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REPORTING OF UNCERTAIN TAX POSITIONS

by

Martin H. Zem*

I. INTRODUCTION

According to a December 2010 article in the Wall Street Journal, the United States (U.S.) has one of the highest corporate tax rates in the world. The article surmised that President Obama in his January 2011 State of the Union address would propose major corporate tax reform to reduce corporate tax rates, make the U.S. more competitive, induce companies to invest in the U.S. and reduce complexity. The loss of revenue would be offset by eliminating certain deductions, credits and “loopholes.” Many of these tax breaks benefit “targeted” industries that might conclude they are more valuable than a broad rate reduction. Although the top corporate tax rate is 35%, many companies pay far less using investment incentives and other tax reduction provisions. The stated goal of the Administration is to both reduce corporate tax rates and eliminate or cut back on the tax breaks so that the tax reform legislation will be revenue neutral. Also, less complexity should reduce the high cost of compliance, which is a common and perhaps increasing corporate grievance. The momentum for corporate tax reform may have been propelled by the Obama Administration’s recent focus on repairing relations with the business community after losing control of the House of Representatives. The President did in fact mention corporate tax reform, though briefly, in his State of the Union address.

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A device a corporation might use to reduce its effective tax rate is to invest in a highly complicated and aggressive transaction commonly referred to as a "tax shelter." Shelters are designed to generate tax losses as an offset to taxable income, yet result in no or relatively little economic loss. The government has attacked the use of shelters asserting they have no business purpose apart from tax reduction. Pressured to reduce their tax expense, many corporations have entered into questionable shelter transactions hoping to avoid Internal Revenue Service (IRS) scrutiny or to win in the event of litigation. In this context, the IRS has pressed for more transparency by corporations on how they calculate their book provision for taxes. A highly contentious issue is whether the IRS has the right to scrutinize tax accrual work papers. Work papers generally show the corporation’s tax reserve amount and assessment of risk on owing more taxes relative to certain transactions, particularly what would be owed if the tax benefits of a shelter investment or other tax position are not upheld. With access to a corporation’s work papers, the IRS would have a clear-cut path to discovering transactions that a corporation itself has determined may result in a tax assessment. Tax accrual work papers are generally shown to a corporation’s outside auditors who have to sign off on the adequacy of the tax reserve for the corporation to get a "clean" opinion. Financial statements of publicly traded companies must be certified by an independent auditor. The position of the IRS is that if the independent auditors have access to the work papers, the IRS also has the right to scrutinize them.

Whether the IRS has the right to review a corporation’s tax accrual work papers has been the subject of recent litigation. The issue is whether work papers are protected by the attorney work product privilege derived from the 1947 U.S. Supreme Court decision in Hickman v. Taylor and since codified. On August 13, 2009, the First Circuit in a 3 to 2 en banc decision held in United States of America v. Textron, Inc. and Subsidiaries that the IRS was entitled to see the corporation’s work papers. A 1982 decision of the Fifth Circuit, United States v. El Paso Co., also favored the government. However, in June of 2010, the D.C. Circuit in U.S. v. Deloitte LLP upheld attorney work product protection, criticizing the decision in Textron.

IRS Commissioner Doug Shulman addressed the controversy over tax accrual work papers in a January 2010 speech stating that the IRS will exercise "restraint" in requesting work papers. He also noted, however, that some corporations starting in 2010 will have to report "uncertain tax positions" at the time they file their tax return. To this end, he announced that the IRS is developing new Schedule UTP to be attached to the corporate return, Form 1120. In a subsequent speech in September of 2010, the Commissioner noted that in April of 2010 the IRS released a draft of the new Schedule UTP with accompanying instructions asking for public comments. He then announced that the IRS will be releasing the final Schedule UTP and its instructions effective for 2010 tax years. Since then, the final schedule and instructions have been released. Also promulgated was an amendment to treasury regulations requiring certain corporations to attach Schedule UTP to their corporate tax return (Form 1120) in accordance with forms, instructions, or other appropriate guidance provided by the IRS. This requirement is effective for tax years beginning on or after January 1, 2010.

II. PREPARED REMARKS OF IRS COMMISSIONER SHULMAN

In his September 2010 speech, the Commissioner made numerous observations concerning Schedule UTP and its instructions. He referred to ".... the basic assumption that a
taxpayer will be forthcoming in dealing with the IRS with respect to items it has reported on its tax return, including the underlying positions related to those items. Based upon comments received with respect to the draft Schedule UTP and instructions, the Commissioner observed that substantial modifications were made to the IRS policy of "restraint."

