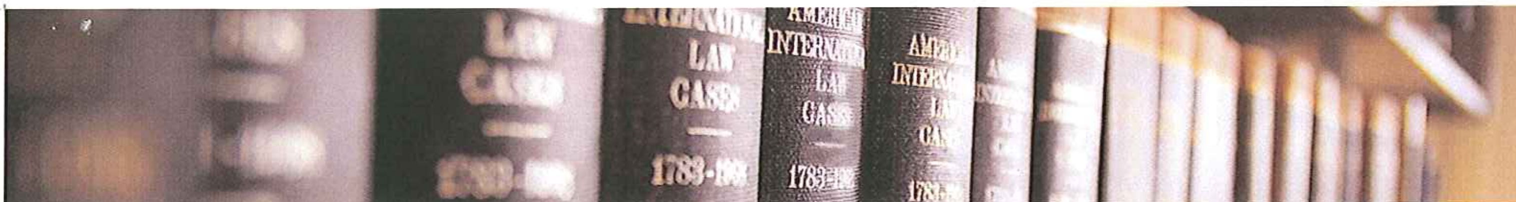

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IRS proposes new "Audit Me" disclosure requirement

By J. Paul Varner, Selby A. Ireland and Kenneth A. (Kap) Primos III

In January, the IRS announced its intent to require business taxpayers to report "uncertain tax positions" as a part of their income tax returns beginning with the 2010 tax year. When finalized, this new requirement would fall on businesses with more than $10 million in total assets. The initial requirement is limited to corporate taxpayers but could be extended to include partnerships, limited liability companies and other flow-through taxpayers.

While still in the comment stage, this proposal is not a trial balloon. It comes on the heels of more stringent financial statement disclosure requirements for uncertain tax positions 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.

In its 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." The new requirement 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.

Background

When FIN 48 was adopted, many feared 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 tax reserve disclosures required under FIN 48.

FIN 48, however, is a financial accounting rule, not an IRS tax compliance rule. It was adopted in response to continuing concerns about "earnings management," and one of its goals was to limit the potential misuse of tax-related reserves as a "cookie jar" to smooth out corporate earnings.

What Did FIN 48 Require?

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 allowed 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 positions 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.

The Proposed Rules

IRS Announcement 2010-9 details the preliminary proposal to require certain business taxpayers to identify and report uncertain tax positions on a schedule attached to their annual income tax return. Although the rule is not yet final, the specific categories of uncertain income tax positions would include any position for which a reserve has been established for financial reporting purposes.

The required schedule must include a concise description of each uncertain tax position and the maximum amount of potential federal tax liability associated with such position if it were disallowed. The description must also include other information relevant to IRS examiners, including (i) the applicable code section, (ii) the tax years implicated, and (ii) whether the item in question is an item of income, gain, loss, deduction or credit, among other requirements.

How Do I Respond?

Public companies have had several years of experience with FIN 48 and operating in the more challenging financial accounting and compliance environment resulting from enactment of the Sarbanes-Oxley Act of 2002. By contrast, privately-held companies 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 could have a much greater impact on private companies 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 those 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 company'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 companies 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 company.

Directors and executive managers should also consider more extensive vetting of uncertain tax positions to build a better case for their positions. And as a complement to existing tax planning and compliance efforts, companies should consider the use of professionals whose work is less likely to be targeted for disclosure by the IRS, including special tax counsel or tax consultants independent of their audit firm. While the IRS has indicated that it will maintain its policy of restraint in requesting 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.

Finally, non-corporate "business taxpayers" who do not yet fall within the purview of the initial proposal (including partnerships, limited liability companies and other flow-through entities) should consider how this proposal could affect them, if it were to be extended beyond just corporate filers. The new reporting regime may never be extended beyond the initial proposal but it may be prudent to consider its implications just in case.

Conclusion

In announcing the proposed rule, IRS Commissioner Doug Shulman complained that IRS audits of corporate returns are inefficient because agents spend too much time going through documents in an attempt to uncover poorly defended tax positions. In its proposal, the IRS unabashedly demands the taxpayers' help so that it may more quickly target risky income tax positions.

The IRS has indicated that it intends to finalize the proposed disclosure schedule "as quickly as possible." 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.

Companies that will fall under the new rules need to take immediate steps to better understand their risk profile. This is especially true for private companies which may not be as accustomed to the issues presented by FIN 48. It is far too early to tell how the new disclosure requirements, when final, will affect companies' appetite for uncertain tax positions but it is not too early to know what the IRS hopes will soon result – quicker, more effective income tax examinations and more tax revenue. ■

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