Proceedings of GREAT Day

Volume 2011 Article 9

2012

Government-Taxpayer Tensions in the Wake of FIN 48 and Schedule UTP

Kevin Muller
SUNY Geneseo

Government-Taxpayer Tensions in the Wake of FIN 48 and Schedule UTP

Kevin Muller

Introduction

The Corporate Income Tax

Since the adoption of the United States Constitution endowing Congress with the power to "…lay and collect taxes, duties, imposts, and excises, pay the Debts and provide for the common Defense and general Welfare of the United States" in 1789 (art. I, §8, cl. 1), spirited and evolutionary debate has focused on the manners in which the government should collect revenues and monitor citizens' compliance with those manners. Though the underlying purpose of the U.S. taxation system is of course to collect revenue for use in government-directed programs, the specific sources of wealth that have been subject to – or not subject to – taxation have been chosen in part to encourage social, economic and political initiatives of national and state governments with due consideration toward the fairness of the system itself and the economic burden that different taxes place on various classes of citizens. Today, taxpayers are subject to a complex, nuanced and unwieldy tax code: According to a report released on Aug. 27, 2010 by the President's Economic Recovery Advisory Board, American taxpayers spend 7.6 billion hours and roughly $140 billion a year to comply with federal tax regulations (Montgomery).

Until the passage of the Revenue Act of 1861, government revenues were collected exclusively through tariffs, sales and property taxes (U.S. Treasury 2010). In 1862, the government first levied a tax on personal income using a system conceptually not far removed from the one used today. Employers withheld taxes, deductions were permitted and higher incomes were taxed at a greater rate than lower incomes. The U.S. Supreme Court ruled such a system unconstitutional in 1895 (Pollock v. Farmers' Loan & Trust Co.) on the basis that certain of these taxes could be classified as "direct," thereby violating Article I of the U.S. Constitution: "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers…" (art. I, §2, cl. 3).

The taxation of corporations began in 1909 with the passage of the corporate excise tax as part of the Payne-Aldrich Tariff Act. The act applied definitions of taxable income and tax rates to the corporation without regard to the status of its owners.

The corporate excise tax was able to come to fruition in advance of the Sixteenth Amendment because it was considered to be an excise, indirect tax and thus not prohibited by Article 1, §9 of the Constitution. In the early part of the twentieth century, most corporations distributed virtually all of their profits as dividends, and so the corporate tax at its inception primarily took the form of withholdings on dividends. In addition to being a source of revenue when individual taxes were disallowed, the act of taxing corporations instead of individuals had administrative benefits: "Because of its regular and open distribution of dividends, the corporation was an obvious target for an expansion of stoppage-at-the-source collection efforts that had proven so successful during the Civil War and Reconstruction. In effect, the corporate tax was thought to be a necessary mechanism for enforcing a comprehensive scheme of individual income taxation" (Bank, 452). The principal method of enforcing personal income tax compliance during the era had been to require taxpayers to sign an oath swearing to the accuracy of the return (Bank, 519); tax assessors were usually elected by the local taxpayers and did not always act in the interest of the government, so evasion was rampant. Because corporate dividends were often distributed regularly, formally and publicly according to state corporation laws, withholding taxes on their distribution provided a convenient method of collecting revenue in such a way that the unpopular and controversial inquisition into the private matters of individuals was not necessary.

Today, the relative administrative advantages of collecting taxes from corporations are less compelling than they were a century ago. Information technology advances have made employee withholdings automated. Moreover, corporate shares are increasingly owned by pension funds, mutual funds and other corporations and so the tracking of dividend payments is not as straightforward as it was in the days of paper stock certificates. Reporting requirements already provide the IRS with data concerning wages, withholdings, annuity and pension payments,

Published by KnightScholar, 2012

Social Security benefits and a variety of other transactions affecting income and potential deductions. Door-to-door surveys have been replaced with dual-reporting systems and electronic filing software that improve drastically the ability of the IRS to verify information reported on individual tax returns without personal inquisition.

Though discourse commonly treats the corporation – and governments, for that matter – in the abstract as an entity separable from the sum of its parts, corporations are better characterized as a vehicle through which individuals can organize in order to operate more conveniently and efficiently than they would as a collection of legally distinct parties. In 1894, Sen. Anthony Higgins (R-Del.) defined corporations as "but aggregations of the capital of individuals for joint profit, with joint liability and joint loss, conveniently divided into shares for the purposes of distribution and management" (Higgins). Though partnerships also represent a form of organization for business purposes, partnerships are a pass-through entity for taxation purposes; income, credits and deductions are allocated to the individuals that share ownership and are taxed according to the status of those individuals. Sole proprietorships are taxed at the individual level as well, but current tax reporting requirements make it difficult to statistically determine the breakdown of revenues between sole proprietorships and individuals.

In 1913, Congress passed the Sixteenth Amendment, which gave the government the authority to collect income taxes without regard to the census of individual states. Until 1936, dividends were excluded from personal income and so corporate income was taxed only once; in 1936 that exclusion was removed. So began the "considerable tension between the corporate income tax and the individual income tax, because corporations are owned, directly or indirectly, by individuals who (ultimately) receive a share of the corporations' incomes" (IRS Data Release, 284). Much of this tension has centered on the so-called "double taxation" of corporate income: Revenues are taxed once as income to the corporation - at applicable corporate tax rates, which may, depending on the taxpayer, be substantially greater than corresponding individual rates and dividend/capital gains rates – and again when received by individual owners as dividends or capital gains.

Upon passage of the Payne-Aldrich Tariff Act in 1909, President William Taft defended a corporate tax because it served as "an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock" (Taft). An official report at the time countered that corporations represented "normal and necessary forms for doing business … that hence in creating corporations a State should be considered as performing a duty rather than granting a privilege. [T]he property and the business of corporations … should be taxed with no exceptional machinery" (Report).

Today, corporate taxes represent an important, but relatively minor source of federal funds; in 2008, they provided 12 percent of total federal revenues (Tax Policy Center). Imposing a corporate tax allows the government to grant preferential treatment to certain organizations by classifying them as non-profit or creating tax incentives that affect targeted industries or types of companies. A more frequently cited argument for continuing to tax corporations, though, is that absent corporate taxes, the corporate form of organization itself might be used as a tax shelter for individuals. That is, individuals could shift part or all of their wealth into corporations and thereby enjoy a lower tax liability than wage employees. "As long as dividends were taxed as ordinary income and the accumulated earnings tax was strict enough, it was difficult to use the corporate form to shelter a great deal of income [prior to the corporate relief package of 2003 that taxes dividends at a marginal rate of 15% instead of at the taxpayer's ordinary rate]," wrote senior specialists in economic policy and public finance in a 2007 report to Congress (Gravelle, Hungerford 2007).

The argument that taxing corporations serves as a backstop for wealthy investors is based on the presumption that the corporate tax is paid wholly by shareholders, but some economists argue that this is not the case. In the phrasing of the Congressional Budget Office, "A corporation may write its check to the Internal Revenue Service for payment of the corporate income tax, but that money must come from somewhere: from reduced returns to investors in the company, lower wages to its workers, or higher prices that consumers pay for the products the company produces" (CBO 1996, 2). Historian Bruce Bartlett observed, "The [corporate] tax remains a major source of revenue for governments at all levels and periodically draws the ire of tax reformers, who feel that corporations are not paying their 'fair share' of taxes – based on a naïve and incorrect assumption that, if corporations paid more, other Americans would pay less" (Bartlett 1985, 1). Bartlett argues that the double taxation of corporate income also has a significant effect on the cost of equity financing because taxes on dividends reduce increase the cost of investing; this distortion may contribute to the decision to raise capital through debt instead of equity financing and incur interest expense.

Joel Slemrod, a professor of economics at the University of Michigan, argues that the double taxation of corporate income is inefficient from a policy perspective (Slemrod 2004). He states that dividend payouts are easier to monitor and tax than corporate income and that corporations might be less likely to aggressively pursue tax shelters if tax savings accrue directly to shareholders and not to the corporation itself (21).

Determining the true incidence of the corporate income tax is further complicated when one considers the responses of each group to the effects of the tax and the residual effects of those responses. Existing literature regarding who bears the incidence of corporate taxes is varied and does not point decisively to one conclusion over another (CBO 1996, 30). As recently as December 2010, the CBO has written that "households bear the burden of corporate income taxes, but the extent to which they bear that burden as owners of capital, workers, or consumers is not clear" (CBO 2010, 2).

Accounting for Income Taxes

Though the very first corporate taxes were exacted based on income as defined by accounting standards, it quickly became clear that the goals of accounting systems were divergent from those of taxation systems and so tax laws were developed that included "specific definitions of many items of income and deductions, and many pages specifying when and how to account for the items…" (IRS Data Release, 285).

Though taxes are not calculated using financial reporting standards, corporations have to record the cash flow and economic effects of income taxes using the framework of generally accepted accounting principles. Because GAAP uses an accrual basis of accounting where revenues and expenses are recognized when they are incurred and not when cash is received or remitted (SFAC No. 1, 3), a corporation's recorded income tax expense can frequently be markedly different from the sum of income tax liabilities reported to various regulatory agencies for a given period. Additionally, the range of items that qualify as deductions for income tax purposes differ from the range of items that qualify as expenses for GAAP reporting, so certain permanent differences between "book" and tax income exist that need never be reconciled. The manner through which companies have been required to communicate information about their obligation to pay taxes has evolved over the past century; currently, companies record a "current" liability or asset that corresponds to the cash amount of taxes to be paid or refunded, and a "deferred" liability or asset representing future taxable income or future deductions from income that have been recorded in the company's GAAP financial statements but will not be considered a taxable event until a future period (ASC 740-10-25-2).

