

State Tax Issues Resulting From IRS Announcement 2010-9

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The new IRS policy that requires taxpayers to disclose uncertain tax positions (UTPs) is getting some well-deserved attention.¹ On April 19 the IRS issued a draft form Uncertain Tax Position Statement (Schedule UTP) for comment by June 1.² Some tax professionals question the necessity or fundamental fairness of requiring taxpayers to report UTPs, while others question the specifics of the proposed reporting requirement, such as the materiality threshold, the requirement to provide a brief statement of the UTP, and the quantification of the UTP.

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In this installment of A Pinch of SALT, we explore some state and local tax issues resulting from the new IRS policy. Because state and local tax presents unique financial statement challenges, there are a number of questions to consider in anticipating how the proposed disclosure will affect state taxation. Those questions include:

- What information must be reported on Schedule UTP?
- How will a state obtain Schedule UTP?
- How much of Schedule UTP is a state entitled to?
- What will states do with Schedule UTP?
- How might a taxpayer use Schedule UTP to its advantage?
- What if a state required a state-tax-specific Schedule UTP?

We evaluate those questions with a particular focus on taxpayer concerns that confidential information may be disclosed to states that may not have the authority or need to obtain that information.

What Information Must Be Reported on Schedule UTP?

Based on the IRS guidance and the draft Schedule UTP, a taxpayer must provide the required disclosure if the taxpayer either prepares financial statements for or is included in the financial statements of a related entity and has assets that exceed \$10 million.³ An affiliated group of corporations filing a federal consolidated return will file one Schedule UTP for the affiliated group.⁴ Although a single Schedule UTP for a federal affiliated group may present its own set of challenges,⁵ it will create significant additional concerns at the state and local level, where taxpayers often file as part of a different group of related entities.

³*Supra* note 1. Related entity is defined by reference to IRC sections 267(b), 318(a), and 707(b) and includes “any entity that is included in a consolidated audited financial statement in which the corporation is also included.”

⁴Instructions for Schedule UTP (Draft, Apr. 19, 2010).

⁵The federal tax concerns associated with Schedule UTP are beyond the scope of this article, *but see* Lee Sheppard and Amy Elliott, “Officials Try to Assuage Fears About UTP Reporting Proposal,” *Tax Notes*, Apr. 26, 2010, p. 364, *Doc 2010-8966*, or *2010 TNT 78-1*; Jeremiah Coder, “IRS Releases Draft Schedule for Uncertain Tax Positions,” *Tax Notes*, Apr. 26, 2010, p. 363, *Doc 2010-8700*, or *2010 TNT 75-1* for a discussion of some of those issues.

¹IRS Announcement 2010-9 (Feb. 16, 2010).

²The IRS released a draft of Uncertain Tax Position Statement and the accompanying instructions for public comment to be submitted by June 1, 2010. IRS Announcement 2010-30 (Apr. 19, 2010).

The Schedule UTP will require taxpayers to disclose information regarding UTPs “that affect their United States federal income tax liability.”⁶ A tax position is defined in the draft Instructions to Schedule UTP as that which “would result in an adjustment to a line item on that tax return if the position is not sustained.”⁷ The IRS has defined UTPs in connection with the tax accounting requirements of FASB Interpretation No. 48.⁸ The IRS is requiring taxpayers to disclose, in part, tax positions for which it has recorded a reserve for financial accounting purposes. Such “uncertainty” is now measured by the FIN 48 more-likely-than-not threshold of the likelihood of success on the tax technical merits.⁹ Further, the IRS is going beyond FIN 48 reserve items by requiring taxpayers to report any instances when a taxpayer believes that it will successfully litigate an issue, or the taxpayer has identified an administrative practice or procedure that supports the management judgment that it is not necessary to record a reserve.

Therefore, the IRS is capturing much more than just the taxpayer’s UTPs. The breadth of these reporting requirements will create fascinating, if not unadministrable, rules as applied to state taxation.

