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Uncertain Tax Positions: Reconciling the Existing Guidance

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ABSTRACT: Multiple revisions in recent years to IRC §6694, IRC §6662, U.S. Generally Accepted Accounting Principles (GAAP), and International Financial Reporting Standards (IFRS) have created conflicting recognition and disclosure requirements for uncertain tax positions. This paper reviews the existing recognition thresholds under these various standards—"reasonable basis," "substantial authority," and "more-likely-than-not"—and discusses scenarios in which the standards may cause reporting conflicts between tax and financial reporting. This paper also reviews the extant disclosure guidance for uncertain tax positions included in tax and financial reporting, with a particular emphasis on the newly issued proposed IRS regulations regarding general and specific-item disclosures for tax return preparers.

Keywords: uncertain tax positions; disclosure; FIN 48; IRC §6694.

INTRODUCTION

Starting with the Small Business and Work Opportunity Tax Act of 2007,[1] and up through the recently issued IRS Notice 2009-5,[2] the Internal Revenue Code (IRC) and other guidance related to the scope, amount, and applicability of tax return preparer penalties has undergone a series of revisions. The new rules represent a greater alignment of penalties levied against taxpayers and tax preparers associated with uncertain tax positions. However, a discrepancy exists between the standards for tax preparers and those for financial statement preparers set forth in Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*.[3]

Uncertain tax positions fall into three categories: (1) any current or future reduction in taxable income reported or expected to be reported on a tax return, (2) the decision not to report a transaction in a tax return, or (3) an assertion that the reporting entity is not subject to taxation that is not fully supported by statutory or case law. The revised tax preparer standards for avoiding penalties under IRC §6694 require that tax shelters or other "reportable transactions" must be "more-likely-than-not"[4] to be sustained on their merits to be included in a tax return. This is the same threshold prescribed by FIN 48 for the recognition of any uncertain tax position for financial reporting purposes. Nevertheless, for transactions that do not meet the tax shelter

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[1] PL 110-28, Act §8210.
[2] 2009-3 IRB 309.
[3] FASB Interpretation No. 48. 2006. *Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109* (June). Norwalk, CT: Financial Accounting Standards Board.
[4] Greater than 50 percent chance per Treas. Reg. §1.6694-2(b).

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or reportable transaction definition, IRC §6694 establishes that tax preparers must have only "substantial authority" to include an uncertain tax position in a return, and for positions that are adequately disclosed, they are bound by an even lower "reasonable basis" standard.[5] The purpose of this paper is to reconcile the revised guidance for accounting practitioners regarding the recognition and disclosure of uncertain tax positions.

REPORTING THRESHOLDS

Authoritative accounting guidance in the U.S. has established different reporting thresholds for uncertain tax positions that principally can be classified into those which apply to tax reporting (both tax return preparers and taxpayers) and financial reporting. Figure 1 provides an overview of these reporting thresholds and Figure 2 presents application examples of the various uncertainty thresholds.

Tax Return Preparers

Tax preparers are subject to various recognition thresholds for uncertain tax positions. These recognition thresholds are operationalized in extant literature and practice in the form of probabilistic estimates regarding the ultimate success of uncertain tax positions. However, the probabilities assigned to tax compliance standards such as these are not precise estimates and cannot be found within the Internal Revenue Code or regulations thereto. Instead, these probabilities are rough approximations typically suggested by practitioners and commentators to evaluate the success of uncertain tax positions.[6] The staff of the Joint Committee on Taxation of the House Committee on Ways and Means adopted the customary probability thresholds in

FIGURE 1

Reporting Thresholds for Uncertain Tax Positions

	Tax Preparers and Taxpayers[a]		Financial Reporting
	With Disclosure	No Disclosure	U.S. GAAP
Applicable Thresholds	Reasonable Basis	Substantial Authority	More-Likely-Than-Not
Threshold Probability	≥20%	≥40%	>50%
Threshold Source	IRC §6694(a) and IRC §6662(d), IRS Notice 2009-5		FIN 48
Consequence for Not Meeting Threshold	Preparers: Greater of $1,000 or 50% of income derived from position Taxpayers: 20% of understatement[b]		Potential legal and professional liability

[a] Does not include tax shelters or other reportable transactions.
[b] For substantial underpayments the penalties are more severe.