For example, corporations are permitted to use accelerated cost recovery methods for tax purposes that allocate depreciation deductions/expense differently than methods typically followed under GAAP. While the sum total of depreciation for a given asset will ultimately be the same under both methods when all years are considered, the depreciation for any individual year will likely be different under each system. Other areas where temporary differences frequently occur include the provision for bad debts, pension contributions, unearned revenue and the carry-forward or carry-back effects of tax losses. Substantial book-tax differences can arise for companies with subsidiaries, since the IRS uses different consolidation rules than GAAP. Temporary and permanent differences are currently outlined to the IRS using Schedule M-3.

Publicly-traded corporations have an obligation to shareholders to maximize income and create wealth. Reducing tax expense has an immediate effect on bottom-line profitability and corporations therefore have an interest in minimizing tax expense. In the short term, it is possible for corporations to keep taxable income low while keeping reported net income high through the careful use of accounting techniques that defer taxable income and take advantage of preferential tax treatments. Research suggests, though, that firms cannot permanently sustain large book-tax differences without being aggressive and potentially risking IRS adjustments upon audit (Mills 1998, 355).

Many corporations are proactive in making business decisions that avoid the realization of taxable income. These corporations create tax savings by shifting income into low-tax jurisdictions and take advantage of existing deductions, tax credits and organizational structures that entail a preferential tax status. The term "tax planning" can refer to the collective effort of management to consciously minimize tax expense through elective decisions. Though firms of all kinds – as well as individuals – can engage in tax planning at some level, a 2009 study using data from 1998 finds that the companies which manage and measure their tax departments as profit centers versus firms that view their tax department primarily as a cost center tend to be larger and often yield lower effective tax rates and higher coordination between departments (Robinson et. al. 2009, 24-25). A corporation's effective tax rate is most often calculated by dividing accrued income tax expense by pretax income from continuing operations.

Most firms are interested primarily in reducing accrual, not cash, tax expense (Robinson et. al. 2009, 30). A possible reason for this behavior is that executives tend to be compensated based on after-tax GAAP earnings. Additionally, because the cash payment for taxes for any given tax year is not publicly available, accrual tax expense tends to be the most convenient measurement of a firm's tax performance for investors. Though cash outflows related to taxes are separately identified in the statement of cash flows, this number may represent years of back taxes or prepayments in addition to the current year tax bill.

Appendix B illustrates selected tax information of General Electric Company for 2008-2010. GE's reported 2010 current tax expense of $4 million on pretax earnings of $14,208 million drew much attention in popular media, but the situation is not as simple as it might seem. First off, the accrual-based tax provision reported in the company's income statement for 2010 was $1,050 million – still a fairly paltry effective tax rate of 7.39%, but a far cry from just $4 million. An examination of the notes to GE's financial statements reveals that though the company is subject to the top U.S. marginal corporate tax rate of 35.0%, the tax effects of global operations reduced this rate by 25.8%. Roughly 64.3% of GE's 2010 net earnings were derived from international operations, and a substantial portion of these earnings were reinvested indefinitely and therefore subject to tax rates of less than 35%. U.S. tax law currently defers the imposition of U.S. tax on certain active financial services income until that income is repatriated to the U.S. as a dividend. Required financial statement notes related to income taxes are not so detailed as to allow a recreation of a company's specific transactions that yield current and deferred tax expenses and benefits, but GE's statements demonstrate that accrual techniques and international tax laws can have a dramatic impact on a company's current tax expense and therefore a more comprehensive understanding of tax expense is required to evaluate the extent to which a company effectively manages its tax expense.

In order to realize actual net tax savings, firms must consider both the tax and economic effects of a decision. For example, a firm might enjoy a lower marginal income tax rate by operating out of a certain jurisdiction, but the cost of constructing a plant and transferring resources to that jurisdiction might well outweigh any pure tax savings. In its Guiding Principles of Good Tax Policy (Appendix A), the Tax Division of the American Institute of Certified Public Accountants writes, "The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum … That is, taxpayers should not be unduly encouraged or discouraged from engaging in certain activities or taking certain courses of action primarily due to the effect of the tax law on the activity or action." The AICPA acknowledges, though, challenges that "stem from the desire to use the tax law for more than raising revenue, for instance, to implement social or economic policies" and notes that tradeoffs must be made among all the considerations of a fair tax system in order to create an optimal model (AICPA, 13).

Tax Avoidance versus Tax Evasion

To fully appreciate the complexities that make requirements like Financial Accounting Standards Board Interpretation No. 48 and the Schedule of Uncertain Tax Positions unpopular among some taxpayers, one must consider the difference between tax avoidance and tax evasion, as well as the difficulty of distinguishing between the two. Tax avoidance refers to strategically making business decisions that are fully legal but take advantage of preferential tax jurisdictions and treatments. For example, an individual might avoid incurring taxes on income by investing in tax-free municipal bonds, instructing an employer to deposit wages into a tax-free individual retirement account or choosing to realize capital gains only when he can realize losses to offset the taxable gains. Tax evasion, on the other hand, generally refers to illegally and knowingly underpaying taxes either by intentionally reporting taxable income incorrectly or incompletely or by engaging in transactions that create tax losses but bear little or no economic risk. In the former case, issues of legality are usually cut-and-dry; taking a job that pays wages "under the table" and not reporting that income is clearly tax evasion. Classifying transactions that might be considered tax evasion on the basis that they reduce tax liability outside the spirit of the law, however, can involve a substantial level of judgment, especially when those transactions are made at the corporate level and involve complicated legal and financial steps.

In some cases, corporations and in particular large, international firms with tax haven subsidiaries (Lisowsky 2010, 1711) are able to take advantage of tax avoidance transactions, defined by the U.S. Treasury as "any transaction in which the reasonably expected pre-tax profit … of the transaction are insignificant relative to the reasonably expected net tax benefits … of such transaction" (Treasury 1999, 157). The IRS characterizes these abusive shelters as "very complicated transactions that sophisticated tax professionals promote to corporations and wealthy individuals, exploiting tax loopholes and reaping large and unintended tax benefits" (GAO Testimony 2003). Nevertheless, "Under present law, there is no uniform standard as to what constitutes a tax shelter; however, there are statutory provisions, judicial doctrines, and administrative guidance that attempt to limit or identify transactions in which a significant purpose is the avoidance of evasion of income tax" (Joint Committee on Taxation 2002, 4).

Since many abusive shelters are based on legal tax planning techniques, it is often difficult for courts to distinguish legitimate tax planning efforts from illicit shelters (Levinsohn 2005). The Supreme Court has repeatedly affirmed that all taxpayers retain the right to reduce their tax liability or avoid paying taxes altogether provided they do so within the boundaries of the law. Frequently, though, courts defer to the economic substance doctrine frequently credited to the 1934 Gregory v. Helvering. In this and many cases since, courts have found that tax savings based on literal and straightforward application of tax law are not permissible if the taxpayer realizes no economic benefits from entering into a transaction aside from the tax savings themselves. The IRS has more recently clarified that transactions may be legal even if they do not actually yield a profit as long as a cash flow or net present value analysis proves that the taxpayer could have reasonably realized a profit (IRS Notice 2002-50, 6-B-III). The IRS also advocates employing the substance over form test, that is, a set of transactions yielding the same end result should be treated in the same way for tax purposes regardless of the legal steps used to achieve that end (IRS 2002-50, 6-C). Nevertheless, federal courts have sometimes ruled that transactions are allowable even if executed exclusively for the purpose of realizing tax savings.

Often, tax avoidance transactions are created and sold to corporations and individuals as "tax shelters." The U.S. Senate Permanent Subcommittee on Investigations found that between 1997 and 2001, KPMG sold four "active tax products" to more than 350 individuals which generated revenues for the firm in excess of $124 million; three of those products were later determined by the IRS to be potentially abusive or illegal tax shelters (U.S. Senate 2003, 27). In that 2003 report, the Committee concluded that "the tax shelter industry as a whole remains active, developing new products, marketing dubious tax shelters to numerous individuals and corporations, and continuing to wrongfully deny the U.S. Treasury billions of dollars in revenues, leaving average U.S. taxpayers to make up the difference" (3). In a tax shelter case involving global accounting firm KPMG, internal emails sent by tax professionals demonstrated calculations showing that the penalties for not registering tax products with the IRS, thus violating federal tax shelter laws, would be low compared to the fees generated by selling the products to clients, and that registering the tax shelters with the IRS would place the firm at a competitive disadvantage (13).

Though methodological and data constraints make it difficult to estimate with certainty the dollar amount of potential tax revenues lost through the use of tax shelters, an IRS contractor estimated that the average between 1993 and 1999 was between $11.6 billion and $15.1 billion per year (GAO Testimony 2003, 6). The U.S. Treasury has expressed concern about the proliferation of corporate tax shelters not only because of the short-term reduction in the corporate tax base but also because "corporate tax shelters breed disrespect for the tax system – both by the people who participate in the tax shelter market and by others who perceive unfairness" (U.S. Treasury 1999, iv). Additionally, the costs incurred by users and promoters of tax shelters to create and defend tax benefits are economically unproductive. For all of these reasons, the government has in the past decade especially taken a serious interest in reducing the prevalence of tax shelters.