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The IRS has indicated that it will not require taxpayers to report uncertain *state* tax positions on Schedule UTP. Although taxpayers receive a deduction for state and local taxes paid when computing federal taxable income, and therefore, any uncertainty regarding a state tax position may have a direct effect on a line item on the federal return,¹⁰ the IRS apparently determined that its resources are best spent examining issues about which its auditors are knowledgeable and experienced. The IRS has not issued guidance regarding what consti-

tutes a state tax issue, but it appears that state-only issues such as nexus, apportionment, and other state-tax-specific issues will be excluded from Schedule UTP.

There has been much concern regarding what information will be required to be reported in Schedule UTP. For each UTP, the taxpayer is required to report:

- (i) a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements and (ii) the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer’s risk analysis regarding its likelihood of prevailing on the merits).¹¹

Recent comments from the IRS Chief Counsel William J. Wilkins indicate that the IRS is looking for a brief, detailed description of the UTP. The chief counsel said that a simple factual description would not provide sufficient information for the IRS to determine whether it wants to audit the taxpayer. Although the IRS claims that it is adhering to its “policy of restraint,” the IRS has significantly narrowed its policy.

Regarding the extent of disclosure, concern has been expressed about attorney/client privilege, tax practitioner/client privilege, and the work-product doctrine. The ability to protect privileged or protected information or documentation is becoming increasingly more difficult and uncertain. There exists a very real concern that taxpayers may cause a subject matter waiver¹² of the attorney/client privilege by disclosing too much information in Schedule UTP. By reporting a comprehensive description of the tax position and the uncertainty surrounding that tax position, compliance with Schedule UTP may cause such a waiver.

How Will a State Obtain Schedule UTP?

State tax authorities may take several approaches to obtain the information in Schedule UTP, including requiring taxpayers to file a copy of Schedule UTP with their state tax return, requesting Schedule UTP from the taxpayer during an audit, or acquiring Schedule UTP through information sharing arrangements with the IRS.

First, state tax authorities may assert that they have authority to require taxpayers to include a copy

⁶*Supra* note 1.

⁷Instructions for Schedule UTP (Draft Apr. 19, 2010).

⁸Financial Accounting Standards Board, “FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes” (June 2006).

⁹It is important to remember that the convergence and conversion of U.S. generally accepted accounting principles and the international financial reporting standards may change the standard for accounting for uncertainty in income taxes. Such a change to the present FIN 48 standard may significantly reduce the amount of information that would have to be reported under Schedule UTP.

¹⁰The deduction for state taxes is part of line 17 of Federal Form 1120.

¹¹IRS Announcement 2010-9 (Feb. 16, 2010).

¹²A subject matter waiver of the attorney/client privilege results when the subject matter of the privileged communication is sufficiently disclosed to destroy the expectation of confidentiality.

of their federal tax return (including federal Schedule UTP) as part of their state tax filing requirement. Some state tax departments of revenue may have authority to require taxpayers to include Schedule UTP in their standard filing requirement based on the broad authority provided for the administration of state tax laws. That authority may stem from the IRS's ability to require the filing of Schedule UTP.

State tax authorities may assert that they have authority to require taxpayers to include a copy of their federal tax return (including federal Schedule UTP) as part of their state tax filing requirement.

The IRS has general authority under IRC sections 6001 and 6011 to require taxpayers to report UTPs on Schedule UTP. The IRS also has fairly broad authority to require taxpayers to provide information in pursuit of its authority to administer tax laws. That authority was illustrated several years ago when the IRS required taxpayers to report "reportable transactions" with their income tax filing. Although new legislation was enacted to provide the basis for additional penalties to enforce the reporting requirement, the underlying authority for the reporting requirement was based on the IRS's standard authority.¹³

Second, state tax authorities may request Schedule UTP during a state tax audit. Taxpayers might receive the request for Schedule UTP with a state's initial notification of an intent to audit. Since the inception of FIN 48, some states have become increasingly aggressive in asserting their authority to obtain tax accrual work papers.¹⁴ Schedule UTP is another information resource that state departments of revenue will pursue.