[5] IRC §6694(a)(2)(B).
[6] Logue, K. 2007. Optimal tax compliance and penalties when the law is uncertain. *Virginia Tax Review* 27 (2): 241–296.

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FIGURE 2
Application Examples of Reporting Thresholds

Scenario	Action or Treatment: Tax Practitioners	Taxpayers	Financial Reporting
>50% probability	Exceeds Substantial Authority (40%): • Sign tax return • No disclosure	Exceeds Substantial Authority (40%): • Sign tax return • No disclosure	Exceeds More-Likely-Than-Not (50%): Record full benefit
21–49% probability	Exceeds Reasonable Basis (20%): • Sign tax return • Disclosure	Exceeds Reasonable Basis (20%): • Sign tax return • Disclosure	Does not meet More-Likely-Than-Not (50%): • Estimate and record partial benefit (if any) • Record adjustment for difference
<20% probability	Does not meet Reasonable Basis (20%): • May not sign tax return as a preparer, will be subject to understatement penalty	Does not meet Reasonable Basis (20%): • If return is filed, could be subject to 20% penalty on understatement	Does not meet More-Likely-Than-Not (50%): • Estimate and record partial benefit (if any) • Record adjustment for difference

their report evaluating the penalty and interest provisions of the IRC.[7] As such, probabilistic estimates for uncertain tax positions thresholds can be used to compare the various standards to one another.

The two primary thresholds of concern are the "reasonable basis" and "substantial authority" standards.[8] The *reasonable basis* threshold establishes the lower bound for including uncertain tax positions in a tax return and accordingly requires specific disclosure of the position to avoid preparer penalties under IRC §6694(a). Treas. Reg. §1.6662-3(b) states that a "reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper." The Joint Committee on Taxation report described a "reasonable basis" as at least a 20 percent likelihood a tax position would be upheld on its merits, and a tax position is considered to be "not frivolous" when there is at least a 5–10 percent likelihood of success if challenged. Based on recent changes to IRC §6694, the penalty levied against tax practitioners for violating this standard is the greater of $1,000 ($5,000 in the case of a corporation) or 50 percent of the income derived from services related to the return or claim for refund on a broad array of returns, including income tax, gift, estate, and employment tax returns. Note that specific disclosure of a tax position that fails to meet the reasonable basis

[7] Staff of Joint Committee on Taxation, 103d Congress. 1999. *Comparison of Recommendation of the Joint Committee Staff and Treasury Recommendations Relating to Penalty and Interest Provisions of the Internal Revenue Code* (Nov. 5). Available at: http://www.house.gov/jct/x-79-99.pdf.

[8] The penalty threshold for tax shelters and other listed transactions is currently the more-likely-than-not standard (IRC §6662A). However, a complete discussion of tax shelters and other listed transactions is outside the scope of this paper.

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standards does not avoid the IRC §6694 penalties. Further, repeat violations of this standard could result in an injunction to practice before the IRS.

Treas. Reg. §1.6662-4(d) defines *substantial authority* as an "objective standard" involving an analysis of the law and its application to relevant facts. The Joint Committee on Taxation report described substantial authority as being at least a 40 percent likelihood that a tax position would be upheld on its merits. An alternative view is that substantial authority exists if the weight of authorities supporting the taxpayer's treatment is substantial in relation to the weight of those that take a contrary position. The recently issued IRS Notice 2009-5, 2009-3 IRB 309 ("Notice") provides additional guidance for complying with the substantial authority standard. First, the Notice extends the protection against penalties afforded taxpayers by a written determination under IRC §6662 to tax preparers, including those for which a misstatement or substantial omission of fact is present, unless the tax preparer should have known of the misstatement or omission.[9] Additionally, the pertinent date for the existence of substantial authority is the date the return or claim of refund is *prepared* or on the last day of the taxable year related to the return. Perhaps most important is that solely under IRC §6694(a), a tax preparer will be considered to have met the substantial authority standard if relying in good faith on the advice of another advisor, another tax return preparer, or other party. A tax preparer has not acted in good faith in situations where the advice is unreasonable on its face, the tax preparer knew or should have known that the facts were incorrect, or the tax preparer knew or should have known that the advice was incorrect due to changes in the tax law.[10]

