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IRS TO REQUIRE DISCLOSURES OF UNCERTAIN TAX POSITIONS

By Samuel A. Mitchell and Peter H. Winslow

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

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

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

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

Under the current law, taxpayers generally are not required to report detailed descriptions of particular items on their tax returns unless they have determined that they have less than substantial authority for the position, the item has been designated as an abusive tax avoidance transaction, or the item falls within some other specific disclosure requirement, such as the requirement to describe differences between book and tax treatment. Unlike these existing disclosure requirements, which are backed by penalties for failure to disclose, there is no specific penalty for a taxpayer's failure to disclose uncertain tax positions on a tax return. As a result, the IRS is considering whether it can extend any existing penalties to this situation and whether to seek new legislation imposing penalties for failure to make the disclosures. An IRS official also has stated that a penalty for filing an incomplete schedule might apply, but it is unclear what this penalty may be.[9] If the IRS determines that an imposition of a specific monetary penalty is problematic, it is likely to resort to a procedural "penalty" for failure to provide the schedule, such as more vigorous audits of non-compliant taxpayers.

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

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

END NOTES

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

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

3 2002-2 C.B. 72.

4 IRM 4.10.20.3.1.

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

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

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

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

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

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

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

DISALLOWED INTEREST REDUCES EARNINGS AND PROFITS IN THE CURRENT YEAR

By Stephen Baker

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

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

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of the reduction in E&P for the interest paid or accrued. The Service ruled that:

> Disallowed Interest under § 264(a)(4) reduces earnings and profits for the taxable year in which the interest would have been allowable as a deduction but for its disallowance under § 264(a)(4). It does not further reduce earnings and profits when the death benefit is received under a life insurance contract. [6]

In the ruling, the Service used a fairly straightforward fact pattern.

> A, an individual, holds a paid-up life insurance contract on his own life. Upon the death of A, the $500 death benefit under the contract is payable to the beneficiary named in the contract. X is a calendar year subchapter C corporation unrelated to A.
>
> On the first day of Year 1, X purchases A's life insurance contract for $100 and names itself the beneficiary under the contract. The purchase transaction is one whereby the underlying contract does not have a basis for determining gain or loss in the hands of the transferee that is determined in whole or in part by reference to such basis in the hands of the transferor. Thus the purchase is not a transaction that is described in § 101(a)(2)(A) or (B).[7]
>
> On the first day of Year 1, X borrows $100 at 7 percent simple interest per annum to purchase the life insurance contract. The interest on the loan is unconditionally payable at the end of Year 1 and Year 2 and the interest was in fact paid at the end of Year 1 and Year 2. But for its disallowance under § 264(a)(4), X could deduct seven dollars of interest on the loan in both Year 1 and Year 2 under § 163. Other than the initial purchase price, the interest on the loan is the only amount X incurs in connection with the contract.
>
> A dies on the first day of Year 3, and X receives the $500 death benefit under the life insurance contract. Pursuant to § 101(a)(2), X includes $386 in gross income ($500 (death benefit) - ($100 (amount paid for the contract) + $14 (Disallowed Interest deductions in Year 1 and Year 2))).

Leading up to its analysis of E&P, the Service discusses the general rule of excluding from gross income amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.[8] The analysis also includes a brief mention of the exceptions to this general rule:

- A life insurance contract that is transferred for value,[9]
- Payment on a life insurance contract at a date later than death,[10]
- Certain contracts issued before Jan. 1, 1985;[11] and
- Certain employer owned life insurance contracts.[12]

The analysis then continues with a short mention of the general deduction allowed for interest paid or accrued within the taxable year on indebtedness, section 163(a), and the disallowance of that deduction, section 264(a)(4). The discussion on E&P is just over one half-page, and while not voluminous, develops the appropriate ruling. The analysis begins with a Senate Report definition of E&P "… a measure of economic income, or a corporation's capacity to pay dividends."[13]

The discussion then cites Rev. Rul. 75-515[14] which, although made obsolete by Rev. Rul. 2003-99,[15] still provides valuable discussion of the computation of E&P. Rev. Rul. 75-515 provides that:

> In general, the computation of earnings and profits of a corporation … is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitation provided therefore [sic], and other items that have actually depleted the assets of the corporation, even though not reflected in the income computations, are allowed as deductions in computing earnings and profits.[16]

It is also interesting to note that Treasury Regulations discuss the need that due consideration be given to the facts. While mere bookkeeping entries increasing or decreasing surplus will be considered, generally they will not be conclusive; the amount of E&P in any case will depend upon the method of accounting properly employed.[17] There is, as one would hope, a general consistency between the Revenue Rulings to date and the Treasury Regulations, requiring reasonable and proper accounting treatment.

