

**New York State Bar Association**

**Tax Section**

**Report on Uncertain Tax Positions in the Context of Mergers, Acquisitions and Spin-offs**

**December 20, 2010**

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**Report on Uncertain Tax Positions in the Context of Mergers, Acquisitions and Spin-Offs\***

**I. Introduction and General Recommendations**

This report (the “Report”) comments on the recently released Schedule UTP, *Uncertain Tax Position Statement* (the “Schedule”), Instructions for the Schedule (the “Instructions”) and Announcement 2010-75<sup>1</sup> (the “Announcement”) in the context of mergers, acquisitions and spin-offs. Following previous pronouncements regarding uncertain tax positions (“UTPs”),<sup>2</sup> the Schedule links a taxpayer’s disclosure obligations to the recording of a reserve on the taxpayer’s audited financial statements. For most United States corporations, *Financial Accounting Standards Board Interpretation No. 48: Accounting for Uncertainty in Income Taxes* (“FIN 48”)<sup>3</sup> sets forth the rules regarding recording of reserves on financial statements for UTPs.<sup>4</sup> We believe that the approach of the Internal Revenue Service (the

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<sup>1</sup> I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428 (Oct. 12, 2010).

<sup>2</sup> See STEVEN T. MILLER, I.R.S., DIRECTIVE FOR ALL LARGE BUSINESS AND INTERNATIONAL DIVISION (LB&I) PERSONNEL: REPORTING OF UNCERTAIN TAX POSITIONS (Sept. 24, 2010); Notice of Proposed Rulemaking and Notice of Public Hearing, Requirement of a Statement Disclosing Uncertain Tax Positions, 75 Fed. Reg. 9754 (proposed Sept. 9, 2010) (containing Prop. Treas. Reg. § 1.6012-2); I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668 (May 10, 2010); I.R.S. Announcement 2010-17, 2010-13 I.R.B. 515 (Mar. 29, 2010); I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408 (Feb. 16, 2010); see also Treas. Reg. § 1.6012-2(a)(4)–(5) (2010).

<sup>3</sup> FIN 48 has been codified in certain sections of ACCOUNTING STANDARDS CODIFICATION, Subtopic 740-10, Income Taxes – Overall (Fin. Accounting Standards Bd. 2010).

<sup>4</sup> Recording of a reserve for a UTP under another accounting regime could also trigger reporting of the position on the Schedule. See Instructions, at 1 (requiring reporting regardless of whether the audited financial statements are prepared under U.S. generally accepted accounting

“Service”) of requiring UTP reporting when a reserve is recorded works adequately in the context of mergers, acquisitions and spin-offs. This Report discusses how we believe the requirements of the Schedule apply in the context of mergers, acquisitions and spin-offs and identifies areas where guidance would be helpful.

Generally, a corporate taxpayer must report a tax position on its Schedule when (1) it has taken the position on its federal income tax return for the current tax year or a prior tax year, and (2) the corporation or a related party issues audited financial statements for all or a portion of the corporation’s tax year and those financial statements either record a reserve with respect to that position for federal income tax or those financial statements do not record a reserve because the taxpayer expects to litigate the position.<sup>5</sup> However, if a UTP is listed on a Schedule once, it need not be listed again in a later year (the “Only Once Rule”).<sup>6</sup> The Service has explained that the obligation to list a position on the Schedule is meant to be consistent with the decision to record a reserve for the position on audited financial statements.<sup>7</sup>

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principles, International Financial Reporting Standards or other country-specific accounting standards).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* (“A corporation is not required to report a tax position it has taken in a prior tax year if the corporation reported that tax position on a Schedule UTP filed with a prior year tax return.”). The Only Once Rule should apply if the corporation *or a predecessor* previously reported the position. For example, if the corporation takes a position on a tax return, reserves for it, reports it on a Schedule and then merges into another corporation, the successor corporation should not be required to report the position again.

<sup>7</sup> *Id.* (“Consistency with financial statement reporting. The analysis of whether a reserve has been recorded for the purpose of completing Schedule UTP is determined by reference to those reserve decisions made by the corporation or a related party for audited financial statement purposes. If the corporation or a related party determined that, under applicable accounting standards, either no reserve was required for a tax position taken on a tax return because the amount was immaterial for audited financial statement purposes, or that a tax position was sufficiently certain so that no reserve was required, then the corporation need not report the tax position on Schedule UTP.”).