Another threshold currently in effect for tax preparers is the *realistic possibility* standard. Treasury Department Circular 230 (Subpart B, Section 10.34(a) 31 C.F.R. Subtitle A, Part 10) states that a *realistic possibility* exists when a reasonable and well-informed analysis by a person knowledgeable in the tax law concludes there is at least an approximately one-in-three (33 percent) likelihood the position would be upheld on its merits. This places a realistic possibility for a tax position somewhere in between having a reasonable basis and substantial authority. Circular 230 will require an update to more appropriately reflect the recent changes to the tax positions standards. Currently, the American Institute of Certified Public Accountants (AICPA) Statement on Standards for Tax Services No. 1, *Tax Return Positions* (SSTS No. 1) prescribes that a member of the AICPA should not recommend a tax return position unless they have a good-faith belief that the position has a *realistic possibility* of being sustained administratively or judicially on its merits if challenged, unless the member concludes it is not frivolous and advises the taxpayer to appropriately disclose the item. It is important to note that the exposure draft of the revised SSTS No. 1[11] requires first that a member must comply with any standards imposed by the applicable taxing authority (e.g., substantial authority under IRC §6694). The exposure draft of SSTS No. 1 also replaced the "not frivolous" standard with the "reasonable basis" standard as the threshold by which a preparer can recommend or include a tax position on a tax return. However, if the taxing authority has no or lower standards, then the member should apply the realistic possibility standard to any tax positions recommended or taken on a prepared or signed tax return. The intent of the SSTS No. 1 exposure draft appears to be that a member should adhere to the taxing authority's standard but in no case below the reasonable basis standard.

[9] Treas. Reg. §1.6662-4(d)(3)(iv)(A).

[10] Treas. Reg. §1.6694-2(e)(5).

[11] *Proposed Statements on Standards for Tax Services*. Exposure draft issued November 28, 2008. Washington, D.C.: AICPA.

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Taxpayers

Taxpayers are also subject to the reasonable basis and substantial authority standards prescribed for tax preparers. Under IRC §6662(d), taxpayers are subject to a 20 percent accuracy-related penalty if the understatement exceeds the greater of 10 percent of the proper tax liability or $5,000 ($10,000 for corporate taxpayers).[12] For items that do not meet the definition of a tax shelter, this penalty can be avoided if: (1) the taxpayer has *substantial authority* for the position, or (2) there is a *reasonable basis* for the position and the position is specifically disclosed on the tax return. For non-tax shelter items, the penalty standards for taxpayers have remained largely the same since 1989 (the year §6662 was established). Changes to the tax preparer standards in 2007[13] raised the penalty thresholds for preparers above those for taxpayers, creating a potential conflict of interest.[14] The most recent changes have equalized the penalty standards between taxpayers and tax preparers.[15]

Financial Accountants

FIN 48 augmented FASB Statement No. 109 (FAS No. 109), *Accounting for Income Taxes*, to increase the comparability of financial statements by providing guidance on accounting for uncertain tax positions. Specifically, it applies the more-likely-than-not-standard (greater than 50 percent likelihood the tax position will be upheld) to the recognition of uncertain tax positions in financial statements. This threshold effectively requires a positive assertion by management that the reporting entity is entitled to the economic benefits of the tax position. For public companies, FIN 48 applies to all tax positions accounted for under FAS No. 109, including tax positions acquired in business combinations beginning with the fiscal years after December 15, 2006. For nonpublic companies, the date of application has been extended to fiscal years beginning after December 15, 2008.[16]

