization prepares financial statement, meets the scope requirements, and has uncertain income tax positions on its financial statements, we recommend such entities be required to file the Schedule with its Form 990.

(13) Size of Taxpayer Scope

The Announcement is limited to taxpayers with more than $10 million in assets. We recommend that the Service incorporate the existing rules under Schedule M-3 to determine which entities must file the proposed Schedule, which generally provide for a $10 million threshold. Although certain of the Schedule M-3 tests need to be modified, the Schedule M-3 tests are familiar to taxpayers and will provide for consistent treatment among taxpayers of a certain size.

Schedule M-3 (Form 1120) must be filed by any of the following: (i) any domestic or group of domestic corporations that reports total assets of $10 million or more, (ii) any non-consolidated corporation that reports total assets of $10 million or more, or (iii) any US parent and includible corporations[101] that report total combined assets of $10 million or

[100] NY Executive Law § 172-b(1).

[101] Those corporations listed on Form 851.

more.[102] The Instructions to Schedule M-3 provide specific examples of when to include or exclude related companies' assets. Other Schedules M-3 apply to different entities, such as partnerships (Schedule M-3 (Form 1065)), insurance companies (Schedule M-3 (Form 1120-PC)), and foreign corporations (Schedule M-3(Form 1120-F)).

We recommend the Service use (and modify to the extent necessary) the Schedule M-3 rules to determine who must file the proposed Schedule. First, we recommend that foreign entities' assets (whether or not included in the prepared financial statements) should be excluded from the $10 million asset test, as is the case on Schedule M-3 (Form 1120). However, Schedule M-3 (1120-F) permits taxpayers to calculate assets on a worldwide or US basis. Guidance will be needed to the extent Schedule M-3 provides alternative calculations. For example, guidance is needed with respect to the calculation of assets in the case of foreign entities with US branches. For example, if a foreign entity is subject to United States federal income tax because it is engaged in a trade or business in the United States, would the $10 million threshold include all assets of the foreign entity or just the assets that are part of the United States trade or business? Second, we recommend the Service exclude the assets of entities that are not included in a taxpayer's (or related party's) prepared financial statements. Third, we recommend that the assets of partnerships or disregarded entities be taken into consideration to the extent such assets are included in the taxpayer's (or related party's) financial statements. Other modifications to the Schedule M-3 requirements might be necessary. One important distinction between the Schedule and Schedule M-3 is the fact that the Schedule applies only to taxpayers that prepare financial statements and have uncertain tax positions.

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[102] Instructions for Schedule M-3, Form 1120 (2009).

(14) Penalties

The Announcement indicates that the Service is evaluating additional options for penalties or sanctions to be imposed if a taxpayer fails to either file the Schedule or make adequate disclosure regarding its uncertain tax positions Current law imposes penalties on taxpayers for failing to file a true and complete return or for inaccurately reporting information on their returns.[103] It is unclear, however, whether a failure to include the Schedule with a tax return would subject a taxpayer to that same regime of penalties. Courts have held that providing enough information to comply substantially with the Service's need to audit a taxpayer's liability is sufficient to shield a taxpayer from penalties for failure to file a return.[104] The Service arguably does not need a schedule disclosing a taxpayer's uncertain positions to assess properly a taxpayer's liability—they make do without one presently—and so it is unclear whether failure to include the Schedule may subject a taxpayer to penalties under current law. The same can be said of accuracy-related penalties, which are measured only by understatements of income tax liability. However, failure to comply with a schedule filing requirement may be taken into account in determining whether a reasonable cause or good faith exception to a penalty otherwise imposable on a non-scheduled issue applies.

A requirement that is considered as important to the enforcement effort as the proposal should entail some sanction for noncompliance. In the absence of adequate existing sanctions, legislation by Congress may be necessary. Congress has enacted other provisions to ensure that proper disclosure schedules or forms are filed by taxpayers. For

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[103] *See supra* notes 9-15 and accompanying text.

[104] *See supra* note 12.

example, there are separate penalties for failure to file Form 8886 with respect to listed and other reportable transactions.[105] Similarly, there are separate penalty provisions when a taxpayer that invests in foreign entities fails to file Form 5471, as imposed under Sections 6038, 6046, and 6046A. In both situations, Congress recognized that compliance with the disclosure obligations was paramount because the information provided would facilitate detection of tax avoidance.

Obviously, a penalty should not be applicable until the Service has provided a clear delineation of the information that is required on a Schedule. We understand based on reported statements of Service officials that the proposal would not be effective for taxable years beginning prior to January 1, 2010.[106] We are cautiously optimistic that, given the full support of the most senior officials of the Service, that should provide adequate time to substantially work out basic compliance requirements. Imposing penalties for inaccuracies, absent intent, would not provide meaningful incentives for taxpayers to properly comply with the Schedule. Therefore, we believe any penalty imposed should be applicable only to an intentional failure.

Finally, if penalties are imposed, the opportunity to correct a Schedule may be appropriate, at least for an interim period for the reasons noted above.[107]

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[105] Section 6707.

[106] *See supra* note 62.

[107] In this regard, we note that Rev. Proc. 94-69 provides a 15-day grace period at the commencement of an audit for filing an amended return. Rev. Proc. 94-69, sec. 3.01 (Oct. 13, 1994).