Mergers, acquisitions and spin-offs typically do not raise special issues with respect to UTP reporting because of the Only Once Rule. If a target took a position in a pre-closing period and reserved for the position, the target typically would have reported the position on the target's Schedule for that pre-closing tax year. In such a case, because of the Only Once Rule, the acquiror need not report the position even if the acquiror records a reserve for the position.<sup>8</sup> Some mergers, acquisitions or spin-offs could, however, involve a situation where the target corporation took a tax position in a pre-closing period and, for one reason or another, did not record a reserve for it (or intend to litigate it). When the target corporation is acquired, the acquiror might record a reserve for that same position on the acquiror's financial statements. Even in the context of such transactions, we believe that the general rule requiring disclosure of a UTP on a taxpayer's Schedule when the UTP is reserved on financial statements operates soundly, as discussed in greater detail below.

Liabilities for taxes imposed under Treasury Regulation § 1.1502-6 raise special issues, but here, as well, we believe that the overriding principle should be that whichever entity records a reserve for a specific tax position should be required to report the position on its Schedule.

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<sup>8</sup> The Only Once Rule should apply despite the fact that the acquiror's financials are a different set of financials from the target's, since the Only Once Rule turns on there having been prior reporting on a Schedule. The Only Once Rule is not limited to circumstances where only one set of financials is involved. Further, the Only Once Rule should apply even if the acquiror records a greater reserve, as "reserve increases or decreases with respect to the tax position will not" trigger reporting. *Id.* at 2. The Only Once Rule should also apply even if the acquiror's reason for booking the reserve differs from the target's reason or because the acquiror and target have different views about what weakness exists in the position. Reporting turns on a position being taken, *i.e.*, a position that would result in a change to a line item on the return if not sustained, *see id.*, and a reserve in respect thereof, not on the reason for the reserve. Finally, reporting by a consolidated group of which a corporation is or was a member should count as prior reporting by the corporation such that, under the Only Once Rule, the corporation need not report again.

We recommend that the Service issue guidance confirming the following:

(1) An acquiring corporation (or target corporation) need not report on its Schedule a tax position taken on a standalone target corporation's pre-closing return for which the target did not record a reserve unless the acquiror (or target, as the case may be) records a reserve for the tax position on its financial statements, in which event the acquiror (or target) must report the tax position.

(2) If a consolidated group sells a target corporation that is a member of the group, the acquiring corporation (or target corporation for post-closing periods) need not report on its Schedule a tax position taken on the selling consolidated group's pre-closing consolidated income tax return for which the selling group did not record a reserve unless the acquiror (or target) records a reserve for the tax position on its financial statements, in which event the acquiror (or target) must generally report the tax position. However, if as a result of the selling consolidated group's bankruptcy or insolvency, acquiror or target records a reserve under FAS 5 (as defined below) for taxes relating to activities of other members of the selling consolidated group, acquiror and target are not required to report such positions. Furthermore, if a consolidated group sells a target corporation that is a member of the group, the Only Once Rule should apply to relieve target and acquiror from being required to report if the selling consolidated group already reported (or concurrently reports), but the Only Once Rule should not relieve the selling consolidated group from being required to report its own reserve relating to the target even if the target or acquiror already reported after the acquisition.

(3) In circumstances where parties to a corporate transaction share information regarding their respective tax positions (whether or not these positions have been identified as positions to be scheduled at the time such information is shared or indeed are ever

scheduled), such information-sharing will not justify an exception to the Service’s policy of restraint in seeking tax accrual workpapers.

The regime may have consequences for negotiations in the context of mergers, acquisitions and spin-offs, but we do not believe that these consequences warrant a departure from the general rule that UTP reporting follows financial accounting reserves. The obligation to disclose UTPs on the Schedule could affect the negotiation of indemnification provisions under which a seller typically indemnifies an acquiror against liability for the target’s pre-closing taxes. Sellers who have not reserved and not reported a pre-closing period position on a Schedule will be sensitive to whether an acquiror reserves and places a pre-closing position on a Schedule for a post-closing period. Further, the reporting regime may affect pre-transaction due diligence, as an acquiror may seek to assess its obligation to report tax positions that it “inherits” from a seller. However, in our view, these potential consequences and dynamics should not cause a departure from the principle that reporting on the Schedule should follow the recording of a reserve.