The application of FIN 48 requires a two-step evaluation for recording uncertain tax positions. First, it must be determined whether the more-likely-than-not threshold is met. Second, the benefit of the tax position recognized in the financial statements is measured at the largest amount for which the cumulative probability is greater than 50 percent likely to be realized upon ultimate settlement.[17] Recognizing the benefit from a tax position in the financial statements that is less than the tax effect reported in the tax return (1) creates a current or noncurrent liability, depending on the timing of the cash flows, and/or (2) reduces the amount of tax net operating loss carryforward or amount refundable from the taxing authority. The measurement of any associated deferred tax asset or liability should be computed as the difference between the carrying value for financial reporting purposes, and the tax basis as adjusted by FIN 48.

[12] The understatement penalty related to tax shelters and reportable transactions is also 20 percent, but increases to 30 percent if the taxpayer fails to disclose the reportable transaction in accordance with IRC §6011.

[13] PL 110-28, Act §8210.

[14] For example, see *AICPA Thanks Congress for Equalizing Reporting Standards for Taxpayers and Tax Preparers*. AICPA Press release dated October 8, 2008. Available at: http://www.aicpa.org/Media+Center/Press+Releases+and+Other+News/.

[15] PL 110-343, Division C, Act §1.

[16] FASB Staff Position 48-3. 2008. *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises* (December). Norwalk, CT: Financial Accounting Standards Board.

[17] FIN 48 requires that the outcome probabilities are evaluated (and modified if necessary) each reporting period until ultimate settlement of a tax position. Alternatively, §6694 requires only an initial up-front evaluation of the outcome probability of the tax position.

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In March 2009, the International Accounting Standards Board (IASB) issued an exposure draft entitled *Income Tax*,[18] which proposed a new standard to replace International Accounting Standard 12 (IAS 12).[19] IAS 12 does not address how to account for uncertainty regarding the acceptance of tax positions by taxing authorities. The *Income Tax* exposure draft proposes that uncertain tax liabilities would be measured using the probability-weighted average amount of all possible outcomes. This approach is consistent with the recognition of all other uncertain liabilities under the proposed amendments to International Accounting Standard 37 (IAS 37), issued in June 2005,[20] which prescribe that "stand-ready" liabilities should be recognized at a probability-weighted average of the possible outcomes. IAS 37 (as proposed) defines a stand-ready liability as one for which the amount that will be required in settlement is contingent on the occurrence or nonoccurrence of a future event. Specifically, paragraph 24 of the exposure draft of IAS 37 states that because an entity has an unconditional obligation to stand ready to fulfill the conditional obligation if the uncertain future event occurs (or fails to occur).

Thus, the treatment of uncertain tax positions under international accounting standards differs from that prescribed in FIN 48 because the proposed standard of recognition requires that uncertain tax positions must be recognized based on *all* possible expected outcomes—effectively disregarding the more-likely-than-not recognition threshold prescribed by FIN 48. In paragraphs BC57–BC63 of the Basis for Conclusions for the *Income Tax* exposure draft, the IASB concluded that a probability-weighted average of all possible outcomes, without any probability-based recognition threshold, provides more relevant information because the measurement includes all known information that could have a material effect on the amounts recognized.[21] In November 2008, the U.S. Securities and Exchange Commission (SEC) issued a proposed rule that sets forth a "roadmap" for the adoption of IFRS by U.S. publicly traded companies.[22] The roadmap specifies a set of milestones that, if accomplished, could result in the mandatory use of IFRS for all financial reports filed with the SEC in 2014. Figure 3 illustrates the application of FIN 48 and the IASB exposure draft on income taxes.

TAX POSITION DISCLOSURE

Tax Reporting

In June 2008, the IRS issued proposed regulations that address the taxpayer and tax preparer penalties associated with a substantial understatement of income tax.[23] These proposed regulations specifically incorporate the disclosure requirements contained in previously released Rev. Proc. 2008-14, 2008-7 IRB 435 (Rev. Proc. 2008-14). Rev. Proc. 2008-14 provided guidance for taxpayers regarding what constitutes "adequate disclosure" to avoid the 20 percent IRC §6662(d) penalty, as well as tax preparer guidance under IRC §6694(a) (understatements due to

[18] Exposure draft of *Income Tax* (March 2009). London, U.K.: International Accounting Standards Board. Comments on this exposure draft are to be received by July 31, 2009.