Initially, the IRS proposed that all corporations with assets over $10 million and who issue audited financial statements would have to file Schedule UTP. Due to concerns about the impact on smaller businesses, this was changed to those corporations with $100 million in assets beginning with the 2010 tax year. Subsequently, however, there will be a phase-in of the filing requirement: $50 million in assets beginning two years later and then $10 million in assets two years after that.

Many comments were received by the IRS concerning the requirement that Schedule UTP filers include a calculation of the Maximum Tax Adjustment (MTA) with respect to each tax position included on the Schedule UTP. Two basic concerns were that: (1) it would be burdensome on taxpayers since this calculation is not currently being done, and (2) the MTA in many cases would be significantly greater than any potential adjustment with respect to an issue. The MTA requirement was dropped. In lieu of it, however, filers will have to rank their UTPs from highest to lowest based upon the size of the position. Taxpayers will have to use their tax reserve amount to rank the position, but will not be required to provide specific reserve amounts.

Another topic the Commissioner touched upon concerned the requirement that a taxpayer identify positions for which it did not reserve, expecting to litigate the issue or because of an IRS administrative practice. Related to this were comments received by the IRS asking for clarification on the reporting of immaterial or unambiguous tax positions. The requirement to identify positions for which no reserve was established because of an IRS administrative practice was eliminated due to concerns about administering this requirement. The "expect to litigate" disclosure was retained although the instructions were clarified to respond to concerns that this requirement might be read more broadly than intended and result in disclosure of highly certain or immaterial positions.

The next major category of comments concerned how the new disclosure rules would impact the long-standing IRS policy of "restraint" concerning access to tax accrual work papers. There were concerns that disclosure of tax positions on Form UTP could raise questions of privilege concerning confidential communications related to the disclosed tax positions. This concern arose because the draft instructions to Schedule UTP required that a rationale for the position be supplied along with a description of the nature of the uncertainty. The final instructions eliminate these requirements. Taxpayers will only have to identify the issue and relevant facts by way of a "concise statement," which will not have to include an assessment of the tax position or an analysis of the support for or against the position.

The Commissioner clarified the IRS policy of "restraint" making three points in this regard: (1) Disclosing issues on Schedule UTP would not affect the IRS policy of restraint on seeking tax accrual work papers; (2) Drafts of issue descriptions and information regarding ranking of issues are protected; and (3) the IRS will not seek documents that would otherwise be privileged even though shown to the taxpayer's auditor.
The Commissioner further responded to concerns about how IRS agents would use the Schedule UTP information during audits. He announced that the IRS is releasing a field directive to its agents that will advise agents to eliminate uncertainty as soon as possible in order to foster efficiency. Agents are to receive special training on handling uncertain tax positions. A centralized process will be established to review UTPs to determine their proper treatment in light of ambiguity in the tax law and a lack of published IRS guidance.20

Some concerns were also raised about disclosing UTPs to foreign governments as may be required by tax treaties or information exchange agreements. The Commissioner observed that this would be very rare and apply only if there were reciprocity requiring the foreign government to report similar information to the IRS. Even then, other factors would be considered, such as relevance to the foreign government, in determining whether to make the disclosure.21

III. SCHEDULE UTP INSTRUCTIONS

The final Schedule UTP instructions elaborate on the Prepared Remarks of the Commissioner and provide further guidance to affected taxpayers.22 Some of the more salient provisions are as follows:

A. Applicability

Corporations are required to file Schedule UTP when they take a tax position affecting their tax liability, issue audited financial statements and have assets exceeding $100 million. As mentioned, the $100 million benchmark will eventually be reduced to $10 million. More specifically, filing of Schedule UTP is required if (1) the corporation has taken a tax position for the current or a prior tax year, and (2) either the corporation or a related party has recorded a reserve for that tax position in audited financial statements of the corporation or a related party, or the corporation or a related party did not record a reserve anticipating litigating the position.

A tax position for which a reserve was recorded, or none recorded because of an expectation to litigate, must be reported regardless of whether the financial statements are prepared using U.S. generally accepted accounting principles (GAAP), international financial reporting standards (IFRS), or other country-specific accounting standards.

A tax position is based on the “unit of account” used to prepare the financial statements and which would result in an adjustment to a “line item” on the tax return if the position is not sustained. If multiple tax positions affect a line item, each position must be reported separately. No reporting is required if the position is immaterial for purposes of the audited financial statements or the tax position was so certain that no reserve was required. Although Schedule UTP must be filed for current and prior tax years, no reporting is required for tax years beginning before January 1, 2010, even if a reserve is recorded for audited financial statements issued in 2010 or later. It is not necessary to report an uncertain tax position taken in a prior year if it has been reported with the prior year’s tax return.