## II. Disclosure of Pre-Closing Positions Taken by a Standalone Target Corporation

We recommend that the Service issue guidance to confirm that an acquiring corporation (or target) must disclose on its Schedule a tax position taken by a target corporation during a pre-closing period for which a reserve is first recorded on the financial statements of the acquiror or target (or a related party) covering a post-closing period. An example (Example 1) will illustrate the situation:

Acquiror Corporation acquires Target Corporation from Seller. Target Corporation does not file U.S. federal consolidated returns with Seller. In a pre-closing period, Target Corporation takes a tax position on its U.S. federal income tax return, but does not record a reserve for the position on its audited financial statements. Because no reserve has been recorded, Target Corporation does not

report the tax position on its Schedule for the pre-closing period. Post-closing, Acquiror Corporation determines that, under FIN 48 (or another relevant financial accounting standard), Acquiror Corporation must record a reserve for the tax position on its financial statements for the post-closing period. Are Acquiror Corporation and Target Corporation required to disclose the pre-closing tax position on a Schedule?

While the factual scenario presented in Example 1 is not typical, it could arise in a variety of contexts. These include:

*Situation 1:* The Target Corporation did not reserve for the tax position because the position was determined to be not material to the target's audited financial statements.<sup>9</sup> However, from the Acquiror Corporation's perspective, the position is material, and the Acquiror Corporation therefore does record a reserve under FIN 48.<sup>10</sup>

*Situation 2:* The Target Corporation did not reserve for the tax position because the target believes the position is "more likely than not" to be sustained. However, the Acquiror Corporation believes that the position does not have a more-likely-than-not likelihood of success on the merits, triggering an obligation to reserve under FIN 48.<sup>11</sup>

*Situation 3:* Changes in law or guidance issued by the Service from the pre- to post-closing period result in a different analysis of likelihood of success on the merits with respect to the tax position and therefore a decision to record a reserve for the position.

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<sup>9</sup> See ACCOUNTING STANDARDS CODIFICATION, ¶ 105-10-05-6 (Fin. Accounting Standards Bd. 2010) ("The provisions of the Codification need not be applied to immaterial items.").

<sup>10</sup> See SEC STAFF ACCOUNTING BULLETIN NO. 108, 71 Fed. Reg. 54,580, at 54,581 (2006) (requiring current-year financial statement adjustments upon a change in a registrant's evaluation of the materiality of prior year misstatements). A change in materiality from a pre-closing to a post-closing year might also require the target corporation to restate its financial statements for the previous years, if recording the reserve in the post-closing year alone would result in a material misstatement for that year. See *id.* at 54,582.

<sup>11</sup> See ACCOUNTING STANDARDS CODIFICATION, ¶¶ 740-10-25-5 to -17 (Fin. Accounting Standards Bd. 2010).



*Situation 4:* The Target Corporation's decision not to reserve for the tax position in its financial statements was erroneous.

*Situation 5:* The Target Corporation and Acquiror Corporation prepare their financial statements under different accounting standards (perhaps one follows U.S. GAAP and the other International Financial Reporting Standards), and the application of these standards results in differing conclusions as to whether a reserve is required for a particular tax position.

*Situation 6:* The Target Corporation is too small to be subject to UTP reporting,<sup>12</sup> but the Acquiror Corporation is not.

In any of these instances, the acquiring corporation (or target, as the case may be) may record a post-closing reserve for the Target Corporation's pre-closing tax position.

We believe that in all these cases, the acquiror (or target) should be required to report the pre-closing tax position on the acquiror's (or target's) Schedule for the year in which the reserve is first recorded. In general, nothing in the merger, acquisition or spin-off context justifies a departure from the policy that a taxpayer's decision to reserve for a tax position on its audited financial statements should trigger disclosure. We have considered whether the potential for an acquiror to report pre-closing positions could interfere with negotiations between the parties and even provide an acquiror with inappropriate leverage over the seller. While this may be possible, similar possibilities existed prior to the Schedule but tend not to arise. Moreover, the Schedule's reliance on financial accounting reserves creates a degree of objectivity. Thus,

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<sup>12</sup> Reporting is only required of corporations having a minimum amount of assets. The minimum is to be phased in over five years. Filing is required with respect to 2010 and 2011 for corporations with assets of at least \$100 million. The threshold is reduced to \$50 million starting with 2012 and to \$10 million starting with 2014. *See* Announcement 2010-75, *supra* note 1, at 428.

we believe that the potential for interference with merger negotiations would not justify a departure from the regime when a corporation changes ownership.