Investors, too, can easily justify an interest in understanding how aggressive a particular company is in avoiding taxes and utilizing tax shelters. Public exposure of a company's use of tax shelters is almost certainly a negative event – often, penalties and legal defense expenses are incurred, and there exists a public characterization of firms that evade taxes as poor corporate citizens. Some investors may also view aggressive tax behavior as an indicator of poor corporate governance and wonder if the firm is cheating not only the IRS but investors as well (Hanlon, Slemrod 2006, 12). On average, news of a corporation being involved in a tax shelter negatively affects that firm's stock price, especially for retail firms (Hanlon, Slemrod 2006, 5). Hanlon and Slemrod note, though, the difficulty of gauging the actual or perceived earnings effect of a tax shelter savings reversal since it is nearly impossible to reliably determine when a firm booked the savings initially and what amount of savings have been surrendered after exposure of the tax shelter since any valuation reserves would have been recorded in aggregate (28). Hanlon and Slemrod did not find a significant correlation between stock prices and the release of reports from Citizens for Tax Justice identifying firms that pay little or no taxes (35).

Controversies Arising from Disclosing Uncertainty

An individual tax position may involve a deduction or exclusion from income, the claim of a tax credit, the use of a carry-forward or carry-back loss, the classification of an entity, transfer pricing allocation or a number of other assertions made on a tax return for the purpose of minimizing income tax liability. Because modern tax law is complex and does not specifically address every conceivable transaction structure or situation but, like GAAP, institutes rules that companies must apply to their respective industries and circumstances, managers must make a conscious decision to report or not report certain events in a tax return where ambiguity exists regarding the specific application of regulations.

In March 1975, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 5, which requires firms to accrue a contingent liability such as income taxes payable if such liability is "probable" and "the amount of the loss can be reasonably estimated" (FAS 5, 8a-b). This guidance allowed substantial flexibility for firms to gauge materiality in their decision to accrue or disclose, and firms developed divergent policies for dealing with SFAS No. 5 based on a variety of factors. Research indicates that many firms under-disclosed material claims and did not provide the detailed information required by SFAS No. 5 (Gleason and Mills 338). In June 2006, the Financial Accounting Standards Board, a nongovernmental body that develops accounting techniques for U.S. companies, issued an interpretation of SFAS No. 109, which had established the asset-liability approach to recording temporary and permanent book-tax differences. FASB Interpretation No. 48, now a part of Accounting Standards Codification 740-10, "prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return" (FIN 48, Summary).

While FIN 48 established a needed consistency for treating contingencies related to UTPs, it contains provisions that depart from the foundational goal of financial reporting – providing relevant, reliable information to third-party users of investors and creditors – in favor of an idealistic model that assumes companies will remit all possible taxes to all possible collecting agencies even when the practical likelihood of such an occurrence is remote. FIN 48 caters to another third-party user that stands to benefit from the profitability of corporations: the government, and by extension, all who benefit from the expenditures of government. In effect, FIN 48 asks corporations to audit themselves for tax compliance and then publicize a hypothetical income tax liability that is likely different from the one the company has proposed to the Internal Revenue Service under the voluntary reporting system addressed in Flora v. United States; in that case, the Supreme Court noted that "our system of taxation is based upon voluntary assessment and payment, not upon distraint" (362 U.S. 167) Normally, both individual and corporate taxpayers are permitted to assess their own tax liability using the instructional tools made available by the IRS and state and local governments with the understanding that their self-evaluation may be audited for completeness and accuracy and that penalties, interest and potentially criminal sanctions can be imposed if the original return is found to underreport tax liability and sufficient disclosure has not provided to apprise the regulatory agency of the taxpayer's uncertainty in taking the positions in question. Though the public has always had a justified interest in preventing outright tax evasion, FIN 48 potentially serves as a disincentive to corporations seeking to implement tax savings strategies in that it exposes those strategies to regulators who are interested in collecting maximal revenue.

Beginning in 2011, companies will face even further disclosure requirements: The largest U.S. corporations will be required to submit a completed Schedule of Uncertain Tax Positions (Form 1120) to the IRS. Schedule UTP requires companies to list all uncertain tax positions being taken in that year's return as well as in prior years' returns from 2010 onward and, for each listed UTP, to indicate whether the UTP represents a permanent or temporary difference and whether the UTP represents a "major" position, defined as 10 percent or greater of the total amount of UTP reserves. Corporations are also required to rank the UTPs based on the size of the associated reserves. Although the requirements of Schedule UTP for the most part build upon the analysis prescribed by FIN 48, the instructions also indicate that a taxpayer "must report on Schedule UTP a tax position taken on its return for which no reserve for income tax is recorded if the tax position is one which the corporation or a related party determines the probability of settling with the IRS to be less than 50 percent and, under applicable accounting standards, no reserve was recorded in the audited financial statements because the corporation intends to litigate the tax position and has determined that it is more likely than not to prevail on the merits in the litigation" (Schedule UTP, Instructions). That is, taxpayers must identify to the IRS any position that is likely to be technically objectionable even if they, their legal counsel and their independent auditors believe the position will likely be sustained in court.

FIN 48 and Schedule UTP have substantially heightened disclosure requirements related to corporate income taxes and the effects of each on individual corporations are contingent on the company's attitude toward and usage of tax planning in its overall business strategy. The requirements will most likely have a meaningful effect on the extent to which companies can lower their effective tax rates as part of a general profit-creating strategy. Additionally, the IRS will be provided with information that can be used in guiding decisions including whether to audit a corporate taxpayer and which positions, if any, to challenge. Though the end result of the requirements for investors is potentially a more consistent and relevant set of income tax information than has been previously available, it may come at the expense of increased effective tax rates. Many corporations implement tax management policies that attempt to maximize profits while minimizing reported tax expense. FIN 48 in some cases raises the reported income tax expense by requiring companies to derecognize tax benefits that would otherwise reduce tax expense. Businesses with an interest in achieving maximum tax compliance will likely face less of an impact from FIN 48 and Schedule UTP than businesses interested in minimizing tax exposure; their conservatism may actually be advantageous in reducing the likelihood of an IRS audit because the disclosure requirements allow them to credibly show a high level of confidence in their tax return. Some tax-aggressive firms may refuse to admit or disclose uncertainty at all; the responsibility of ensuring the integrity of reported uncertainty will now fall on independent auditors to uphold.

The broader notion that the government is now demanding identification of UTPs is concerning to many corporate taxpayers. Though the government must necessarily draw funding from private resources through taxation in order to provide services to a public comprised of private individuals, the United States was founded on the principle that the government ought to carry out its operations with the consent of the public.
The FASB stated in the basis for its conclusions on FIN 48: "Some constituents asserted that requiring a tabular reconciliation is not appropriate because it would inappropriately provide a 'roadmap' for taxing authorities. Those constituents analogized the relationship between a taxpayer and a taxing authority to the parties in a lawsuit … A counterparty in a lawsuit is acting in the broader public interest in regulating compliance with self-reporting income tax laws" (B64). While that statement is not incorrect, a taxing authority is privy to developing internal policies, interpretations and methods that diverge from a totally neutral reading of tax law and should not be treated as a pinnacle of objectivity and fairness. Political, societal and other pressures have the propensity to affect the IRS just as they do the FASB and public representatives.

Though it is in the public's interest for the IRS to deter noncompliance and tax evasion at both the individual and entity level, the public similarly has an interest in being able to continue to use the corporate form of organization to conduct business free of unfair and undue government intervention. "All businesses want lower taxes. But businesses understand that their success as businesses depends in part on what the government does – on education, infrastructure, national security … Most businesses understand that we have limited resources, that we can't raise taxes on individuals to lower business taxes and that unsustainable long-term deficits hurt growth too," offered Treasury Secretary Timothy Geithner in an interview following President Barack Obama's 2011 State of the Union address that suggested a future reduction in U.S. corporate tax rates (Wessel 2011).

In requiring corporations to report the technical results of an imprecise, broadly-conceived accounting test, the IRS is opening the door to a troubling environment where corporations with uncertain tax positions are subject to a game of courtroom 'gotcha' – the IRS can use Schedule UTP disclosures to identify tax benefits that are properly determined to be uncertain because relevant tax law is not easily or directly applicable to the event in question, and then use the very fact that the taxpayer reported such uncertainty to sway the court's opinion or pressure the taxpayer into a settlement. While it is of course entirely plausible that the IRS might indeed use enhanced disclosure solely to increase efficiency and to resolve disputes quickly, there exist at this time no clear mechanisms to protect the taxpayer from this type of underhanded government action.

Current GAAP for Recognizing UTPs in Financial Statements

FASB Interpretation No. 48 became effective as part of U.S. GAAP for fiscal years beginning after Dec. 15, 2006 and is currently incorporated into ASC 740. Under ASC 740-10, firms must evaluate each tax position to determine whether it is more likely than not to be sustained upon examination based on technical merit (740-10-55-3). Taxpayers may consider in this evaluation whether they would litigate or appeal an adverse judgment, but they are to presume that the appropriate taxing authorities have "full knowledge of all relevant information." Detection risk is ignored in the assessment of whether a position will be sustained, but widely understood administrative practices may be considered (e.g., for the sake of convenience the IRS typically ignores certain deviations from tax law such as the deduction of assets below a taxpayer-determined dollar amount) so that a company can record a related tax benefit even though the position technically would not be sustained if challenged (740-10-55-90). If any position meets the More-Likely-Than-Not threshold, then the benefit of the position recognized in the financial statements should be as large as possible provided that amount is More-Likely-Than-Not to be realized upon settlement. Tax effects are recorded as reductions or additions to income taxes payable or as deferred tax assets or liabilities in accordance with SFAS No. 109. The recognition or non-recognition status of tax positions can change as the MLTN analysis is applied in subsequent financial reporting periods (740-10-35-3).