B. Unit of Account

The term “unit of account” refers to the level of detail used in analyzing a tax position considering the level supporting the tax return and the level at which the taxpayer expects to address the issue with the IRS. There must be consistency between the unit of account used pursuant to a generally accepted accounting principle and the unit of account used for
reporting a tax position on Schedule UTP. An example is given in the instructions concerning two corporations, A and B, each having research projects for which each will claim a research and development credit for increasing research activities. Corporation A chooses each research project as a unit of account for GAAP reporting purposes since it accumulates information for its tax return at the project level and expects to deal with the IRS on each project separately. Corporation B determines that its unit of account for GAAP is functional expenditures, based on the amount of expenditures, credits to be claimed, previous experience and the advice of its tax advisors. The example concludes that for purposes of the research and development credit, Corporation A must use each project as its unit of account for purposes of reporting on Schedule UTP whereas Corporation B must use functional expenditures for reporting purposes. Further guidance clarifying what is meant by a unit of account seems warranted. The research and development credit for increasing research activities, due to expire December 31, 2009, was recently reinstated for two years through December 31, 2011.\textsuperscript{23}

C. Multiple Year Positions

If a tax position could affect a line item on multiple year tax returns and a tax reserve is established for each affected year, the tax position must be reported with each return even though disclosed with a prior year’s return. For example, a corporation incurs an expenditure it deducts in full in 2010 that it determines possibly should have been amortized over five years including 2010. A tax reserve is recorded in its audited financial statements for 2010 apropos to the tax position, but no reserve is recorded for 2011-2014. According to the instructions, the taxpayer has taken a tax position in each of the five years since there might be an adjustment to a line item on the return for each year. A Schedule UTP, however, need be filed only for 2010 and not for each of the years 2011-2014 since the corporation did not record a reserve for the tax position in those years. Assume, however, that a corporation incurs an expense in 2010 that it believes may be amortized over five taxable years. In reviewing this tax position for purposes of recording a tax reserve for its audited financial statements, it determines that it is uncertain whether any deduction or amortization is allowable. Accordingly, the corporation records a tax reserve in 2010 covering all five taxable years. The corporation must file a Schedule UTP with each of the tax returns for the five taxable years. The result would be the same if, instead of recording the entire reserve for the five taxable years in its financial statements for 2010, the corporation records an applicable reserve in its financial statements for each of the five taxable years. However, if a corporation records a reserve in its audited financial statements for a year relative to a tax position taken and files Schedule UTP, it need not file another Schedule UTP in a later year if the reserve is increased.

If a corporation is uncertain as to which of two years it is to report income, say 2010 or 2011, and has an expiring net operating loss carryover, it has taken a position in each year because in each year there would be an adjustment to a line item if the position is not sustained.

D. Related Party

The instructions refer to several Internal Revenue Code sections dealing with attribution rules to determine who is a “related party.”\textsuperscript{24} An example refers to U.S Corporation A filing Form 1120 and foreign Corporation B that does no business in the U.S. and does not file a U.S. return. The two corporations are related but issue separate audited financial statements. Corporation A takes a tax position on its tax return
and Corporation B records a tax reserve relative to that position in its audited financial statements. The example concludes that even though Corporation A does not record a reserve for the tax position, it must report the tax position on its Schedule UTP. Also included as a related party is any corporation included in consolidated audited financial statements in which the corporation is also included. An example refers to Corporations C and D that issue consolidated audited financial statements but do not file a consolidated income tax return. Corporation C takes a tax position for which a reserve is recorded in the consolidated financial statements of the two corporations. The example concludes that Corporation C must file a Schedule UTP because a reserve was included in consolidated financial statements in which it was included.

E. Ranking Tax Positions by Size

Although tax positions must be ranked by size on Schedule UTP, the specific dollar amount of the position need not be disclosed. The size of a position is determined annually and is the amount of the tax reserve established for the position in the corporation’s financial statements. If a single reserve is recorded for multiple positions, a reasonable allocation of the reserve among the positions must be made for purposes of their ranking. An expectation to litigate position is not to be considered in determining the size of a position. There is a separate column on Schedule UTP that must be checked if the tax position is a “major tax position,” which is a relative size equal or greater than 10%. Relative size is determined by dividing the size of a position by the total of the sizes of all positions. Ranking on Schedule UTP is to be done by assigning the number 1 to the largest position, the number 2 to the next largest position, and so on. Ranking is not to be done by the type of position. Expectation to litigate positions, however, may be assigned any ranking number, apparently due to the uncertainty of litigation.