[19] International Accounting Standard 12. *Income Taxes* (Revised 2000). London, U.K.: International Accounting Standards Board.

[20] Exposure draft of proposed amendments to IAS 37, *Provisions, Contingent Liabilities, and Contingent Assets*, and IAS 19, *Employee Benefits* (October 2005). London, U.K.: International Accounting Standards Board. The comments from the exposure draft are currently being reviewed and discussed by the IASB.

[21] *Basis for Conclusions, Exposure Draft, Income Tax* (March 2009). London, U.K.: International Accounting Standards Board. Available at: http://www.iasb.org/NR/rdonlyres/A119DC06-B150-49FF-B60B-88CD8ED5FB20/0/EDIncomeTaxesBC.pdf.

[22] Securities and Exchange Commission, Proposed Rule, Release No. 33-8982. 2008. *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers* (November 14).

[23] *Tax Return Preparer Penalties under Sections 6694 and 6695*. Proposed rule, Fed. Reg.73, No. 117 (6/17/2008): 34559.

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FIGURE 3

Measurement Application using FIN 48 and IASB Exposure Draft on Income Taxes[a]

An enterprise has determined that a tax position resulting in a $100 benefit qualifies for recognition and needs to be measured. The following table summarizes the enterprise's estimates for the possible outcome amounts and the probabilities of these outcomes occurring, and the benefit recognized under FIN 48 and the IASB *Income Tax* exposure draft.

	Possible Estimated Outcome ($)	Individual Probability of Occurrence (%)	Cumulative Probability of Occurrence (%)	Probability-Weighted Outcomes($)
	100	5	5	5
	80	25	30	20
FIN 48 Amount →	**60**	25	55	15
	50	20	75	10
	40	10	85	4
	20	10	95	2
	0	5	100	0
				56 (sum) ↑ IASB Exposure Draft Amount

[a] Source: Adapted from FIN 48 (¶A21).

unreasonable positions) with respect to avoiding preparer penalties on income tax returns.[24] The proposed regulations indicate that the Rev. Proc. 2008-14 disclosure requirements will apply to a signing tax return preparer seeking to avoid IRC §6694 penalties through adequate disclosure.[25] Rev. Proc. 2008-14 contains two types of penalty-avoiding disclosures. The first is a set of "general disclosures" procedures that are broad in scope, and the second is a set of "specific-item disclosures" that apply to various line-item reporting requirements on tax forms and schedules.

General Disclosures

Five general procedure disclosures apply to most tax reporting circumstances and address the use of additional disclosure, relying on verifiable amounts, implications of related-party transactions, lack of item descriptions on tax forms, and disclosure exceptions.

Additional Disclosure. In order to avoid any potential penalties, all forms and attachments must be completed in a clear manner and in accordance with their instructions. Rev. Proc. 2008-14 specifically notes that any additional, nonrequired disclosures are irrelevant in preventing any penalties (except for certain M-1 and M-3 disclosures). As a result, it appears taxpayers and tax preparers should minimize any additional nonrequired supporting schedules when filing a tax return.

[24] IRB 2008-7 428.

[25] Treas. Reg. §1.6694-2(c)(3).

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Verifiable Amounts. All amounts entered on tax forms must be verifiable to avoid any penalties addressed in Rev. Proc. 2008-14. A number is verifiable if the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the IRS on audit) and the taxpayer can show good faith in entering that number on the applicable form. Thus, prudent taxpayers should have sufficient records for all amounts entered on tax forms.

Related-Party Transactions. For transactions involving related parties, disclosure of required dollar amounts is not adequate to avoid penalties under Rev. Proc. 2008-14. If an entry presents an issue or controversy because of a related-party transaction, then that transaction and the relationship require additional disclosure and must be reported on Form 8275 or Form 8275-R.