If a taxpayer takes positions on a tax return or expects to do so but those positions do not meet the MLTN threshold, the taxpayer must accrue appropriate interest and penalties related to those positions under ASC 740-10. ASC 740-10-25-56 requires that this interest be expensed separately of general income tax expense. In the notes to the financial statements, companies are required to report the potential changes in the status of unrecognized tax benefits, benefits related to UTPs that are taken in a tax return but not recorded because they fail the two-part FIN 48 test (740-10-50-15d). Publicly traded companies are additionally required to disclose changes in the gross amount of unrecognized tax benefits as well as the amount of unrecognized tax benefits that are realized because the statute of limitations has expired for those positions (740-10-50-15A).

Taxpayers must derecognize any and all tax benefits that do not meet the MLTN threshold. A valuation allowance is not permissible if established solely because the sustainability of the position is in question. This is significant in that the potential value of any tax benefits that fail the MLTN test are completely absent from the consolidated financial statements. Even though any potential tax benefit with a sustainability probability greater than zero theoretically holds some value to the company, many of these benefits are confined to the notes to the financial statements under ASC 740-10. If ultimately never challenged, the income effects of non-MLTN tax benefits will not be realized until all relevant statutes of limitations expire; this ordinarily takes at least three years starting from the end of the tax year in question.

Accounting Implications and Complexities

The most challenging component of FIN 48 from an accounting standpoint is probably the charge to evaluate every tax position for sustainability upon examination. Retaining experts in tax law can be prohibitively expensive for small and medium-sized companies, and unreasonably costly for large corporations that have to contend with a multitude of potentially taxable events and a variety of operating jurisdictions, each with its own set of laws. ASC 740-10 requires tax positions to be evaluated for each "unit of account," the most specific level at which taxpayers accumulate information to support the tax return and at which it anticipates a taxing authority will address the issue (740-10-55-85). The Codification illustrates, for example, a scenario where a research credit taken on a tax return might represent the cumulative tax effect of four separate research projects that are individually and separately substantial in scope; if documentation exists for each project, then each of the four projects would be tested using FIN 48 versus testing the aggregate research credit only. Each unit of account is tested ignoring the potential canceling or amplifying effects of interrelated tax positions. The determination of what constitutes a unit of account is subjective and dependent on relevant facts and circumstances.

Accountants also must deal with the difficult problem of trying to develop an empirical probability that a tax position will be approved upon examination. Many tax positions are widely accepted and clearly defendable using tax literature and case law, but large companies in particular are likely to find themselves wanting to take tax positions that are more problematic. It can be difficult in the latter case to quantitatively benchmark the likelihood that the IRS or another regulatory agency will accept a tax position when tax law does not yield an obvious conclusion and precedent is either nonexistent or not directly comparable to the situation at hand. FIN 48 does not prescribe a specific method of coming up with a number other than to evaluate a tax position "based on its technical merits" (FIN 48, B27). In its basis for conclusions on FIN 48, the FASB writes, "the Board does not believe that a legal tax position must be obtained to demonstrate that the more-likely-than-not recognition threshold is met. The Board believes that a tax opinion can be external evidence supporting a management assertion and that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law. Other evidence, in addition to or instead of a tax opinion, supporting the assertion also could be obtained; the level of evidence that is necessary and appropriate is a matter of judgment that depends on all available information" (FIN 48, B34).

In particular, state and local income taxes must come under substantially greater scrutiny internally as a result of FIN 48's requirements (Kwiatek). Many states and locales utilize a complicated set of criteria to determine whether a company has nexus in that jurisdiction. Public Law 86-272 holds that states are prohibited from "imposing a tax on or measured by net income when an entity's only connection with the state is the solicitation of orders or sales of tangible personal property." Many states have passed statues or regulations, though, that invoke a principle known as "economic nexus" whereby businesses can be subject to some form of income tax even if not physically present in that place. Some states have argued that intangible holding companies create an economic presence within their borders and attempt then to collect income tax from the company. Questions that states might ask in order to determine whether or not a company has nexus range from, "Does the business have an office, agency, warehouse or other business location owned or leased in the state?" to, "Does the business have any employees or representatives who use their in-state home to receive business callers?" (State Tax Nexus). CPAs with Financial Executives International observe: "A business can face multiple overlapping tax-collecting jurisdictions – countries, states, counties, cities and special districts – and tangled rules in the various tax authorities based on the type of business, location or where the products and services will ultimately be used" (Yrjanson, Tuthill 2010).

FIN 48 requires firms to identify and potentially record a liability for taxes owed to a state in which it has never before filed a return – the statute of limitations never begins to run if a return is never filed. The interpretation does allow firms to consider widely accepted administrative practice where nexus is concerned since several states have implemented tax amnesty or voluntary disclosure programs in which the "lookback" period is reduced if firms initiate contact with the jurisdiction to clarify whether they have nexus in that jurisdiction (FIN 48 A14-15, Kwiatek). Nevertheless, revisiting past years to determine whether additional liabilities ought to be recorded in accordance with FIN 48 for state and local income taxes can present administrative difficulty and will require CPAs to continually update their understanding of local tax laws or consult lawyers or tax professionals with the necessary expertise.

FIN 48 creates additional complications related to auditor independence. Accounting firms that provide both auditing and tax planning advisement services may find their perceived and individual independence compromised. It is unlikely that a CPA can be properly objective in analyzing the sustainability of a tax position that he or she advocated for the purpose of filing a tax return (Stromsem). Smaller business in particular may be forced to retain a tax professional in addition to a CPA firm as a result of FIN 48.

Achieving Consistency Using FIN 48 versus SFAS No. 5 and SFAS No. 109

According to the FASB, "Diverse accounting practices had developed with respect to the recognition and measurement of current and deferred tax assets and liabilities in financial statements [as of July 2005 when the FASB first issued an exposure draft on uncertain tax positions]. That diversity resulted from the inconsistency in the criteria used to recognize, derecognize, and measure the economic benefits associated with tax positions" (FIN 48, B2). Statement of Financial Accounting Concepts No. 2, one of the documents that guides the FASB in issuing accounting pronouncements and interpretations, advises, "Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises … Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance" (SFAC 2, 3). The stated primary goal of FIN 48, then, was to achieve comparability in accounting for UTPs among various enterprises. To this end, FIN 48 is successful in that it establishes a consistent methodology that had not existed previously.

From 1992 until the effective date of FIN 48 in 2006, the prevailing guidance for recording and disclosing income tax liability had been SFAS No. 109, Accounting for Income Taxes. SFAS No. 109 superseded 1987's FASB Statement No. 96, itself a replacement of Accounting Principles Board Opinion No. 11, issued in 1967. SFAS No. 109 made the significant change of requiring companies to record temporary book-tax differences as assets and liabilities in the balance sheet rather than as deferred charges in the income statement. SFAS No. 109 provided no guidance on how firms should record UTPs, so most companies deferred to SFAS No. 5, a generic statement on contingencies that requires firms to accrue material losses that are "probable" and "reasonably estimated" and to disclose those that are unlikely or not estimable. With regard to UTPs, SFAS No. 5 was not always useful to financial statement users because firms enjoyed considerable flexibility when deciding when and how to disclose and accrue tax liabilities contingent upon possible audit (Gleason and Mills, 318). Investors typically have no access to IRS audit information or progress, so under the SFAS No. 5 approach of accounting for UTPs they were afforded no meaningful information related to the magnitude of any taxpayer-IRS disputes or the likelihood of favorable or unfavorable resolution of those disputes. Disagreements between taxpayers and the IRS can be ongoing until the completion of the audit and related settlements, often months or years after the end of the tax year in question.

Gleason and Mills found through interviews that the "primary consideration" in deciding whether or not to disclose an expected loss related to a tax position pre-FIN 48 was the size of the anticipated loss after settlement. Other qualities of an expected loss that led to disclosure were extremely large IRS claims, public awareness of a claim through the press and industry factors. A popular benchmark for materiality among large, frequently audited taxpaying firms was five percent of "normal income," the greater of actual income or five percent of assets (Gleason and Mills 319). The study concluded that though firms tended to disclose the largest contingent tax liabilities voluntarily, they often under-disclosed claims that users and regulators would reasonably consider to be material. It is worth noting that Gleason and Mills ignored for the purposes of their study all unaudited returns in part "because firms may consider claims on unaudited returns to be too remote to require disclosure," a supposition that FIN 48 markedly affected.

Another major accounting problem that FIN 48 attempted to rectify was the use of so-called "tax cushions" to manipulate earnings. "Prior to the issuance of this Interpretation," the FASB wrote, "tax positions were sometimes recognized in the financial statements on an as-filed or to-be-filed tax basis, such that current or deferred tax assets and liabilities were immediately recognized when the related tax position was taken (or expected to be taken). In some cases, the ultimate realizability of any current or deferred tax benefit was evaluated and a valuation allowance was recorded" (FIN 48 B4). The term "tax cushion" ordinarily refers to the difference between U.S. current income tax expense reported in the financial statements and total taxes due as reported on the corresponding income tax return (Gleason and Mills 323).

