Volume 2010 - August 6

IRS Implements New Corporate "Audit Me" Disclosure Requirement

In February, the IRS announced its intent to require certain corporate taxpayers to report “uncertain tax positions” (“UTP”) as part of their income tax returns beginning with the 2010 tax year.[1] In April, the IRS released for public comment its draft of Schedule UTP and the related instructions for completing the form.[2] The comment period ended on June 1, 2010, and the final form and instructions could be issued at any time.

Key Points

When will the new rules apply?
Generally, reporting will be required beginning with the 2010 tax year.[3]

What corporate taxpayers are covered?
A taxpayer must report a UTP if it meets all of the following tests:[4]

- Type of Corporate Filer. UTPs must be reported by (i) any corporation that files using Form 1120, (ii) insurance companies that file using Form 1120L or Form 1120 PC, or (iii) foreign corporations that file using Form 1120F;
- Size. Any corporation with assets equal to or greater than $10 million; and
- Audited Financial Statements. A corporation or a related party

Butler Snow has been a leading presence in the legal community since 1954. With more than 165 attorneys, the firm provides a broad range of services to clients on a regional and national basis from its offices in Jackson and Gulfport, Mississippi; Memphis, Tennessee; New Orleans, Louisiana and Bethlehem, Pennsylvania.

that issues an audited financial statement that covers all or a portion of the corporation's operations for all or a portion of the corporation's tax year.

What tax positions are required to be disclosed?

A reportable UTP is any tax position taken by the corporation taxpayer (or a related party) (i) for which a tax reserve was recorded in an audited financial statement (at least 60-days prior to the date the tax return is filed) or (ii) for which no reserve was established based on either an expectation of litigation or an IRS administrative practice not to challenge the position. The UTP may relate to the current tax year or to a previous tax year.[5]

What must be reported on Schedule UTP for each uncertain tax position?

- The relevant Internal Revenue Code section(s)
- The maximum tax adjustment (excluding penalties and interest) if the UTP were to be disallowed upon audit, including all resulting changes to items of income, gain, loss, deduction, or credit or if the UTP arises out of a valuation or transfer pricing issue, then (separately as to valuation and transfer pricing issues), a ranking of each such UTP by the amount of the potential adjustment
- Whether the UTP was reported because it was determined that the IRS would not challenge it based on an IRS administrative practice
- Whether the UTP reflects a temporary/timing difference or a permanent difference
- If the UTP relates to a position taken by a pass-through entity, the taxpayer ID number of that entity
- The tax year of the UTP
- A concise description of the tax position

A copy of the draft Form UTP and the related instructions can be found at:
http://www.irs.gov/pub/irs-drop/schedule-utp.pdf
http://www.irs.gov/pub/irs-drop/instructions-for-schedule-utp.pdf

Except as otherwise noted above, the initial requirement is directed at corporate taxpayers (excluding S corporation filers), but the IRS has not ruled out extending the reporting obligations to S corporations, partnerships, limited liability companies and other flow-through taxpayers in future years.

How did we get here?

The new reporting regime for uncertain tax positions comes on the heels of more stringent financial statement disclosure requirements first adopted for financial accounting purposes in 2006 by the Financial Accounting Standard Board (FASB), the body that promulgates generally accepted accounting principles in the United States. Those requirements, embodied in FASB Interpretation No. 48 ("FIN 48"), have been in effect for public companies since 2007 and are now in effect for privately-held companies. FIN 48 was adopted in response to concerns about "earnings management," and one of its goals was to limit the potential for misuse of tax-related reserves as a "cookie jar" to smooth out corporate earnings.

When FIN 48 was first adopted, several commentators expressed concern that compliance with its requirements would serve as an "audit me" sign for public companies and produce a wave of targeted tax examinations. Indeed, one senior IRS official was quoted in 2007 as confirming that the IRS "would not turn a blind eye" to the more robust tax reserve disclosures required under FIN 48.[6] However, FIN 48 (a financial accounting rule) was not designed to promote tax compliance and it has yet to affect income tax examinations to the degree feared.

Prior to FIN 48, financial statement disclosure of uncertain tax positions was not required if the potential loss (from an aggressive tax position) was not "probable" or the amount of the loss could not be reasonably estimated. Either circumstance would allow companies to reflect the full benefit of an aggressive tax position without any offset for the associated risk.

By contrast, FIN 48 inverted that framework, requiring a company (and its auditors) to conclude that the aggressive tax position was more likely than not to be sustained in order to claim the benefit in its financial statements. It also requires greater disclosure of the nature of the uncertain position(s) and the potential effect of an adverse determination. The IRS's new proposal takes FIN 48 a step further, since its requirements (unlike those of FIN 48) are expressly intended to give the IRS a tax examination roadmap.

In its February announcement, the IRS specifically referenced FIN 48 disclosures in explaining that " [the additional] information [it will require] would aid the Service in focusing its examination resources on returns that contain specific uncertain tax positions that are of particular interest or of sufficient magnitude to warrant Service inquiry."[7] The new requirements would expand a taxpayer's obligation to self-report sensitive income tax matters on its tax return beyond existing requirements related to tax shelters and listed transactions.

Public Comments

The IRS's draft Schedule UTP attracted a large number of comments. Several specific provisions were the subject of sharp criticism, including:

- The disclosure requirement for UTPs which are expected to be litigated with the IRS are viewed as contrary to the IRS's stated policy of restraint regarding disclosure of potentially privileged information.