The result in Example 1 should moreover be consistent with what would occur outside the context of mergers, acquisitions and spin-offs where a corporation first records a reserve for a tax position in a year after the year the position appeared on its tax return. For example (Example 2):

Parent corporation owns a large subsidiary corporation (Big Sub) and a small subsidiary corporation (Small Sub). In Year 1, Small Sub engages in a transaction that gives rise to a questionable tax position on the return filed by Small Sub (or Parent if they file consolidated returns). However, because Small Sub's questionable tax position is immaterial in the context of Parent's overall financial statements, in Year 1, Parent does not record a reserve for the tax position on its financial statements. Thus, the tax position is not disclosed on a Schedule for Year 1. In Year 2, Parent spins off Big Sub (or otherwise reduces the size of Parent's operations), altering the applicable materiality threshold. Due to the changed circumstances, Parent records a reserve on its Year 2 financial statements for the Year 1 tax position.<sup>13</sup> Is Small Sub (or Parent) required to disclose the tax position in Year 2 (*i.e.*, the year in which the tax position is first recorded on Parent's financial statements under FIN 48)?

We believe that, in Example 2, Small Sub (or Parent) would be required to disclose the tax position on its Schedule in Year 2 (*i.e.*, the year that the position becomes material and results in a reserve) because, as of that year, (1) Small Sub (or Parent) has taken the position on its return (in a prior year), and (2) Parent has recorded a reserve for the position under FIN 48 (in the current year). The Announcement notes that the Instructions "clarify that a tax position is reported on Schedule UTP once (1) a reserve for a tax position is recorded and (2)

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<sup>13</sup> See SEC STAFF ACCOUNTING BULLETIN NO. 108, *supra* note 10. As mentioned in note 10, *supra*, a change in materiality from one year to the next might also require Parent to restate its financial statements for the previous years. See *id.* at 54,582.

a tax position is taken on a return regardless of the order in which those two events occur.”<sup>14</sup>

According to our interpretation, in a situation where a corporation first records a reserve on its audited financial statements for a year after the year in which the tax position is reflected on its tax return, the corporation must disclose the tax position on its Schedule filed with its return for the later year. It follows that if a merger, acquisition or spin-off transaction causes a change which results in a reserve being first recorded in a later year for a tax position taken in a prior year, the tax position should be reported on the Schedule filed for the year in which the reserve is first recorded. In Example 1, we interpret this to require the target to disclose the tax position on its post-closing Schedule in the year that it records the reserve.<sup>15</sup>

Notwithstanding our general conclusion that a taxpayer should be required to disclose a position on the Schedule if and only if the taxpayer records a reserve, we have identified a potential situation in which we believe a taxpayer should be required to report even if the taxpayer does not record a reserve. Specifically, if a taxpayer does not record a reserve because the taxpayer is protected economically either through an indemnity or through insurance, we believe that the taxpayer should be required to disclose the position if the taxpayer would have recorded a reserve absent the indemnity or insurance. As a general matter, we understand that the existence of an indemnity or insurance does not affect the requirement to record a FIN 48 reserve. The potential tax liability is not netted against the indemnification or insurance asset for purposes of preparing audited financial statements.<sup>16</sup> Therefore, we do not

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<sup>14</sup> I.R.S. Announcement 2010-75, *supra* note 1, at 430.

<sup>15</sup> The position would be reported on Part II of Schedule UTP. *See* Instructions, at 1. In circumstances where a corporation takes a position on its return in a year before 2010, the obligation to disclose on a Schedule will never arise. *See* I.R.S. Announcement 2010-75, *supra* note 1, at 430.

<sup>16</sup> *ASC 805: Business Combinations* (“ASC 805”) applies a “mirror image” method of accounting for indemnification assets in the context of mergers and acquisitions. Under this

believe that taxpayers typically fail to reserve on the basis of indemnification or insurance. However, it is possible that some taxpayers might take the view that a reserve need not be recorded for a potential tax liability on the basis that the liability is not material because the taxpayer has a right to an indemnity or has insurance.<sup>17</sup> Materiality for financial accounting purposes is a complex and multi-factored analysis involving both quantitative and qualitative considerations. If a situation did occur where a taxpayer did not record a reserve because the taxpayer was entitled to an indemnity or insurance, we believe the taxpayer should be required to disclose the position on its Schedule, just as it would have in the absence of the indemnification or insurance. While we generally agree with the Service’s approach that positions that are not reserved on the basis of immateriality need not be reported,<sup>18</sup> we believe that that approach was not intended to apply when the liability standing on its own is material. Our conclusion applies

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method, an indemnified party records “an indemnification asset at the same time that it [records a reserve for] the indemnified item, measured on the same basis as the indemnified item.” ACCOUNTING STANDARDS CODIFICATION, ¶ 805-20-25-27 (Fin. Accounting Standards Bd. 2010). For indemnification assets related to income taxes, the principles of FIN 48 apply. *See id.* at ¶¶ 805-20-25-28, 805-740-25-2. Thus, in a business combination transaction, when a taxpayer is indemnified against liability for an uncertain tax position, two separate items are generally recorded simultaneously: (1) a reserve for the uncertain tax position (*i.e.*, a liability), and (2) an indemnification asset, both at the time and in the amount prescribed under FIN 48.