After discussing the computation of E&P, the ruling goes on to cite two pertinent revenue rulings; Rev. Rul. 71-165[18] and Rev. Rul. 77-442.[19] Rev. Rul. 71-165 holds that a nondeductible expense of an accrual basis corporation reduces E&P in the year in which the expense is realized and recognized, unless the Code specifically provides otherwise. Rev. Rul. 77-442 holds that because disallowed interest depletes the assets of a corporation at the time the interest would be allowed as a deduction but for its disallowance under section 264(a)(4), E&P are also reduced in that year. Thus, following the logic of the above two revenue rulings, the Service holds in Rev. Rul. 2009-25 that "X in both Year 1 and Year 2 reduces its earnings and profits by the seven dollars of Disallowed Interest."

The next section of the discussion focuses on the impact of the year three events, *i.e.,* X receives the $500 death benefit under the life insurance contract purchased from A. The ruling holds to the guidance provided under Treasury Regulation section 1.312-6(d) which states that a loss sustained for a year before the taxable year does not affect the E&P of the taxable year. The service then goes on to cite Rev. Rul. 76-299[20] for the proposition that "A capital loss carryover does not affect the E&P of the taxable year in which it is used because the loss giving rise to the carryover is reflected in the accumulated earnings and profits at the beginning of the taxable year of the carryover." Based upon this logic, there is no further reduction of E&P in Year 3 for the previously Disallowed Interest.[21]

By year 3, X has already reduced its E&P for the Disallowed Interest. Therefore, X includes $400 ($500 (the death benefit) less $100 (the amount X pays for the contract)) in its E&P in Year 3. However, for income tax purposes, in Year 3, X includes in its gross income only $386 of the $500 death benefit because of the applicable offsets under section 101(a)(2) for the $100 paid for the policy and the $14 of Disallowed Interest. The ruling does not address the timing of the impact of the death benefit on E&P. Aside from pronouncements in the excess profits tax area, the Service has issued only one pronouncement addressing this directly. Rev. Rul. 54-230[22] states that "the excess of the insurance proceeds received by the corporation over the aggregate sum of the premiums paid will constitute earnings and profits available for distribution."

It is interesting to note that there was no administrative or judicial guidance directly on point prior to the issuance of this ruling. Based upon the logic and definitions above, the ruling reaches the proper result.

END NOTES

1 Revenue Ruling 2009-25, I.R.B 2009-38, Sept. 4, 2009.
2 Except as otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
3 I.R.C. §163(a).
4 I.R.C. §264(a)(4).
5 Revenue Ruling 2009-25, I.R.B 2009-38, Sept.4, 2009.
6 Rev. Rul. 2009-25, Holding.
7 This section defines a "Transfer for Value" transaction. A policy that is transferred for a valuable consideration loses most of the income tax-free character of its death proceeds. If a transfer for value occurs, the death proceeds are excludable from the recipient's income only to the extent of the value of the consideration paid plus the amount of any subsequent premiums and other amounts paid by the transferee.
8 I.R.C. §101(a)(1).
9 I.R.C. §101(a)(2).
10 I.R.C. §101(d).
11 I.R.C. §101(f).
12 I.R.C. §101(j).
13 S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess., 198 (1984).
14 Rev. Rul. 75-515 , 1975-2 C.B. 117, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388 (holding codified in § 312(l)).
15 Rev. Rul. 2003-99, 2003-2 C.B. 388 (holding codified in § 312(l)).
16 Rev. Rul. 75-515.
17 Treas. Reg. §1.312-6(a).
18 Rev. Rul. 71-165, 1971-1 C.B. 111.
19 Rev. Rul. 77-442 ,1977-2 C.B. 264 (quoting Rev. Rul. 71-165 and Rev. Rul. 75-515).
20 Rev. Rul. 76-299 , 1976-2 C.B. 211.
21 For additional support on this point see for example *Bangor & Aroostook Railroad Co. v. Commissioner,* 16 T.C. 578, 586 (1951), *aff'd* 193 F.2d 827 (1st Cir. 1951).
22 Rev. Rul. 54-230, 1954-1 C.B. 114.