No Preprinted Description on Form. If a tax form does not have a preprinted description (e.g., other expenses), then the item must be clearly identified by including a description on that line. For example, to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written on Schedule C (Form 1040) that shows the amount of the bad debt. Furthermore, for Schedule M-3 (Form 1120), the entry must provide descriptive language such as, "Cost of non-compete agreement deductible not capitalizable." If space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.

Disclosure Exceptions. Although a taxpayer meets the disclosure requirements of Rev. Proc. 2008-14, the disclosure will not affect the IRC §6662 accuracy-related penalty if the item or position on the return: (1) does not have a reasonable basis,[26] (2) is attributable to a tax shelter,[27] (3) is not properly substantiated, or (4) is not adequately supported by the taxpayer's books and records with respect to the item or position.

Specific-Item Disclosures

Rev. Proc. 2008-14 also explains the IRS's disclosure requirements for specific entries on various tax forms and schedules. These specific-item disclosures address items included on Schedule A (Form 1040), certain trade or business expenses, book-income reporting differences, and other expenses and tax credits.

Schedule A (Form 1040). The specific adequate disclosures for Schedule A of Form 1040 include medical and dental expenses, taxes, interest expense, charitable contributions, and casualty and theft losses. A recurring theme throughout the Schedule A disclosure requirements is that one must complete all appropriate lines in order to avoid any potential substantial understatement or IRC §6694 penalties. Figure 4 presents the adequate disclosure for the Schedule A items.

Certain Trade or Business Expenses. The second set of specific items addressed by this guidance deals with certain common trade or business expenses (e.g., Schedule C of Form 1040). These trade or business disclosure requirements also apply to expenses related to rental property (e.g., Schedule E of Form 1040). The required adequate disclosures for specific trade or business expenses are presented in Figure 5.

Book-Income Reporting Differences. Figure 6 presents the general disclosure requirements for Schedules M-1 and M-3 for various entity tax returns. For these schedules, the information must be reasonably expected to apprise the IRS of the nature of the potential controversy

[26] Treas. Reg. §1.6662-3(b)(3).
[27] IRC §6662(d)(2) and Treas. Reg. §1.6662-4(g).

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FIGURE 4

Schedule A (Form 1040)[a]

Item	Adequate Disclosure
Medical and Dental Expenses	Complete lines 1 through 4, supplying all required information.
Taxes	Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.
Interest Expenses	Complete lines 10 through 15, supplying all required information. This section does not apply to (1) amounts disallowed under IRC §163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or (2) amounts disallowed under IRC §265 (expenses related to tax-exempt income).
Contributions	Complete lines 16 through 19, supplying all required information. Entering the value of the contribution unreduced by the value of the benefit received will not constitute adequate disclosure. If a contribution of $250 or more is made, this section will not apply unless a contemporaneous written acknowledgment is obtained. If a contribution of cash of less than $250 is made, this section will not apply unless a bank record or written communication is obtained. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds $500, attach a properly completed Form 8283. In addition to the Form 8283, if a contribution of a qualified motor vehicle, boat, or airplane has a value of more than $500, this section will not apply unless a contemporaneous written acknowledgment is obtained and attached to the return. An acknowledgment under IRC §170(f)(8) is not required if an acknowledgment under IRC §170(f)(12) is required.
Casualty and Theft Losses	Complete Form 4684 and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

[a] Source: Rev. Proc. 2008-14, 2008-7 IRB 435.

concerning the tax treatment of any item presented by a taxpayer. If the information provided does not meet this requirement, then taxpayers must complete a Form 8275 or Form 8275-R. The IRS also notes that an item reported on a line (1) with a preprinted description, (2) shown on an attached schedule, or (3) "itemized" on Schedule M-1 may represent the aggregate amount of several transactions producing that item (i.e., a group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business). However, if a potentially controversial specific item involves a portion of the amount disclosed on the schedule, then the IRS states that it will not consider itself to be reasonably apprised of the potential controversy by the amount disclosed. In these situations, the taxpayer must use Form 8275 or Form 8275-R regarding that portion of the item. Additionally, the IRS states that the combining of unlike items, whether on Schedule M-1 or Schedule M-3 (or on an attachment when directed by the instructions), will not constitute an adequate disclosure.