ASC 805 applies by its terms to business combinations and not to spin-offs. In the case of a spin-off, some taxpayers might account for indemnification assets by analogy to the “mirror image” method of ASC 805. Others might account for indemnification assets as a contingent gain under *ASC 450: Contingencies* (“ASC 450”). Under ASC 450, the indemnified party would not record the indemnification asset until actual realization of the contingent gain (*i.e.*, recovery by the indemnified party under the indemnification agreement). *See* ACCOUNTING STANDARDS CODIFICATION, para. 450-30-25-1 (Fin. Accounting Standards Bd. 2010) (“A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.”). Whether ASC 805 or 450 applies, the asset should not be netted, for financial accounting purposes, against the related liability with respect to the uncertain tax position and thus should not affect the requirement to record a reserve for the liability under FIN 48.

<sup>17</sup> *See* ACCOUNTING STANDARDS CODIFICATION, ¶ 105-10-05-6 (Fin. Accounting Standards Bd. 2010).

<sup>18</sup> *See supra* note 7.

equally to standalone target companies discussed in this Part II and target members of a seller's consolidated group discussed in Part III below.

### III. Disclosure of Pre-Closing Positions Taken by a Seller Consolidated Group

We recommend that the Service issue guidance to confirm that, in general, UTP reporting by the acquiror or target is required for pre-closing positions taken by the consolidated group of which the target corporation was a member<sup>19</sup> if, and only if, after the acquisition the acquiror or target records a reserve for financial accounting purposes for this liability. However, if as a result of the selling consolidated group's bankruptcy or insolvency, acquiror or target records a reserve under *Statement of Financial Accounting Standards No. 5: Accounting for Contingencies* ("FAS 5")<sup>20</sup> for taxes relating to activities of other members of the selling consolidated group, neither acquiror nor target should be required to report such positions on the Schedule.

Consider Example 3:

Acquiror Corporation acquires Target Corporation from Parent. Target Corporation has been included as a member in the Parent group's consolidated returns and, thus, is liable under Treasury Regulation § 1.1502-6 for any tax liabilities (including those arising from positions that may be required to be reported on a Schedule) of the Parent group for any year in which Target was included in the Parent group's consolidated return. In a pre-closing period, the Parent consolidated group takes a tax position on its return. In one variation, the position relates to activities of members of the Parent group other than Target

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<sup>19</sup> We believe that an election under Section 338(h)(10) should not be relevant to the question whether a target or acquiror should be required to report a tax position for the pre-closing period, because even if a Section 338(h)(10) election has been made, the target would remain liable for pre-closing taxes. Treas. Reg. § 1.338-1(b)(3)(i). Thus, any reference in this Report to the sale of a subsidiary corporation of a consolidated group should be interpreted to include a sale for which an election under Section 338(h)(10) has been made.

<sup>20</sup> ACCOUNTING STANDARDS CODIFICATION, Topic 450, Contingencies (Fin. Accounting Standards Bd. 2010).

Corporation. In another variation, the position relates to activities of the Target Corporation. In any event, the Parent group does not record a reserve for the position on its financial statements. Because no reserve has been recorded, Parent does not report the position on its Schedule for the pre-closing period. Post-closing, Target Corporation remains liable under Treasury Regulation § 1.1502-6 for any pre-closing taxes arising from the tax position. That is, under Treasury Regulation § 1.1502-6, the Service could pursue Target Corporation for those taxes. Under what circumstances is Acquiror Corporation or Target Corporation required to disclose the position on its Schedule for a post-closing period?

In our view, the overriding principle behind the Schedule is that UTP reporting goes hand in hand with recording a reserve. This principle serves an important policy: simplicity. Thus, we believe that despite some nuances, discussed below, regarding the recording of reserves when a member leaves a consolidated group, whichever party or parties record a reserve for a pre-closing consolidated group tax liability should generally be required to report the position on its Schedule.