There is also a requirement to “code” the ranked positions. The letter “T” is to be used for transfer pricing positions and the letter “G” for all other positions. Singling out transfer pricing positions for separate coding is consistent with increased IRS focus on this contentious area. An example of coding is given of a corporation with three reportable tax positions: transfer pricing, which is the largest position, a second smaller one and a third expectation to litigate position. The transfer pricing position is coded and ranked T1. The expectation to litigate position is coded G2 and the smaller position is coded G3. Since an expectation to litigate position can be assigned any ranking, it could have been assigned G3 with G3 moving up to G2. In the draft instructions, an expectation to litigate position had to be reported and ranked by size. Although the IRS dropped ranking such positions by size due to adverse comments made by interested parties, it nevertheless retained the requirement to report the position.

F. Concise Statement

The instructions are in accord with the remarks of the Commissioner that the concise statement does not have to include an assessment of the tax position or an analysis of the support for or against the position. The instructions provide limited guidance stating that there must be a “description of the relevant facts .... and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue. In most cases, the description should not exceed a few sentences.” The concise statement does not have to “include an assessment of the hazards of a tax position or an analysis of the support for or against the tax position.” The instructions set forth three examples, which
perhaps intentionally have few sentences. Two of the examples state the facts with four sentences and one with five sentences. Two of the concise descriptions have three sentences and one with two sentences. Since the examples deal with disparate situations, they are of limited value except perhaps to make it clear that a prolix reporting of the tax position is not required.

IV. CONCLUSION

One can argue that the alleged IRS policy of restraint on seeking tax accrual work papers is merely a public relations effort to demonstrate that the IRS is not unreasonable. Despite its professed restraint, however, the IRS clearly wants more transparency from corporations. Essentially, the information the IRS seeks from corporations should be obtainable through the requirement to file Schedule UTP, which obviously will guide it in identifying and examining questionable tax positions. One of the goals of the IRS noted by Commissioner Shulman is for it to become more efficient. To this end, corporations filing Schedule UTP will surely be audited with more precision, and consequently with less time and effort by IRS agents. What better way to foster more efficiency than to enlist corporations and their advisors to describe to the IRS what they themselves perceive to be problematic tax positions. Law and accounting firms will surely be enlisted as advisors regarding the filing of Schedule UTP, with the attendant expense. It has even been suggested that tax advisors should think of the government as their new boss.27 It will, of course, be interesting to see how all this plays out in practice.

Apart from Schedule UTP, there is continuing momentum to overhaul corporate tax rules generally, provided revenue is not impacted significantly and worsen the already grim federal budget.28

7 577 F.3d 21 (1st Cir. 2009), 2009 U.S. LEXIS 18103, cert. denied, 2010 U.S. LEXIS 4373 (May 24, 2010).
10 IR-2010-13, Announcement 2010-9. The Announcement was part of Prepared Remarks of IRS Commissioner Doug Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City on January 26, 2010.
11 IR-2010-98, Announcements 2010-75 and 76. The Announcements were part of Prepared Remarks of IRS Commissioner Doug Shulman to the American Bar Association in Toronto on September 24, 2010.
12 T.D. 9510 (Dec. 13, 2010), adding C.F.R. § 1.6012-2(a)(4)and (5).
13 Supra 10.
14 Id.
15 Id.
INTERNATIONAL FINANCIAL REGULATION: TOWARD A RULE OF LAW

by

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INTRODUCTION

Since the 1947 General Agreement on Tariffs and Trade (GATT), many nations have subscribed to multi-national treaties, agreements, and conventions seeking to govern the regulation of international trade in goods and services. National and International tribunals have settled or made recommendations concerning individual and national disputes submitted to their jurisdictions. For example, the 1988 United Nations Convention on Contracts for the International Sale of Goods (CISG) has been applied to enforce contracts and grant remedies for breach of an agreement. In 1994, 138 nations incorporated GATT and the General Agreement on Trade in Services (GATS) into the World Trade Organization (WTO) agreement. The Agreement recommends remedies to ensure free trade in Goods and Services. Annexes to the agreement seek freedom of trade in other areas, including finance. In particular, the WTO, by its financial services annex, seeks to open the banking, securities and insurance industries to competition from foreign companies. While intending to open

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