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FIGURE 5

Certain Trade or Business Expenses (Including Rental Property)[a]

Item	Adequate Disclosure
Casualty and Theft Losses	Same procedure as for Schedule A (Form 1040).
Legal Expenses	The amount claimed must be stated. This section does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or nondeductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.
Specific Bad Debt Charge-Off	The amount written off must be stated.
Reasonableness of Officers' Compensation	Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section does not apply to "golden parachute" payments, as defined under section 280G. This section will not apply to the extent that remuneration paid or incurred exceeds the $1 million employee remuneration limitation, if applicable.
Repair Expenses	The amount claimed must be stated. This does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.
Taxes (Other than Foreign Taxes)	The amount claimed must be stated.

[a] Source: Rev. Proc. 2008-14, 2008-7 IRB 435.

FIGURE 6

Differences in Book and Income Tax Reporting[a]

Item	Adequate Disclosure
Form 1065. Schedule M-3 Form 1120. Schedule M-1 and M-3* Form 1120-L. Schedule M-3* Form 1120-PC. Schedule M-3* Form 1120-S. Schedule M-3* Form 1120-F. Schedule M-3*	Column (b), Temporary Difference, and Column (c), Permanent Difference, of Part II (reconciliation of income [loss] items) and Part III (reconciliation of expense/deduction items)

* Note: Schedule M-3 is completed for taxpayers with total assets of $10 million or more.
[a] Source: Rev. Proc. 2008-14, 2008-7 IRB 435.

Other Expenses and Credits. Rev. Proc. 2008-14 also addresses several other miscellaneous specific-item disclosures such as foreign taxes, moving expenses, employee business expenses, and the fuels credit. Generally, completely filling out the appropriate form is sufficient to meet the adequate disclosure requirements. However, in the case of employee expenses, the IRS states that completing Form 2106 properly will not meet the disclosure requirement for club dues or travel expenses for any nonemployee accompanying the taxpayer on a trip. These items must be disclosed as per specific IRS instructions relating to each item.

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Financial Reporting

The disclosure for uncertain tax positions in financial statements prepared under GAAP is largely governed by FIN 48. Annual financial statement disclosures must include a tabular reconciliation of unrecognized tax benefits at the beginning and end of each period.[28] This reconciliation should provide information on increases and decreases in unrecognized tax benefits as a result of tax positions taken in the current and prior periods, settlements of tax positions resulting in a decrease in unrecognized tax benefits, and reductions in unrecognized tax benefits due to a lapse in the applicable statute of limitations. Since FIN 48 allows for some flexibility in the classification of accrued interest and penalties on unrecognized tax positions, the entity's accounting policy with regard to classification of these items and the total amounts allocated to either tax expense or other expenses must be disclosed. Other disclosures include the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate and the nature of any uncertain tax position that has a reasonable possibility of changing within the next 12 months and the nature of the event which might cause the change. A description of the tax years which remain open for examination by significant tax jurisdictions is also a required disclosure under FIN 48.

The Securities and Exchange Commission has largely followed FIN 48 and only specifically addressed the need to disclose FIN 48 liabilities in the "known contractual obligations" table of the Management's Discussion and Analysis required under Regulation S-K Item 303(a)(5).[29] Similarly, the IASB exposure draft on income tax requires a description of the uncertainties for tax positions and an indication of the possible financial implications on the amounts recognized and timing of recognition. While less precise in its description of disclosures for uncertain tax positions, the spirit of the IASB exposure draft on income tax is consistent with the disclosure intent of the FASB and SEC guidance—disclose information about the major sources of estimation uncertainties related to tax positions to allow financial statement users to evaluate the possible financial implications of the estimation uncertainties and related timing effects.