*A. Disclosure of Positions Relating to Members Other Than the Target Corporation*

We understand that after a target corporation has been sold by a consolidated group, generally neither the target nor the acquiror records a reserve under FIN 48 to reflect the potential Treasury Regulation § 1.1502-6 liabilities relating to members of the group other than the target corporation (the “Other Members”). This practice derives from a financial accounting principle to the effect that where members of a single consolidated group for tax purposes file separate financial statements, tax liabilities are generally allocated as if the two financial reporting groups were separate taxpayers (the “Separate Taxpayer Construct”).<sup>21</sup> Thus, if the

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<sup>21</sup> Paragraph 740-10-30-27 of the *Accounting Standards Codification* provides: “The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Subtopic does not require a single allocation method. The method

potential tax liability relates to the Other Members, the selling consolidated group (and not the target corporation) would potentially report a reserve. As a practical matter, this approach is very helpful, because an acquiror would be unlikely to know all the liabilities relating to the Other Members that target is exposed to under Treasury Regulation § 1.1502-6. Finding out would involve an unusual, time consuming and expensive due diligence exercise on all the seller consolidated group's exposures and would likely not ultimately yield an accurate reflection of the target's exposure.

Furthermore, under FIN 48, the determination whether a position has a more-likely-than-not likelihood of success on the merits (the first step of the analysis as to whether to record a reserve) may be made by taking into account "past administrative practices and precedents" of the Service that are "widely understood".<sup>22</sup> We believe that the Service has a long-standing administrative practice of generally not assessing subsidiaries that are sold by a consolidated group despite the Service's right to do so under Treasury Regulation § 1.1502-6. This may further bolster the practice of acquiror and target not recording a reserve for consolidated group tax exposures with respect to the Other Members' activities.

If the selling consolidated group does record a reserve for tax liabilities associated with the Other Members, then the selling consolidated group (and not the target corporation or acquiror) should be required to disclose the tax position on its Schedule.<sup>23</sup> We believe that the

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adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Subtopic. A method that allocates current and deferred taxes to members of the group by applying this Topic to each member as if it were a separate taxpayer meets those criteria." ACCOUNTING STANDARDS CODIFICATION, ¶ 740-10-30-27 (Fin. Accounting Standards Bd. 2010).

<sup>22</sup> See *id.* at subparagraph 740-10-25-7(b).

<sup>23</sup> The Service's draft Schedule proposed in Announcement 2010-30 would have required UTP reporting if a reserve was not booked on account of an administrative practice. This was changed in the final Schedule. I.R.S. Announcement 2010-75, *supra* note 1, at 429-30. Thus, if

Service should confirm that Treasury Regulation § 1.1502-6 liabilities related to Other Members' tax liabilities are not required to be disclosed on an acquiror corporation's Schedule (or on a target corporation's Schedule in post-closing periods) if the acquiror and the target have not recorded a reserve on their audited financial statements with regard to such liabilities. We believe further that the Service should confirm that the above rule should apply regardless of whether the acquiror would litigate the liability if the Service were to assert it and regardless of whether the reason that the seller group did not book a reserve is any of the six reasons described in the preceding section.

The target corporation might eventually record a reserve for potential tax liabilities associated with Other Members' activities if the common parent of the selling consolidated group becomes insolvent or bankrupt. Where the target corporation records a reserve in respect of a tax position relating to Other Members, the reserve is likely not taken under FIN 48, the usual standard relating to uncertain tax positions. Rather, it is likely taken under FAS 5. Under FAS 5, a contingency must be reserved for if the contingency is "probable" and the loss relating thereto can be "reasonably estimated."<sup>24</sup> For financial accounting purposes, the taxable income associated with the position that relates to Other Members is considered not to be the target corporation's taxable income under the Separate Taxpayer Construct, described above. Thus, the potential liability associated with that income is not reserved for under the accounting standard relating to uncertain tax positions, but rather under a standard relating to contingencies.

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a reserve is not booked because of a widely understood administrative practice, no Schedule reporting is required.

<sup>24</sup> ACCOUNTING STANDARDS CODIFICATION, ¶ 450-20-25-2 (Fin. Accounting Standards Bd. 2010).