Essentially, "tax cushions" allowed a company to record for financial purposes a tax liability of, say, $100 while only claiming $60 of liability on the corresponding tax return, ignoring temporary differences, on the basis that the IRS might in the future disagree with the company's treatment of a position and require payment of $100 instead of $60. The $60 would be expensed in the same fiscal year as the tax return was filed – again, disregarding any temporary differences for simplicity – and the $40 would remain on the books as a financial liability. The firm could then in a later year release the $40 presuming that the position would be successful and record income of $40 for that subsequent year. The tax cushion fell into the category of what Arthur Levitt termed "cookie jar reserves" in describing prominent methods of earnings management through accounting techniques (Levitt 1998). Corporate income tax returns are not publicly accessible, and so investors had no way of determining the extent to which the release of tax reserves was affecting earnings. Research suggests that some firms that might otherwise miss earning targets manage tax expense in order to meet or exceed expectations (Dhaliwal, et. al. 2004 445).

Asset/Liability Approach to Deferred Taxes

The prevailing guidance for recording the income tax effects of an event is Statement of Financial Accounting Standards No. 109, issued in February 1992. Under SFAS No. 109, tax consequences of events where no temporary difference occurs are recorded as tax expense – or a current tax asset if a refund is expected – in the same period as the taxable event. When the tax basis of an asset or liability becomes different from its reported amount in the financial statements because of a temporary difference, a deferred tax asset or liability is recorded in the balance sheet. "A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year" (SFAS 109, Summary).

The predecessor to SFAS No. 109, Accounting Principles Bulletin 11, required companies to record deferred charges in the income statement instead of in the balance sheet. The "deferred tax" account that appeared in the income statement under APB 11 was the product of a relatively simple calculation representing the difference between the tax effects of all of the transactions undertaken in a given year and the tax owed on the corresponding tax return. No assets or liabilities were recognized, and some users treated the deferred entries as mere bookkeeping entries since no amounts were listed as being receivable or payable. APB 11 included no requirement to establish a valuation allowance for uncertain tax positions, and the effects of temporary differences were accounted for at the tax rate in effect at the time of the difference, even if the rates were expected to be different at the time of reversal. A scenario in which subscription to APB 11 would have yielded a different tax expense than subscription to SFAS 109 is illustrated in Appendix C.

Though SFAS No. 109 does require companies to record a valuation allowance, the allowance is created to capture not the sustainability of tax positions upon audit but the potential for deferred tax assets or liabilities to be unrealizable based on future circumstances. For example, a deferred tax asset related to a carry-forward loss might warrant a valuation allowance if the ability of the company to generate taxable income to be offset by the loss carried forward is not definite.

The Financial Accounting Standards Board defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (SFAC 6, 25). The first characteristic of an asset, per Statement of Financial Accounting Concepts No. 6, is that it "embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows" (SFAC 6, 26). Using this definition, FIN 48 properly holds that a claimed tax benefit should not be recognized in a company's financial statements if it is not probable that the benefit will be realized. Instead, a liability should be accrued representing the probable taxes payable in the future as well as any associated penalties and interest.

If the accounting treatment of the tax consequence of an event is to fairly reflect the underlying reality, though, the analysis prescribed by FIN 48 is improper as it tests not the holistic probability that a tax position will be sustained but rather the theoretical probability that a tax position would be sustained provided regulatory agencies had the same information as the taxpayer. In its conclusions supporting FIN 48, the Board writes, "at this time, it is preferable to separately evaluate tax positions for recognition against a recognition threshold and to provide separate measurement guidance for positions that qualify for recognition" versus using an expected-outcome measurement (B26). Disregarding the effects of disclosure on the decisions of regulators, FIN 48 requires firms to record liabilities that are not actually expected.

"Implementation of the Proposed Interpretation will have the effect of consistently overstating the tax accruals for uncertain tax positions in direct conflict with the conceptual framework of the Board," wrote one chief tax officer of a major company in a comment letter to the FASB (Stecker 2005, 4). While it is certainly possible that FIN 48 could indeed result in an overstatement of liabilities related to UTPs, such is not a necessary outcome (Mills, et. al. 2009, 26). For example, if a firm determines that the possibility of audit is 100 percent and that the likelihood that an all-or-nothing claimed tax benefit will be sustained is 60 percent, the firm will record a FIN 48 liability of zero even though there is a 40 percent chance that the full amount of the claimed benefit will be remitted to a collecting agency in the future. In such a scenario, FIN 48 actually understates the theoretical liability. When the probability of audit is greater than zero, a FIN 48 analysis may understate, overstate or correctly state the tax liability depending on the difference between the recognized and claimed benefit, the probability of audit and the probability that the recognized and unrecognized portions of the claimed tax position will be sustained on audit.

Though FIN 48 does require firms to disclose information that may assist the IRS in gauging the extent to which the firm has claimed tax benefits that are not likely to be sustained upon audit, the FIN 48 liability in aggregated form is not especially informative to any one government (Mills, et. al. 2009 27). While FIN 48 requires firms to test each tax position individually, they are not required to actually disclose reserves associated with any position and so the FIN 48 requirements alone could perhaps signal a government audit but probably would not spur the inspection of specific positions.

Where certain large transactions are concerned, it is possible that a reported FIN 48 liability could represent the effect of one large event. For example, companies sometimes engage in what is known as a "tax-free spin-off" when they divest a portion of their business by establishing a brand new company with new management. Because the business is not sold, the parent company does not realize a taxable capital gain on the sale. If the tax-free status of such a transaction is questionable, the potential capital gain might wholly or largely comprise a FIN 48 liability for the parent company and in such a situation FIN 48 could by itself serve as a "roadmap" for the IRS. It is likely, though, that an IRS might be triggered regardless of FIN 48 simply because the major transaction took place at all. Additionally, FIN 48 disclosure requirements do not require a breakdown of the taxes owed to various local, state, national and international regulatory bodies.

Where FIN 48 draws the line in terms of disclosure requirements, however, Schedule UTP continues. Because Schedule UTP does require taxpayers to identify and describe each UTP individually, it is possible that its existence increases detection risk substantially. If this is true, the technical merits of a position as well as administrative practice will indeed be the only factors governing whether or not a claimed but uncertain tax benefit is realized and FIN 48 will be effective in depicting the actual tax benefits and liabilities likely to be ultimately realized. The extent to which the IRS pursues various UTPs using the information provided by taxpayers of various size – for tax year 2010, only firms with assets of $100 million or greater will complete the form – is not yet clear. It is important to note that in the final version of Schedule UTP, the IRS will not be provided with a dollar amount of the potential reversal, but will be alerted to UTPs that represent an amount greater than 10 percent of the entire sum of reported UTPs. The IRS, then, will not have the fullest set of data necessary to perform an exact cost-benefit analysis and operate most efficiently.

Usefulness of Tax Disclosures to Financial Statement Users

At this time, it is generally impossible for a third-party user of a set of GAAP financial statements to discern with confidence the cash amount of taxes paid by a corporation to a given government for a given tax year (McGill, Outslay 2002 1131, 1136). Though the total amount of cash payments attributable to owed taxes is identified in the statement of cash flows, that number represents tax payments to multiple jurisdictions related to multiple years. U.S. tax returns are not made available to the public, so users of financial statements are forced to try to deduce an estimate of taxes paid for a certain tax year using the cash outflow for income taxes number in the statement of cash flows in conjunction with reported income tax expense and any related footnotes. Because neither amount will necessarily approximate the cash amount of taxes paid to the IRS or any other regulatory agency, the public may jump to incorrect conclusions. In a Nov. 30, 2010 speech on the floor of the United States Senate, Sen. Bernie Sanders (I-Vt.) said, “Last year, ExxonMobil made $19 billion in profit. Guess what. They paid zero in taxes. They got a $156 million refund from the IRS.” The company’s 2009 10-K does indeed show that the U.S. portion of income tax expense for fiscal year 2009 was negative $156 million, but this number represents the finalization of tax bills from previous years as well as current and deferred tax expense for 2009. *Forbes* reported that according to an Exxon spokesperson, the company will owe a “substantial 2009 tax liability” once the final tax bill is figured but declined to offer a number (Helman 2010). It is also worth noting that ExxonMobil booked $15,165 million of non-U.S. income tax for 2009. It is not uncommon for large, international companies to siphon taxable income to countries with lower tax rates through the use of transfer pricing and complex business structures. Search engine giant Google, for example, paid an overseas tax rate of just 2.4 percent in 2009; its transfer pricing arrangements were approved by the IRS in 2006 (Drucker 2010).

Confidentiality of Corporate Tax Returns

Since 1894 (Bernasek 2010), the federal government has been prohibited from disclosing any portion of an individual or corporate tax return with limited and carefully defined exceptions. Until 1976, income tax returns were classified as public records; though not readily accessible to the public, they were permitted to be inspected by certain government agencies and parties with a material interest in the return subject to Treasury regulations and the president’s executive order (Lenter, et. al. 2003 813). The Tax Reform Act of 1976, a response to allegations that the Nixon administration had improperly used tax return information against its political opponents, eliminated executive branch control over tax return disclosure and reclassified tax returns to confidential status (Lenter, et. al. 2003 813). Today, there are few circumstances under which the IRS may release information from a tax return without the express consent of the taxpayer. The major circumstances are: when a state tax official or state or local law enforcement agency requires such information “for the administration of State tax laws for the purpose of, and only to the extent necessary in, the administration of such laws” (U.S. Code §6103 d-1), when a shareholder owning more than one percent of a corporation requests the information (6103 e-1-D-iii), when information is requested by the chair of a Congressional committee or the President or an appointee thereof (6103 f,g), when certain federal officers or employees require information for tax administration (6103 h) and when the information is to be used in a criminal or national security investigation at the federal level (6103 i). Under none of these circumstances is the designated recipient of the information permitted to share it; i.e. a shareholder of a corporation may not obtain the corporation’s tax return legally and then publish it or disseminate information to a third party.