- The disclosure requirement for UTPs for which the IRS had an announced (no examination) policy is contrary to the IRS's stated tax return examination efficiency rationale. The IRS adopted those administrative policies based on its experience that those particular tax positions were rarely material or not efficient to pursue.

- The maximum tax assessment calculation was criticized as excessively burdensome and misleading because the amount disclosed may bear little relation to the true potential adjustment.

- The $10 million size threshold was criticized as too low which would result in disproportionate effect on smaller businesses.

It remains to be seen if these or any other comments will result in any changes to the final requirements but it is clear that some aspects of the new regime has fostered serious opposition. Indeed, the American Institute of Certified Public Accountants (AICPA) asserted that the proposal conflates tax reporting with financial reporting in such a manner as to raise the risk of unduly influencing management decisions regarding when a reserve should be established.[8] The AICPA also raised concerns regarding whether the reporting requirements impose a higher reporting standard than that mandated by Congress.[9]

How Do I Respond?

Public companies have had several years of experience with FIN 48 and with navigating the more challenging financial accounting and compliance environment resulting from enactment of the Sarbanes-Oxley Act of 2002. By contrast, privately-held corporations are often less concerned with financial reporting under GAAP than with managing their tax liabilities. And since their financial statements are not publicly available (even to the IRS), the proposed rule would likely have a much greater impact on private corporations which have less experience in considering how FIN 48 could affect their income tax audit risk. A key first step for private companies is to evaluate their income tax risks now, before the new tax reporting requirements are in place.

Robust tax planning is not only legal but appropriate, and directors and executive managers should continue to be prudent stewards of their corporation's assets. At the same time, they must be more involved in evaluating the risks associated with maintaining an aggressive tax posture. As a result, private corporations should consider ways (including, where appropriate, better internal controls) to ensure that decisions regarding which tax risks to take (and which to avoid) are made at an appropriate level within the corporation.

Directors and executive managers should also consider more extensive vetting of UTPs to build a better case for their positions before they file and report them. And as a complement to existing tax planning and compliance efforts, corporations should consider the use of professionals whose work is protected by a professional privilege, including special tax counsel. While the IRS has indicated that it will maintain its policy of restraint in requesting an independent auditor's tax accrual work papers during the course of an IRS examination, a recent court decision indicates that it can and will seek that information in certain circumstances.[10]

Conclusion

In announcing the proposed rule, IRS Commissioner Doug Shulman complained that IRS examinations of corporate returns are inefficient because agents spend too much time going through documents in an attempt to uncover poorly defended tax positions.[11]   In its proposal, the IRS unabashedly demands that corporate taxpayers' disclose information that will assist the IRS in more quickly targeting risky income tax positions.

The IRS has indicated that it intends to finalize the proposed disclosure requirements "as quickly as possible.[12]" The IRS is also evaluating options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure of the required information.

Corporations that will fall under the new rules need to take immediate steps to better understand their income tax audit risk profile. This is especially true for private corporations which may not be as accustomed to the issues presented by FIN 48. Regardless of whether the new disclosure requirements are in any way relaxed in response to the public comments, it is clear that the IRS expects its new regime to directly affect covered corporations' appetite for UTPs and significantly improve the efficiency and effectiveness of its corporate income tax examinations.

____

[1]Internal Revenue Service Announcement 2010-9 (IRB 2010-7).

[2]Internal Revenue Service Announcement 2010-30 (IRB 2010-19).

[3]Draft Instructions for Schedule UTP at 2, available at http://www.irs.gov/pub/irs-drop/instructions-for-schedule-utp.pdf. Although not required for 2010, UTPs not reported in a prior year will be required on Part II of Schedule UTP. Id. at 8.

[4]4Id. at 2.

[5]Id.

[6]Marie Leone, FIN 48: Standing Naked Before the IRS, CFO.com, May 22, 2007.

[7]Internal Revenue Service Announcement 2010-9 (IRB 2010-7).

[8]American Institute of Certified Public Accountants Comments on Announcements 2010-9, 2010-17, and 2010-30 with Regard to Uncertain Tax Positions (June 1, 2010), at 3, available by clicking here.

[9]Id at 6.

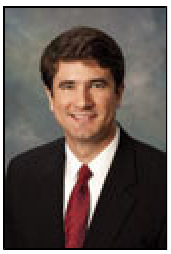
[10]See U.S. v. Textron Inc., 577 F.3d 21 (1st Cir. 2009) (attorney work product doctrine does not shield tax accrual work papers from IRS).

[11]Douglas Shulman, Commissioner, Internal Revenue Service, Prepared Remarks to New York State Bar Association Taxation Section Annual Meeting in New York City (Jan. 26, 2010).

[12]Internal Revenue Service Announcement 2010-9 (IRB 2010-7).

Contact Us

• Sai Ireland is a member of the firm's Business Services Group. His practice focuses on mergers and acquisitions, business planning and operations, exempt securities and antitrust law. Sai can be contacted via e-mail at sai.ireland@butlersnow.com. He is licensed to practice in Mississippi.



• Kap Primos is a member of the firm's Business Services Group. His practice focuses on mergers and acquisitions and Corporate/LLC. Kap can be contacted via e-mail at kap.primos@butlersnow.com. He is licensed to practice in Mississippi.

• Paul Varner is a member of the firm's Tax Group. His practice includes state and local taxation, tax planning and tax dispute resolution. Paul can be contacted via e-mail at paul.varner@butlersnow.com.   He is licensed to practice in Mississippi.