We do not believe that an acquiror or target should be required to report tax positions of the target's former consolidated group in these circumstances. First, we do not believe that FAS 5 reserves in respect of tax liabilities should generally result in Schedule UTP reporting. Announcement 2010-9 appears to contemplate that, for a taxpayer that is subject to FIN 48, only FIN 48 reserves result in Schedule UTP reporting.<sup>25</sup> On the other hand, notwithstanding the financial accountants' view that the reserve is not a reserve for taxes, from a tax point of view, it is a reserve for taxes because under Treasury Regulation § 1.1502-6, the target corporation is liable for the taxes.<sup>26</sup> Arguably, Schedule UTP reporting should not be limited to FIN 48 reserves for taxpayers subject to FIN 48. Nonetheless, we do not believe that a FAS 5 reserve should generally give rise to reporting because the FAS 5 regime is not specifically designed to address taxes.

Second, a target corporation that reserves for tax liabilities related to the activities of Other Members would likely have little information about the tax positions taken by such Other Members and might not have any information as to whether the selling consolidated group has recorded or will record FIN 48 reserves for such positions. Where the selling consolidated group did not record reserves for the tax positions of Other Members in pre-closing years, it would be onerous to require the target to report the selling consolidated group's pre-closing positions on the target's Schedule in a post-closing year when the common parent of the selling

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<sup>25</sup> Announcement 2010-9, *supra* note 2, at 408–9 (uncertain tax positions include those giving rise to a FIN 48 reserve or a reserve under other accounting standards (*e.g.*, International Financial Reporting Standards) and those not giving rise to a reserve either because the taxpayer expects to litigate or because the Service has a general administrative practice not to examine the position).

<sup>26</sup> We would distinguish indemnification obligations, where one party is contractually obligated to pay another, or to pay another's taxes, without having any obligation under U.S. federal income tax law to pay the taxes. We do not believe that indemnification obligations are required to be reported on a Schedule.

consolidated group becomes insolvent or bankrupt and the target is no longer a member of the group. Even if the target determines its potential total liability under Treasury Regulation § 1.1502-6 for purposes of recording a FAS 5 reserve, it is unlikely that the target corporation would have the necessary information to make the detailed, position-specific disclosures required under the Schedule. Thus, we believe that the selling consolidated group should have sole responsibility for reporting these positions on its Schedule.

It should be noted that in such circumstances, the Only Once Rule would often apply. That is, the selling consolidated group may well have already reported the position on its Schedule. If so, the acquiror and target corporation should not be required to do so.

If the Service were to take the position that the target corporation's recording of a FAS 5 reserve related to the tax liabilities of Other Members triggers an obligation for the target to disclose the Other Members' positions on its Schedule, then the target would need to be able to obtain information regarding those positions. The fact that the target corporation records a FAS 5 reserve does not necessarily mean that the target corporation has the information required in order to complete the Schedule. In order to comply with the Schedule, the target corporation would need detailed information with respect to the nature of each of the Other Members' positions and would need to know whether the selling consolidated group previously reported each position on the Schedule. Requiring the selling consolidated group to share its confidential tax and accounting information with the target, an unrelated party, would be awkward both for policy reasons and logistically. Such an obligation would raise issues as to whether recipients of the group's information would be subject to confidentiality obligations and whether the information exchange would affect privileged status. We believe that the difficulty of facilitating

the target's compliance with the Schedule if it were obligated to disclose Other Members' positions supports the recommendation not to adopt such a requirement.

*B. Disclosure of Positions Relating to the Target Corporation*

If a target corporation is sold by a consolidated group, a potential tax liability from the pre-closing period relates to the target corporation, and the selling consolidated group did not record a reserve for this liability in a pre-closing period, then our understanding is that the target corporation and the selling consolidated group must each potentially record a reserve for that liability. If so, from a simplicity perspective, the party or parties that record a reserve with respect to such tax liability should generally be required to report the position on their Schedules. This could result in both the acquiror corporation (or target corporation), on the one hand, and the selling consolidated group, on the other hand, reporting the position on their respective Schedules. Under this approach, Schedule reporting follows the decision to record a reserve, thereby enhancing the goal of simplicity.<sup>27</sup> In some situations, such as the six situations described in Part II above, the selling consolidated group might not record a reserve for the pre-closing tax position that the group took related to the target's activities, while the target might record a post-closing reserve. In these circumstances, we believe that the target should be required to report the position on its Schedule, since the target recorded the reserve.