SSAP 43R AND TAX STANDARDS FOR PARTIAL WORTHLESSNESS DEDUCTIONS

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In September 2009, the NAIC adopted Statement of Statutory Accounting Principles 43R (SSAP 43R), providing guidance effective as of Sept. 30, 2009, for the impairment of loan-backed and structured securities. SSAP 43R replaced SSAP 98, which was an amendment to SSAP 43 and SSAP 99 paragraph 13. The adoption of SSAP 43R, and the movement away from the fair value approach of SSAP 98, may facilitate claims of partial bad debts under Internal Revenue Code section 166 for debts that do not qualify as securities for tax purposes. This is because the new SSAP isolates credit-related impairments (potentially available for bad debt treatment) from interest-related impairments (that the Internal Revenue Service (IRS) is likely to challenge if claimed as a tax deduction). [1]

SSAP 43R requires a charge against current statutory earnings for Other-Than-Temporary impairments that are

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credit-related to the extent the discounted expected cash flows are less than book value. It requires a further impairment to fair value and a charge against current earnings only if the company has the intent to sell the instrument or does not have the ability to hold it until recovery. In the latter situation, the standard requires the company to disclose the amount of the impairment to fair value that is interest-related.

The Other-Than-Temporary impairments insurance companies have recorded for instruments such as REMIC regular interests under SSAP 43R and earlier standards may be eligible for partial worthlessness deductions of debts held by insurance companies.[2] Under the tax standards, a taxpayer that holds a business debt that is not considered a security under section 165(g) has the discretion to take a tax deduction for partial worthlessness rather than wait until disposition or total worthlessness to realize the tax loss. Partial worthlessness deductions are advantageous for both timing and character. The timing benefit arises because the alternative, which applies to securities under section 165(g), is to wait either until the taxpayer sells the instrument or until the instrument becomes wholly worthless. The character benefit arises because partial worthlessness deductions are charged against ordinary income, whereas losses on disposition, and in some cases losses on total worthlessness, are capital losses. Capital losses can be used only to offset capital gains and are subject to expiration after five tax years if not used.[3]

Thus, taxpayers have a strong incentive to claim partial worthlessness deductions for impairments they have charged off their books. In order to qualify for a partial worthlessness deduction, the taxpayer must prove that the instrument is partially worthless and the deduction is limited to the amount the taxpayer has charged off as worthless on its books.[4] The tax standard for proving partial worthlessness is relatively stringent, but insurance companies may have fewer proof problems than other taxpayers because they may be able to take advantage of a conclusive presumption in the Treasury Regulations that applies to banks and other similarly regulated industries. Under the conclusive presumption, at Treasury Regulation section 1.166-2(d), a regulated company's book charge-off is presumed correct if it is made under established policies and procedures of the regulator and if the regulator confirms this fact in writing upon its first examination of the company's books for the year of the charge-off. Recently, many insurance companies have requested their state insurance departments to send them charge-off letters to comply with the Treasury Regulations, and several state regulators have sent the requested letters.

There may be a problem with at least a portion of a partial worthlessness deduction, even under the conclusive presumption, if the amount charged off under the standard for measuring an Other-Than-Temporary impairment for statutory accounting exceeds the amount that is associated with a credit-related impairment.[5] For banks, the IRS has held that the conclusive presumption does not apply to a write-down to fair value, even if the bank's regulator has ordered the charge-off.[6] This presumably is because the interest-related portion of a write-down to fair value may be recovered if the instrument is held long enough, and the tax standard allows only for permanent impairments that reflect a loss of basis that the taxpayer cannot recover. SSAP 43R's focus on credit-related events should be of benefit to insurance company taxpayers who seek to take advantage of the conclusive presumption. Even in cases in which the impairment is to fair value, the conclusive presumption nevertheless may apply because the standard requires identification of the portion that is interest-related.

END NOTES

1 *Tax Aspects of Nonperforming Assets,* 4 TAXING TIMES 28 (Sept. 2008); *REMIC Impairments May Qualify as Worthless Bad Debts,* 5 TAXING TIMES 50 (May 2009).
2 *Id.*
3 The losses are first carried back to the previous three tax years, and unused amounts are carried forward. The amounts carried forward expire if unused in the succeeding five tax years. *See generally* I.R.C. § 1212(a).
4 *See generally* I.R.C. section 166.
5 *Id.*
6 *See* Revenue Ruling 84-95, 1984-2 C.B. 53.