Current law does not allow for prospective investors, less-than-one-percent investors or creditors to access a corporation’s tax return under normal circumstances. In 2003, Rep. Lloyd Doggett (D-TX) introduced in the House of Representatives a bill titled, Corporate Accountability Tax Gap of 2003 which would “…permit inspection of true corporate tax liability and understand the tax strategies undertaken by corporations, to discourage abusive tax sheltering activities, and to restore investor confidence in publicly traded corporations” (U.S. Congress 2003). The Act would have made public certain information including net corporate income tax, taxable income and certain book-tax differences but it has not yet been brought to a vote.

Some believe that public dissemination of tax returns would be a good idea on the basis that “sunlight is the best disinfectant” or that publicizing tax returns would increase the political pressure for tax reform. Others believe that providing information to investors that extends beyond the requirements of GAAP would improve the functionality of financial markets (Lenter, et. al. 2003 814). Because the IRS is the government agency responsible for enforcing tax law and it obviously has access to return data, it is not likely that making tax returns public would improve the ability of the government to enforce laws; §6103 of the U.S. Code already allows for federal agencies to obtain relevant data from a tax return where appropriate. While it is possible that financial experts might be able to obtain information regarding income tax expense calculations beyond what GAAP provides, FIN 48 has already reduced the ability of corporations to manage earnings through valuation allowances to the extent that viewing the tax return would not enhance markedly the quality of information required by GAAP.

An interesting argument for making at least a portion of corporate tax returns public is that to do so would encourage tax compliance because corporate managers would be wary to practice aggressive tax avoidance with the understanding that stakeholders might frown upon such behavior as evidence of bad corporate citizenship. While there is evidence that both customers and stockholders consider a social responsibility and corporate citizenship in decisions to purchase from or invest in a company, the evidence does not suggest that the financial performance of corporations is materially affected by these perceptions or that the dutiful payment of taxes is of particular importance to these stakeholders (Lenter, et. al. 2003 820). The argument is also weakened by the consideration that public disclosure of tax returns might actually incite companies to decrease their tax bills for fear of being compared by investors to competitors with smaller tax bills.

The most sustainable argument for publicizing corporate tax returns, then, is that doing so might encourage political and public pressure for fairness in the tax system by exposing inequities among companies or industries or discrepancies between the goals and outcomes of particular tax laws. While such would likely have positive outcomes, the downsides of making tax returns public need to be considered as well.

Both the Securities and Exchange Commission and the Treasury Department responded negatively to the 2002 inquiry of Sen. Charles Grassley (R-Iowa), a letter suggesting that regulators and the public might benefit from making corporate tax returns public (Lenter, et. al. 2003 804). Lenter, et. al. suggests the following as primary reasons to retain confidentiality of corporate tax returns: corporations might withhold important but sensitive information in reporting their tax liability if that information were to be publicly available, financing and operating strategies of corporations would be openly revealed to competitors and some corporations might choose to become private or even relocate to a foreign country in order to avoid disclosing such information. The issue, then, is whether the privacy of corporations ought to be trumped by the federal government's interest in establishing a fair tax system and collecting an appropriate level of revenue in accordance with the design of that system.

Government/Taxpayer Relationship

By its nature, the relationship between taxpayers and their government – a government comprised of and controlled by taxpayers - is complicated because while it is in the interest of taxpayers in the aggregate for the government to collect enough revenue to provide the services they have, in theory, demanded of it, each individual taxpayer is inclined to pay as little as possible. The task of the IRS, then, is to perform audits at a rate that deters tax evasion, encourages maximum compliance and minimizes the cost of administration.

In fiscal year 2008, the most recent year for which comprehensive data is available, the IRS employed 20,722 enforcement officers and collected a total of $56.4 billion through automatic underreporting techniques – for example, comparing W-2 and 1099 forms submitted from banks, investment firms and employers with the information supplied by taxpayers – and traditional examination techniques. 1.01% of individual returns were audited, with an emphasis on higher-income taxpayers; 5.57% of tax returns reporting an income of $1 million or higher were examined, compared to 0.95% of returns reporting an income of less than $200,000. The audit rate is low for smaller corporations – only 0.95% of corporations listing less than $10 million in assets were audited in FY 2008, but 15.3% of corporations listing assets greater than $10 million were examined; the rate rises to 27.4% for corporations listing assets of over $250 million (Fiscal).

After being notified of the results of an examination, corporate and individual taxpayers have an opportunity to substantiate their claims; the IRS may accept the tax return as filed, propose a settlement with the taxpayer or disallow certain tax treatments. The taxpayer is then afforded the opportunity to contact the Appeals office of the IRS or dispute the IRS's decision with a formal trial in a court of law.

FIN 48 and Schedule UTP stand to affect nearly every step of the audit process. While the specifics of the IRS audit selection methods are purposefully not made public so as to not tip off potential tax evaders on what constitutes a red flag, the IRS has been straightforward in its message that agents will indeed use Schedule UTP to help guide decisions regarding which corporations to audit and which tax positions in particular to examine in that audit. In April 2010, IRS Commissioner Doug Shulman said that taxpayers and tax authorities both desire a balanced tax administration system that provides "an efficient use of government and taxpayer resources by focusing on the issues and taxpayers that pose the greatest risk of tax noncompliance" (Shulman 2010). In that same address, Shulman stated, "An important thing for you to realize is that a major goal of this proposal [an early draft of Schedule UTP that required taxpayers to list a maximum tax adjustment – that requirement was removed from the final instructions] is to use the schedule for audit selection, not just as information in audits."

Taxpayers are also concerned that Schedule UTP implicitly provides the IRS with privileged information. In preparing their financial statements in accordance with GAAP, corporations must frequently consult the expertise and counsel of a tax attorney, an accounting firm, or both so that it can support the MLTN status of claimed tax benefits recorded in the financial statements to its financial statement auditor. Schedule UTP requires taxpayers to identify not only benefits that fail the MLTN test on their technical merits but also benefits that would fail the MLTN were it not for the firm's intent to litigate an adversarial opinion of the IRS. In a very real sense, then, a corporation is required to unveil to the IRS the opinions of its legal counsel – that is, the opinion that a position is not MLTN to succeed on technical merit even if it can, perhaps, succeed on legal merit – before any sort of trial begins. As one scholar articulates, "Ambiguity in the tax law is resolved by litigation – a system of adversaries. For effective common law to develop, courts must hear 'zealous advocacy' from both sides in every case. Tax law is no exception." (Jones 799).

Empirical research finds that many companies released a material amount of tax reserves shortly prior to the effective date of FIN 48 (Blouin, et. al. 2006, 808). The research supports the notion that many companies desire to minimize their FIN 48 liability. A desire to reduce the kind of IRS scrutiny that might weaken a corporation's negotiating positions is a probable contributing factor to this phenomenon; the authors also consider a desire of companies to record the release of any lingering excessive tax reserves as an increase in income statement earnings versus as a cumulative change in accounting principle adjustment to retained earnings that would have no effect on current-year income.

It should be noted that FIN 48 and Schedule UTP do not necessarily yield a disadvantage for every corporate taxpayer in every circumstance. On the contrary, the enhanced disclosure requirements for the first time allow a taxpayer to credibly indicate to the IRS that all or most of the positions taken in the tax return are MLTN to be sustained. "FIN 48 re-enforced my belief that taking risky tax positions is not in a company's best interest," wrote one tax professional wishing to remain anonymous. "I realize there are grey areas and differences of opinion can exist, but I've never lost an issue I've researched and built a solid supporting position for … My comfort level for taking a position is closer to a 'should' position and thus a FIN 48 reserve would be zero." The 2009 paper by Mills, et. al. finds that "taxpayers with strong positions have higher expected payoffs post-FIN 48 than they did pre-FIN 48" (29) because the government has less incentive to audit a company showing little or no uncertainty under FIN 48 compared to a company that provides no credible disclosure of position sustainability at all, and certainty compared to a company showing a high level of uncertainty.

Observed Attitudes of the IRS

In 1984, the U.S. Supreme Court ruled that the IRS may obtain tax accrual workpapers under 26 U.S.C. §7602, which authorizes the Secretary of the Treasury to summon and "examine any books, papers, records, or other data which may be relevant or material" to a particular tax inquiry (United States v. Arthur Young & Co., 813). The Court found that, "It is the responsibility of the IRS to determine whether the corporate taxpayer, in completing its return, has stretched a particular tax concept beyond what is allowed. Records that illuminate any aspect of the return – such as the tax accrual workpapers at issue in this case – are therefore highly relevant to legitimate IRS inquiry" (815). In that same case, the Court considered whether some sort of accountant-client privilege ought to be enacted, but found that because independent auditors, unlike lawyers, ultimately bear responsibility to the public over the client, "To insulate from disclosure a certified public accountant's interpretation of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations" (818).