We acknowledge that, ideally, the position would be reported on the selling consolidated group's Schedule since the selling consolidated group took the position on the

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<sup>27</sup> The selling consolidated group might record the liability related to the Target Corporation's activities as a contingent liability under FAS 5 and not as an uncertain tax position under FIN 48. However, because the selling consolidated group took the position on its pre-closing return and has full information regarding the merits of the position, we believe there should be no distinction between a reserve under FAS 5 and one under FIN 48 in this context. The selling consolidated group's decision to reserve for the liability under either standard should trigger an obligation to report the UTP on its Schedule.

group's tax return. An audit of that return would best be facilitated by having the position reported on the selling consolidated group's Schedule. However, requiring the selling consolidated group to report a position on its Schedule when the target, and not the selling consolidated group, records a reserve with respect to the position raises concerns. From a practical perspective, the selling consolidated group likely will not know which tax positions the target has reserved for. Further, it seems inappropriate to impose on the selling consolidated group a responsibility to schedule a position based on actions of a third party—target—and that third party's auditors. The selling consolidated group may well disagree that a reserve must be posted but would have little ability to make its case with the target's auditors, as it might not even find out about the reserve until after the reserve has been recorded. Finally, requiring the selling consolidated group to report a position on its Schedule when the target records a reserve for the position would conflict with the Service's goal of enhancing simplicity by conforming UTP reporting with financial accounting reserves.

Thus, on balance, we believe that if the target records a reserve in respect of pre-closing positions taken by the seller consolidated group that relate to target, target should have the obligation to schedule those positions and, unless the seller consolidated group also records a reserve, the seller consolidated group should not be required to schedule these positions.

Application of the Only Once Rule in the context of a pre-closing tax position taken by a selling consolidated group relating to the activities of target merits discussion. Under the Only Once Rule, we believe that if the selling consolidated group reports a tax position on its Schedule, then the target and acquiror should not be required to report the position. However, if the target or acquiror reports the position on its Schedule, we do not believe that the selling

consolidated group should be relieved under the Only Once Rule of being required to report its own reserves. If the selling consolidated group records a reserve, either under FIN 48 or FAS 5, in respect of a pre-closing tax position relating to target, the selling consolidated group should be required to report the position on its Schedule regardless of whether the target or acquiror previously reported the position on a post-acquisition Schedule. The position was taken on the selling consolidated group's tax return, and the group has the necessary information for complying with the Schedule.

#### IV. Policy of Restraint

The Service has announced that it will expand its policy of restraint with regard to requesting tax accrual workpapers related to the disclosure of tax positions on the Schedule.<sup>28</sup> Under the policy of restraint, the Service generally does not request tax accrual workpapers absent a listed transaction or unusual circumstances.<sup>29</sup> However, the policy of restraint does not apply if the taxpayer has engaged in any activity or taken any action, other than providing materials to an independent auditor as part of an audit of the taxpayer's financial statements, that would waive the attorney-client privilege, the tax advice privilege in Section 7525 of the Internal Revenue Code or the work product doctrine.<sup>30</sup> In the context of mergers, acquisitions and spin-offs, corporations might share information with respect to their tax positions. For example,

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<sup>28</sup> I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432 (Oct. 12, 2010).

<sup>29</sup> I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72 (June 17, 2002).

<sup>30</sup> I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432 (Oct. 12, 2010). The Service appears to believe that reporting on the Schedule does not itself waive privileges. In the Preamble to the recently promulgated Treasury Regulation § 1.6012-2(a)(4) and (5) requiring reporting under the Schedule, the Service stated that the regulation "does not affect the existence of any applicable privileges taxpayers may have concerning information requested by a return or how they may assert those privileges." T.D. 9510, Requirement of a Statement Disclosing Uncertain Tax Positions, 75 Fed. Reg. 78,160 (Dec. 15, 2010).

a seller might be involved in analyzing whether an acquiror should record a reserve for a pre-closing tax position for which no reserve was previously recorded. Under a typical indemnity, the seller would have the economic stake in whether the position is sustained. We believe that the Service should not depart from its policy of restraint on the basis of interactions between seller and acquiror relating to pre-closing period tax positions (even if the tax position is not eventually reported on the Schedule). Were the Service to find information-sharing in this context to be a rationale for lifting the policy of restraint with respect to Schedule-related documents (as well as other tax accrual workpapers), compliance with disclosure obligations under the Schedule (and financial reporting obligations) would be exceedingly difficult. We believe that the same policy that motivated the Service to announce that Schedule-related documents be subject to the policy of restraint when shared with independent auditors applies when the information is shared with another party to a transaction. We therefore recommend that the Service confirm that such information-sharing will not alter the application of the Service's announced policy of restraint.