It is clear that analyzing uncertain tax positions for financial reporting requires significant documentation. The question then becomes, could this documentation serve as a roadmap for potential items to be examined by taxing authorities? To date, the IRS's position has been to treat FIN 48 workpapers as tax accrual workpapers (TAW). The existing standard for the request of TAWs is the unusual circumstances standard.[30] Under this standard, a request for TAWs (excluding listed transactions) would only be made under unusual circumstances. In the May 2007 *LMSB Field Service Guide on FIN 48*, the IRS reiterated the standard of restraint with regard to FIN 48 workpapers. However, the IRS does consider the FIN 48 disclosures made in the financial statements to be outside of the scope of policy of restraint.

DISCUSSION AND CONCLUSION

The requirements for reporting uncertain tax positions present a challenge to accountants, especially those involved with financial statement presentation. The standards applicable to tax preparers under IRC §6694 set substantial authority as the standard by which return preparers

[28] Note that unrecognized tax benefits and related interest and penalty exposures generally result in the recognition of a current or noncurrent FIN 48 liability.

[29] Discussion Document E from the April 17, 2007, joint meeting of the AICPA's SEC Regulations Committee and the SEC Staff.

[30] Internal Revenue Manual 4.10.20.3(2).

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will be measured (reasonable basis when disclosed), whereas FIN 48 requires a more-likely-than-not standard to be met. Given the fairly small difference in uncertainty between more-likely-than-not (greater than 50 percent) and substantial authority (greater than 40 percent), tax advisors should be prepared to defend their analyses and conclusions given the potential consequences of misclassification.

Should a company utilize the services of one advisor in analyzing uncertain tax positions under FIN 48 but use the services of a different firm in analyzing disclosure for tax reporting and compliance, disagreements may arise between the advisors' opinions on tax positions that may require disclosure for financial statements versus tax returns. The discrepancies would be expected to occur in positions with probabilities that fall between substantial authority and more-likely-than-not (40 percent $<$ probability $<$ 50 percent). Under the prior tax preparer penalties that required a higher standard for tax preparers than taxpayers, companies found themselves in a position to strongly consider bringing compliance work in-house to avoid the necessity of disclosing items to meet the higher tax preparer standard. The revised penalty standards reduce that incentive by aligning taxpayers and preparers, but potentially leave the gap between auditors and tax advisors (albeit a fairly narrow gap). Items within the reasonable basis to more-than-likely standards also create a potential issue in years after the transaction when the FIN 48 liability remains on the financial statements. Items which have been disclosed on the tax return and subject to audit may be eligible for de-recognition quicker than items which were not disclosed on the return and therefore may remain uncertain for a longer period of time.

In addition, the substantial authority definition places greater importance on professional analysis and research, and makes it advisable to retain contemporaneous written documentation of conclusions reached and authorities relied upon—particularly regarding the classification of a position as a tax shelter or listed transaction given the higher standards. Further, FIN 48 requires that the outcome probabilities are evaluated (and modified if necessary) each reporting period until ultimate settlement of a tax position. Although §6694 effectively only requires an initial up-front evaluation of the outcome probability for a tax position, it is important for tax practitioners to consider any adjustments to the probabilities associated with tax positions taken in prior years—particularly if there are similar transactions in the current reporting period.

The disclosure of tax positions on a tax return lowers the standard for the position's estimated likelihood of success in order to escape penalties under the current guidance related to IRC §6694. The guidance issued under Rev. Proc. 2008-14 provides a clearly stated format by which adequate disclosure can be achieved. FIN 48 provides the required financial statement disclosures for uncertain tax positions. These disclosures are clearly subject to IRS review and care should be taken to ensure that adequate disclosures are made without jeopardizing private tax information. The underlying tax accrual workpapers supporting FIN 48 appear to lie within the IRS policy of restraint with regard to the request for tax accrual workpapers, but FIN 48 disclosures in financial statements are not, making decisions about these disclosures particularly important.

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