Since the Supreme Court ruling, the IRS has affirmed a policy of restraint with regard to tax accrual workpapers. "Audit or tax accrual workpapers should normally be sought only when such factual data cannot be obtained from the taxpayer's records or from available third parties, and then only as a collateral source for factual data," the IRS writes in its Internal Revenue Manual (4.10.20.3.1). "Audit or tax accrual workpapers should be requested with discretion and not as a matter of standard examining procedure." This policy was first asserted in 1984, but was adjusted in 2002 to exclude "listed transactions" from restraint as a response to the growing preponderance of high-profile corporate tax shelters. After FIN 48 became effective in December 2006, there was much concern within the accounting profession that the IRS would be tempted to utilize FIN 48 workpapers and renege on its self-imposed policy of restraint. In May 2007, the IRS published a "FIN 48 Implications LB&I Field Examiners' Guide" which noted: "The disclosures required under FIN 48 should give the Service a somewhat better view of a taxpayer's uncertain tax positions; however, the disclosures still do not have the specificity that would allow a perfect view of the issues and amounts at risk." The guide continues, "Even with the lack of specificity, tax footnotes included in financial statements, including FIN 48 disclosures, should be carefully reviewed and analyzed as part of the audit planning process … Revenue Agents should not be reluctant to pursue matters mentioned in FIN 48 disclosures, but should be mindful of our policy of restraint on Tax Accrual Workpapers and not cross over the boundaries contained there." The guide also notes that some taxpayers desire expedient resolution of uncertain tax issues since a large FIN 48 liability can have a negative impact on the financial statements.

In 2009, the issue of work product privilege was applied to FIN 48 in USA v. Textron. Textron is a publicly traded company audited by Ernst & Young; in 2003, the IRS audited Textron's 2001 tax return and issued an administrative summons to obtain tax accrual work papers under §7602 because it was suspected by the IRS that Textron had engaged in sale-in, lease-out transactions as well as other "listed transactions." The U.S. Court of Appeals for the First Circuit ruled that Textron's work papers are not protected under the work product privilege because tax accrual work papers are prepared primarily for the sake of calculating items to be included in financial statements and not in anticipation of a court trial (24). The Supreme Court decided not to review the appeal, letting the ruling of the appeals court stand.

The 2009 Textron case differs from the 1984 Arthur Young case in that Textron's work papers were produced by Textron's tax department with consultation from outside legal counsel; in the Arthur Young case, the work papers were prepared by the auditor and so the issue of work product privilege was never considered. The driving contention in the Textron case is not the relevance of the tax accrual work papers to the IRS audit but whether or not the work papers can be considered documentation that is prepared because of the prospect of litigation. Essentially, the First Circuit court's ruling holds that the work required to document a FIN 48 analysis for the sake of proving proper financial statement to auditors can be requested and summoned by the IRS in order to determine whether or not a tax benefit holds merit. Because managers of publicly traded companies need to support the assertions contained in financial statements in order to obtain an unqualified opinion from an auditor, they are left no choice but to prepare documentation of uncertain tax positions that incorporates the opinions of legal counsel knowing that such documentation could ultimately be used against them by the IRS.

In response to these concerns, the IRS in October 2010 issued Announcement 2010-76, which expanded the Service's existing policy of restraint; the announcement affirms the ability of agents to request documentation of legal support for positions, but permits taxpayers to withhold a document if it "is otherwise privileged under the attorney-client privilege, the tax advice privilege in §7525 of the Code, or the work product doctrine and the document was provided to an independent auditor as part of an audit of the taxpayer's financial statements." That policy became effective Sept. 24, 2010. Once again, the policy of restraint does not apply if unusual circumstances exist or if the taxpayer has claimed the benefits of one or more "listed transactions." The IRS also permits taxpayers to redact information from requested tax reconciliation work papers if that information contains specific calculations and reserve amounts related to Schedule UTP.

On March 23, 2011, the IRS issued a "Frequently Asked Questions on Schedule UTP" on its website; the document clarified that the policy of restraint outlined in Announcement 2010-76 applies to documents requested by Appeals as well as documents requested by Counsel after a Tax Court petition has been filed by a taxpayer.

Initial Schedule UTP Proposal and Feedback

On April 19, 2010, the IRS released a draft of Schedule UTP that would have, if fully enacted without revisions, required corporations listing assets of $10 million or greater to disclose UTPs to the IRS beginning in tax year 2010. The initial draft required filers to complete the same analysis as is required in the final version, but also required corporations to calculate and report a Maximum Tax Adjustment for each UTP – the maximum amount in dollars that might be retained by the IRS should the IRS prevail in challenging the position.

After an open comment period, the IRS made adjustments to the draft that eliminated the Maximum Tax Adjustment requirement, allowed corporations to exclude UTPs that were not reserved under FIN 48 because of administrative practice and scaled back the filing requirements so that only those companies listing $100 million or greater in assets would be subject to the requirements immediately. Corporations listing $50 million in assets will fall under the requirements beginning in tax year 2012, and corporations listing $10 million will begin filing Schedule UTP in tax year 2014. A final major adjustment in the final draft is the elimination of the requirement for corporations to report to the IRS the rationale for taking an uncertain position. Critics had argued that such a requirement would force corporations to reveal privileged information to the IRS. The final version requires corporations to explain the nature of the uncertainty for each UTP but does not ask them to justify their decision to take the position.

The upsides of Schedule UTP from a public perspective are not trivial. The schedule will allow the IRS to audit more efficiently by concentrating its resources on resolving those issues that are most likely to exploit inconsistencies and ambiguities in the tax code. The manager of accounting policy and financial research for FEI writes that a review of reported UTPs will allow the IRS Large Business & International Division to potentially undergo the process of "publishing guidance necessary to eliminate uncertainty wherever possible, as well as identifying areas for possible legislative changes" (Wei 2010). Both of these proposed uses of Schedule UTP would be legitimate and welcome. There is concern, though, that another use of the schedule involves the executive branch equivalent of judicial activism – proactively challenging tax positions in court or in negotiation in such a way as to maximize present and future collections instead of striving for consistent, objective interpretation of the law.

Interactions Between Schedule UTP and Restraint Policy

IRS Commissioner Doug Shulman stated to the American Bar Association that the IRS will not seek documents that would otherwise be privileged, nor will it procure drafts of issue descriptions or information regarding the ranking of issues used in preparation of Schedule UTP (Shulman 2010). The stated goal of the IRS is to create certainty for the government and taxpayers alike sooner and to operate efficiently and effectively. In a September directive, the Deputy Commissioner for Services and Enforcement of the IRS instructed personnel to "approach UTPs on audit keeping in mind their responsibility to apply the law as it currently exist, not how we would like it to be. We must do this without bias in favor of the government or the taxpayer" (Miller 2010). Though these words soothe the fear that the government will use Schedule UTP to exploit ambiguities in tax law, the structural system created by the policy relies heavily on a fallible promise. Once a corporation has acknowledged that a tax position is uncertain, the IRS has full reign to use that information to sway a court.

The LB&I Subgroup of the IRS Advisory Council reported in November 2010 that it disagrees with the issuance of Schedule UTP and finds "significant challenges to overcome to make sure that examination teams utilize the information contained on this schedule in a reasonable manner" (IRS Advisory Council). There is also legitimate concern about the consequences of Schedule UTP contents being released to foreign governments. The release of tax information between countries can trigger heavy scrutiny of transfer pricing arrangements that affect the taxability of income in various international jurisdictions, and jurisdictions outside of the U.S. might use the information aggressively to the disadvantage of corporations. The IRS has responded to this concern by noting that only under very limited conditions would release of Schedule UTP data to other jurisdictions be considered.

Role of Auditors in Government-Taxpayer Relationship

The largest U.S. corporations almost exclusively employ four global accounting firms:

Deloitte & Touch, Ernst & Young, KPMG and PriceWaterhouseCoopers. These firms have collectively become known as the "Big Four" because they collectively provide advisory, tax and auditing services to a vast majority of publicly traded and large private companies. The SEC does not require listed companies to choose these firms as auditors, but the Big Four have established globalized capabilities and competencies that regional firms cannot match. The Sarbanes-Oxley Act of 2002 forbids any accounting firm from simultaneously auditing and providing certain non-assurance to publicly-traded corporations. Many publicly-traded corporations therefore utilize two Big Four firms at once, each providing a different set of services. Considering that two international companies engaged in a merger or acquisition will likely each wish to retain one accounting firm to perform auditing services and one to perform due diligence services, a minimum of four global accounting firms must exist to provide support services to the two companies as they join together.

Accounting firms play a major role in determining the extent to which the IRS can successfully identify UTPs by certifying that the company's FIN 48 analysis has been sound. From an advisement perspective, accounting firms providing tax services can sell tax shelter packages or instruct tax avoidance strategies and provide legal and technical support for uncertain positions that can be used to justify categorizing a tax position as MLTN to be sustained upon audit. From an auditing stance, the firms bear the responsibility of certifying that a company's financial statements comply with GAAP and, by extension, ASC 740. Because the MLTN test involves a subjective judgment of the empirical justifiability of a tax position, the opinions of the tax advisor and auditor directly dictate whether or not a company will be required to report a given tax position to the IRS on Schedule UTP and subject that position to special scrutiny. The value of Schedule UTP, then, depends completely on how accounting firms interpret and enforce ASC 740 and the MLTN test specifically.

