

Please feel free to contact us if we can provide further information on these matters.

**Stephen L. Gordon**  
(212) 474-1704  
gordon@cravath.com

**Lauren Angelilli**  
(212) 474-1016  
langelilli@cravath.com

## IRS Proposes Detailed Disclosure of Financial Statement Tax Reserves

January 27, 2010

The IRS proposed yesterday that taxpayers be required to report to the IRS the nature and amount of all uncertain tax positions for which the taxpayer recorded a financial statement reserve under FIN 48 (or IFRS or other accounting standards).<sup>1</sup> The proposal is intended to make it easier for the IRS to identify which taxpayers to audit and which issues to examine closely on audit.

### **SIGNIFICANT CHANGE FROM CURRENT PRACTICE**

Today the IRS routinely reviews a taxpayer's audited financial statements, which generally disclose the aggregate amount of reserves for uncertain tax positions but not the nature of the specific underlying tax issues or the taxpayer's evaluation of the merits of its position. Although a taxpayer's tax accrual workpapers often contain these details, under its current "policy of restraint" the IRS generally does not examine these workpapers.

The IRS's proposal would require a corporation (or other business taxpayer) to file with its Federal income tax return a schedule disclosing some of the specific information currently found only in the taxpayer's workpapers, namely:

- a specific identification and description of each tax item for which a financial statement reserve has been established,
- the maximum amount of Federal income tax at stake and
- the rationale for the position and reasons for determining it is uncertain.

The IRS has stated that its policy of restraint would continue, at least for the time being, with respect to other information in the taxpayer's tax accrual workpapers.

This proposal would significantly change the threshold at which disclosure of uncertain tax items is required. Under current law, in general no penalty applies for the non-disclosure of most tax items so long as the taxpayer has "substantial authority" for its position (even if the position probably will not be upheld). The new IRS proposal would require a taxpayer to disclose an item for which a financial statement reserve is established. Under FIN 48, such a reserve might be established even for an item with a substantial likelihood of success. Thus, the requisite level of certainty that would allow non-disclosure would be considerably higher and would be determined under financial accounting principles rather than tax standards.

---

<sup>1</sup> See Announcement 2010-9 (Jan. 26, 2010). FIN 48 generally requires a taxpayer that uses United States GAAP to provide a reserve for the taxes that might be payable upon the resolution of its uncertain tax positions. FASB Interpretation No. 48 (FIN 48), [Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109](#) (now codified as FASB ASC 740-10). IFRS and other accounting standards impose similar requirements.

## IMPLICATIONS FOR TAXPAYERS

The proposed change will have several implications for taxpayers once it becomes effective:

- **The new schedule will provide the IRS with a “roadmap” for tax audits.** By requiring taxpayers to identify and size all the uncertain tax issues in their own tax returns at the time they are filed, the IRS will be able to zero in on taxpayers and issues it might have overlooked in the past. A taxpayer’s odds in the audit lottery will be much worse under this new proposal.
- **The dynamics of a tax audit may change.** The proposed schedule will list all positions for which a financial statement reserve has been established, together with an estimate of the *maximum* amount of Federal income tax at stake. The schedule will not show the taxpayer’s estimate of its chances of success (or the actual reserve taken for each position), so the “worst-case” estimates for issues with large dollar amounts may stand out as irresistible targets even if the taxpayer’s likelihood of success on the issue is high. It may be harder to resolve low-probability, high-impact issues if examiners are concerned that their performance is measured against the worst-case amounts on the schedule.
- **There will be more interaction between decisions about financial statements and about tax returns.** FIN 48 has already created concerns and tensions for corporate tax directors, CFOs and audit committee members in establishing financial statement reserves for tax items. The process is often one of judgment and not scientific precision. Under the IRS’s new proposal, the accounting judgment that a reserve — even a small one — should be established for a tax item will place that item under a spotlight. If establishing a reserve for an item significantly increases the probability of an IRS challenge, judgments about whether to establish a reserve will inevitably be affected in some circumstances.

## OPEN ISSUES

It is not clear how much detail will be required in the new schedule, how to treat items that are substantially (but not completely) certain, how items that affect the timing (but not amount) of taxable income will be taken into account, the effect of a taxpayer’s net operating losses that could reduce the amount of tax due even if the taxpayer’s position were not upheld, or whether any *de minimis* thresholds will apply. In addition, it remains to be seen whether the IRS will second-guess a taxpayer’s decision about whether a financial accounting reserve is required for an item, an exercise dependent on accounting rules that are themselves new, complex and uncertain.

## EFFECTIVE DATE

The IRS has requested comments on its proposal by March 29, 2010. The proposed tax return schedule will be published at some time thereafter. The disclosure requirement will apply to all tax returns filed after publication of the schedule. Thus, it is at least theoretically possible that the requirements could apply to 2009 tax returns.

*IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. Federal tax advice contained in this document (including any attachment) is not intended or written by us to be used, and cannot be used, (i) by any taxpayer for the purpose of avoiding tax penalties under the Internal Revenue Code or (ii) for promoting, marketing or recommending to another party any transaction or matter addressed herein.*

*This memorandum relates to general information only and does not constitute legal or accounting advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.*

### New York

Worldwide Plaza  
825 Eighth Avenue  
New York, NY 10019-7475  
212.474.1000

### London

CityPoint  
One Ropemaker Street  
London EC2Y 9HR  
+44.20.7453.1000

[www.cravath.com](http://www.cravath.com)