Evolving Tax Risk Analysis and Disclosure

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The issue at hand really needs to be broadened to include the impacts of the implementation of FIN48 (now ASC 740-10). FIN48 really was the start of a paradigm shift in the corporate approach to analyzing risk in transactions and assessing those risks for financial reporting purposes. A second key factor that came into play was the potential significant increase in penalties on transactions that did not meet certain criteria.

The world was a different place when the greatest risk was that the taxpayer would have to pay additional tax, plus some interest on an assessment. When penalties were increased, including potential public disclosure of the assessment of those penalties, when the accounting rules changed and tax departments were learning the terms “material weakness” and “significant deficiency,” the approach within many departments changed significantly. No longer was it acceptable to throw a position against the wall to see if it would stick. Rather the level of scrutiny of a transaction and the attendant tax implications began to increase. Now, I do not mean to imply that there was any laxity before these changes. Tax professionals were doing their best to get to the correct answer. And to the benefit of the IRS, they were generally doing their best on examinations to get to the correct answer as well.

With the advent of FIN48, the documentation for potential tax liabilities had to be much more detailed than previously was the case. The establishment of the Public Company Accounting Oversight Board (PCAOB) pushed the accounting firms to take a

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harder look at the tax reserves for their propriety and to be sure that nothing had been missed. There is a reason that in the early years of these rules, tax issues ranked in the top five of material weaknesses. These were fundamentally different approaches and procedures, and there was a learning curve for everyone.

I appreciate how difficult it can be to perform a tax examination for a large corporation. The IRS must search for the information from sources such as general ledgers, newspapers, press releases, and also by trying to ask the right questions. Again, there are very few, if any, large corporations that would actively attempt to hide or withhold information from the IRS, but if the corporation isn’t asked the right question, the IRS may never find a potential issue.

This leads us to Schedule UTP. This schedule is the IRS’s attempt to understand the material items that comprise the tax reserve and, by definition, that contain some level of uncertainty as to tax treatment. I believe that the IRS is trying to be very careful in their use of Schedule UTP to avoid prying into the taxpayer’s mental processes or impressions or other matters that might otherwise be subject to privilege. As noted, the IRS has issued a policy of restraint which, in general, provides that they will not use a waiver of privilege argument to pursue privileged documents that were provided to the taxpayer’s audit firm. There is, however, an open question of whether the Justice Department, which is not part of the IRS, will abide by that interpretation.

A combination of factors over recent years has caused an increase in attention to transactions and time spent on analysis of their tax treatment. The new tool now in the IRS arsenal is the availability of the key issues that generated the reserves booked. My view is that if the taxpayer believes in its position, then it should have no problem discussing the transaction with the IRS.
Schedule UTP is still in its infancy, but I absolutely expect other jurisdictions to adopt a similar approach. This includes the various states. California indicated two years ago that it was moving in that direction, and there will be others. If we watch how other countries have been adopting rules in areas such as transfer pricing, there is no doubt that the UTP approach will not be far behind. The world is shrinking, and availability of information is growing. Taxing jurisdictions will be employing all available tactics to gather the best information that they can and to utilize it as effectively as they can.

Corporate taxpayers will continue to perform professional due diligence with respect to the tax treatment of transactions. They will report as they deem most appropriate and must be prepared to defend their positions. It bears mentioning that most uncertain tax positions are the result of a lack of clarity in the tax laws. In my view, this means that one sure way to reduce the amount of uncertain tax positions would be to focus on drafting clear laws and issuing interpretive guidance to assist taxpayers in navigating the complexities of the rules. This will enhance certainty and consistency in tax reporting.