Third, state tax authorities may request Schedule UTP from the IRS. The IRS and many states have put in place information sharing agreements that may allow for the exchange of Schedule UTP. The IRS has authority to disclose "returns" and "return information" to state tax authorities.¹⁵ The IRC defines a "return" and "return information" fairly broadly.¹⁶ States are likely to argue that they are

entitled to request Schedule UTP because the definitions of "return" and "return information" include Schedule UTP.

How Much of Schedule UTP Is a State Entitled to?

Assuming that the states have the authority to request Schedule UTP, what information in Schedule UTP should they be provided? The IRS has yet to provide guidance as to which taxpayers will be forced to file Schedule UTP when the taxpayer (and its consolidated group) is different from the entity(ies) that prepares the associated financial statements.¹⁷ At the state level, the differences between tax return filings and financial statements are magnified. Financial statements may be prepared under a single company name but include several (or several dozen) federal consolidated groups.¹⁸ State filing methods are disparate and range from separate legal entity reporting to combined reporting that include more (or less) legal entities than are included in a federal consolidated return.

The need to protect against unnecessary or irrelevant disclosures should outweigh the states' desire to collect Schedule UTP information.

Under the IRS draft instructions for Schedule UTP, taxpayers will be required to report the UTPs of the affiliated group on an aggregate basis. The draft instructions provide as follows:

An affiliated group of corporations filing a consolidated return will file a Schedule UTP for the affiliated group. The affiliated group

or with respect to any person, and any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed." *Id.* "Return information" means a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, over assessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense." *Id.*

¹⁷New York State Bar Association, Tax Section, Report on Announcement 2010-9 (Mar. 29, 2010).

¹⁸That position is buttressed by the definition of return information under IRC section 6103, which requires the information disclosed to a state to be the taxpayer's information.

¹³See IRC sections 6001; 6011.

¹⁴*Supra* note 8.

¹⁵See IRC section 6103(d).

¹⁶IRC section 6103(b). "Return" means any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for or permitted under, the provisions of this title which is filed with the Secretary by, on behalf of,

(Footnote continued in next column.)

need not identify the member of the group to which the tax position relates or which member recorded the reserve for the tax position. Any affiliate that files separately and satisfies the requirements set forth above must file a Schedule UTP with its return setting forth its own tax positions.

Therefore, an affiliated group of taxpayers that file a federal consolidated group will be required to file Schedule UTP for those legal entities.

Differences between filing groups and financial statement reporting raise issues associated with whether states can be permitted broad access to Schedule UTP, including providing access to a Schedule UTP that includes entities not subject to tax in a given state. The need to protect against unnecessary or irrelevant disclosures should outweigh the states' desire to collect Schedule UTP information. Because there often will be variations between the entities covered by a Schedule UTP and the composition of a state tax return, disclosure should be limited to situations in which there is a compelling need for the Schedule UTP data.

What Will States Do With Schedule UTP?

The IRS has emphasized that Schedule UTP is intended to reduce the time and cost of audits by streamlining the taxpayer and issue selection process and therefore generating more efficient audits.¹⁹ Although Schedule UTP may accomplish those goals for federal tax purposes, it may have exactly the opposite result for state tax purposes.

State corporate income taxes typically calculate state taxable income based on federal taxable income. Generally, state tax authorities refrain from auditing federal tax issues of large corporations because those issues are audited by the IRS. However, some states will audit the determination of federal taxable income (referred to as "above the line" audits) to assess whether adjustments are necessary.

The use of Schedule UTP by state tax authorities may lead to an expansion of the practice of auditing above the line. State auditors may be tempted to examine UTPs identified in Schedule UTP because of the magnitude of the federal issue. If state tax authorities expand the scope of their audit process to review the federal UTPs, the state tax audit process may be overwhelmed.

¹⁹IRS Announcement 2010-9 (Feb. 16, 2010); Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman Before the Tax Executives Institute 60th Midyear Meeting (Apr. 12, 2010); Remarks of William Wilkins, IRS chief counsel, KPMG Tax Governance Institute, Video Webcast: *Disclosing Uncertain Tax Positions to the Internal Revenue Service — A Conversation with the Chief Counsel of the IRS* (Mar. 2, 2010).

Can We Make Lemonade From This Lemon?

There are at least two potential state tax benefits associated with Schedule UTP:

- potential penalty protection resulting from disclosure of UTPs; and
- increased information from UTPs.

Regarding penalties, disclosure of UTPs to the federal government and state tax authorities puts tax authorities on notice that a taxpayer is taking a specific position. That disclosure should insulate a taxpayer from penalties. However, it is worth noting that states have increasingly assessed penalties without regard to whether the item was disclosed or whether there was a showing of negligence.²⁰

Also, taxpayers may benefit from the increased availability of information on controversial tax positions. Although Schedule UTP will constitute confidential taxpayer documentation, the IRS may aggregate taxpayers' UTP information. The IRS may publish that information or make it available via Freedom of Information Act requests. That information could help taxpayers by providing useful information to them. Taxpayers will have a resource from the IRS that will provide support for the position that the IRS has an administrative practice to not challenge specific UTPs. Further, the increased information may provide support for requests for guidance from the IRS on UTPs.

What if a State Required a State-Tax-Specific Schedule UTP?

Unsurprisingly, state taxing authorities already are indicating their desire to access information reported on Schedule UTP. Further, state representatives are indicating their interest in the development (and required compliance with) a state-tax-specific Schedule UTP.

The compliance burdens associated with a state-specific UTP would be significant. Standing alone, identifying and reporting all state-related UTPs to multiple states would add a significant compliance burden to an already lengthy process. The difficulty of that process is compounded by the fact that reserves for UTPs are not always created on a separate entity or combined group basis. Taxpayers would have to identify individual UTPs in the reserves that relate to each separate entity or combined group. States would have to address some issues not covered by the federal Schedule UTP, including whether UTPs that include multiple entities must be reported on both entities' returns.

²⁰*Wal-Mart Stores East, Inc., v. Sec'y of Revenue*, 676 S.E.2d 634 (N.C. Ct. App. 2009) (upholding the North Carolina Department of Revenue's imposition of taxes absent a showing of negligence when taxpayer deducted payments are made to a real estate investment trust).

UTPs associated with nexus are perhaps the most vexing state tax issue. Many states do not have well-articulated nexus rules and instead rely on broad and ambiguous “doing business” statutes. Thus, taxpayers must take their best guess as to whether some remote activities create a sufficient presence in a state. The uncertainty regarding the states’ application of U.S. constitutional standards makes nexus determinations even more challenging.

If states forge ahead with a state-tax-specific Schedule UTP, combined and consolidated reporting states could require taxpayers to reveal nexus positions as a result of positions taken vis-à-vis application of apportionment throwback rules, apportionment throwout rules, *Finnigan* positions, nexus consolidated filings, and other tax return items. Once revealed to one state, a taxpayer’s nexus positions could become widely distributed among the states through information sharing agreements.

Separate entity states could not require information regarding UTPs established for nonnexus positions because those nonnexus entities would not be filing returns in those states. Only in limited cases would a nonfiling corporation’s nexus position affect the separate entity filer. For example, a nonfiling entity’s nexus position in a state with a related-party expense addback provision may affect a related entity’s UTP because of the applicability of an

addback exception for expenses paid to a related party subject to tax in the same state.

Conclusion

Internal Revenue Commissioner Douglas H. Shulman called the IRS’s new policy requiring taxpayers to file Schedule UTP a “game changer” in the federal tax arena.²¹ The state tax impact of the new disclosure requirement is less clear. As we have described, there are significant issues regarding the states use of Schedule UTP. Further, if states were to impose their own reporting requirement, there would be additional considerations that would affect corporate income taxpayers. ☆

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Sutherland’s SALT Practice is composed of 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, unclaimed property, and property tax matters. Sutherland’s SALT Practice also monitors and comments on state tax legislative and policy efforts.

²¹*Supra* note 18.