Because the Big Four exercise what amounts to an oligopoly over providing accounting and auditing services to the largest U.S. corporations, government agencies have a limited ability to sanction firms that violate policies. The 2003 KPMG tax shelter investigation illustrates this perfectly. Though the Senate found that KPMG had indeed knowingly sold tax shelters to clients, the government agreed to dismiss criminal prosecution of the firm so long as it paid $456 million in fines, restitution and penalties and complied with other conditions including the termination of two tax practice areas (IRS Notice 2005-83). Following the 2002 collapse of Arthur Andersen, the risk of another global accounting firm shuttering its doors posed too great a risk to the economy and so the government instead held KPMG to an impossible ultimatum. The Department of Justice's charges against 13 individual KPMG employees were later thrown out after a judge ruled that the U.S. improperly pressured KPMG to not pay the legal fees of its former employees. The case illustrates the tension between the desire of the government to influence the practices of accounting firms and the competing desire to have effective competition among large accounting firms. Though accountants and the FASB are in theory independent of the government and of clients, both are subject to political pressures. Accounting policies and disclosure requirements can either undermine or aid the enforcement techniques of governmental agencies and particularly the IRS, as illustrated by the Service's use of FIN 48 requirements to justify the issuance of Schedule UTP. Accounting practices and standards do not exist in a vacuum; they need to be useable and relevant to a system of stakeholders with different and sometimes conflicting needs.

The fact that the collapse of any one of the Big Four firms would pose a great risk to the global and domestic economy holds foreboding connotations for a public that depends on their auditing services. Though regulatory agencies like the IRS and SEC have the ability to sanction or press charges against corporations, they rely heavily on the notion that corporate financial statements have undergone reasonable verification by a Big Four firm.

Related Topics in Accounting

Accounting for income taxes is distinguished from accounting for most other types of transactions because income taxes are calculated using non-GAAP conventions. In discussing the issues associated with providing information to third-party users based on accounting estimates when the third-party user's reaction to and use of that information may well affect the extent to which the original estimate becomes a certainty, though, it is useful to consider the accounting treatment of contingent liabilities associated with litigation, the environment, and multiemployer plans. Additionally, consideration must be given to the fact that the U.S. will likely adopt International

Financial Reporting Standards to replace GAAP within this decade. Should the change come to pass, differences in accounting for uncertain income tax positions will affect the information collection techniques of the IRS.

Litigation Exposure

SFAS No. 5 provides guidelines that are intended to apply directly to the accounting for pending or threatened litigation. As mentioned earlier, the standard requires companies to accrue a loss if and only if the incurrence of a liability or impairment of an asset is probable and the amount of the loss can be reasonably estimated. The standard defines probable as: "The future event or events are likely to occur" (SFAS 5, 3a). If a loss is not accrued but there is a reasonable probability that a loss has occurred, disclosure must be made indicating the nature of the contingency and the range of the loss, if an estimate can be made (10). Contingent gains are never recorded in a company's financial statements, though careful disclosure must be made in the case that a gain is probable or reasonably possible (17a, b).

The FASB clarifies in SFAS No. 5 that, "The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of an unfavorable outcome must be assessed" (SFAS 5, 37). The statement appropriately suggests that accrual of a contingency should be based on an independent, technical analysis of the situation and not on the formal actions of an antagonist party. Under this thinking, corporations should not write off tax benefits that have been taken under the belief that they are consistent with prevailing tax law simply because the IRS or another regulatory agency has challenged the validity of those benefits.

The current guidelines for recording UTPs differs from the guidelines for recording the potential effect of future lawsuits in that tax benefits must be scrutinized even if management does not believe that the benefits will be challenged. SFAS No. 5 states: "With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome … If the judgment is that assertion is not probable, no accrual or disclosure would be required" (38). Corporations need not disclose or accrue losses related to litigation that is unlikely to ever be threatened because the potential plaintiffs are unaware that they have a valid complaint or choose not to press charges. Indeed, it would be nonsensical for a company to disclose and accrue a loss related to a lawsuit that would not even be brought were the company not openly admitting to having wronged another party. In such a case, the accounting framework would actually lead to the creation of a liability rather than being the mechanism that records it.

Where taxes are concerned, though, GAAP is requiring companies to do just that – create a liability that is nonexistent for practical purposes because of a theoretical application of accounting standards. Accruing or disclosing losses or foregone benefits related to UTPs would be appropriate only if the likelihood of those positions being audited is 100% independently of the loss disclosure.

While disclosures related to ongoing litigation do have the potential to give an opposing party's counsel insight into whether the company considers a loss reasonably possible or even probable, the judgment surrounding those disclosures is based on circumstances as they exist at the time the financial statements are compiled, not as they might exist after the statements are released. ASC 740 in conjunction with Schedule UTP creates an iterative effect whereby the accounting treatment affects the event being accounted for – a very troubling side effect considering the information provided by financial reporting is intended to be historical. The FASB writes: "To the extent that financial reporting provides information that helps identify relatively efficient and inefficient users of resources, aids in assessing relative returns and risks of investment opportunities, or otherwise assists in promoting efficient functioning of capital and other markets, it helps to create a favorable environment for capital formation decisions. However, investors, creditors, and others make those decisions, and it is not a function of financial reporting to try to determine or influence the outcomes of those decisions" (SFAC 1, 33). The FASB addresses taxing authorities specifically: "Although both taxing authorities and rate-making bodies often use the information in financial statements for their purposes, both also have statutory authority to require the specific information they need to fulfill their functions and do not need to rely on information provided to other groups" (26).

Environmental Liabilities and Asset Retirement Obligations

FASB Interpretation No. 47, like FIN 48, was issued in response to companies' adoption of diverse accounting practices related to AROs. FIN 47 clarifies that companies must record the fair value of conditional AROs as soon as incurred if the fair value can be reasonably estimated. In some cases, disclosure provided by the company is supplemented with and even dictated by data that is publicly available through the Superfund Program. Superfund refers to the 1980 Comprehensive Environmental Response, Compensation, and Liability Act that gave the Environmental Protection Agency the authority to identify parties responsible for the contamination of U.S. sites and compel cleanup efforts.

An interesting facet of the accounting guidelines related to AROs involves the characterization of a liability as broader than a contractual obligation to sacrifice a resource. Statement of Financial Accounting Standards No. 143 states that its guidelines apply to "legal obligations … a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel" (2). SFAS 143 applies promissory estoppel as defined by Black's Law Dictionary: "The principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment" (SFAS 143, A2c). The implementation guidance notes correspondingly that "a legal obligation may exist even though no party has taken any formal action" and requires entities to base their evaluation of whether an obligation exists on current laws and not on forecasts of future laws or changed interpretations of existing laws (SFAS 143, A3). The FASB cites the example of a CEO who makes public comments stating that his company will clean up an abandoned building in future years as potentially constituting a recordable liability under promissory estoppel. In its basis for conclusions, the FASB writes: "Once an entity determines that a duty or responsibility exists, it will then need to assess whether an obligating event has occurred that leaves it little or no discretion to avoid the transfer or use of assets" (SFAS 143, B29).

Again, while the public would like for all companies to voluntarily identify and clean up any environmental damage they cause, it would not make sense for companies to report to investors and creditors financial liabilities that have a remote probability of ever materializing. It is possible that laws becoming effective in the future will create environmental liabilities for certain companies, but to record an obligation related to a potential-but-not-certain legal requirement would not reflect the underlying realities in which the company operates and SFAS 143 appropriately requires that judgments be made in accordance with existing interpretations of existing laws. Financial statements should reflect the financial and economic position of a company as it really is, not as it would be under ideal or contrived circumstances. Ideally, all customers would satisfy debts owed to a company and an allowance for bad debts would be unnecessary; in a worst-case scenario, all debts would prove uncollectible and revenues would be recorded only when cash is received. Neither scenario is the most probable, though, and the current accounting system strives to best represent the actual probability of collecting the receivables rather than defer to extreme possibilities. Moreover, the probability that individual accounts will be collected is typically estimated using factors like the creditworthiness of the debtor, the size of the debt, the debtor's payment history and the length of time that has elapsed since the debt arose. The obligation to satisfy the debt has no relation to whether or not the company believes the debt is collectible. Similarly, the obligation to pay taxes associated with income realized in a given transaction or event is unrelated to whether or not the company or the IRS believes that obligation is real.

Of course, the enforcement of tax law by the IRS is usually the predicator of tax liabilities, but the associated actions would not create a liability were there not a legal framework detailing and mandating taxation policies in the first place. There are two factors that predicate the recording or disclosure of a liability where legal or environmental liabilities are concerned: that the liability arises out of a valid mechanism – an on-the-books law – through which a third party including but not limited to a governmental enforcement agency can demand payment from the company, and that some third party, known or unknown to the entity issuing the statement, will be aware of that mechanism and use it to seek payment.

Participation in Multiemployer Plans

The FASB is expected to issue a final document related to enhancing the disclosure requirements about an employer's participation in a multiemployer plans in the second quarter of 2011 (FASB Current Technical Plan). Existing guidance related to accounting for multiemployer plans is represented in Codification Subtopic 715-80. The FASB writes that it decided to update 715-80 after it received "comments from various constituents on the perceived lack of transparency about an employer's participation in a multiemployer plan" (FASB Exposure Draft). The proposed amendments would require employers to provide a narrative description of "the employer's exposure to significant risks and uncertainties arising from its participation in the plan(s). That narrative description shall include the extent to which, under the terms and conditions of the plan(s), the employer can be liable to the plan(s) for other participating employer's obligations." Employers would also be required to identify "known trends in contributions, including the extent to which a surplus or deficit in the plan may affect future contributions," and other related pieces of information.

Critics of the proposed amendment argue that it will discourage employers from providing defined benefit plans to employees and instead offer defined contribution plans because the amendment will force companies to disclose liabilities that are unlikely to be realized. In particular, the amendment would require companies to disclose the effects of their potential withdrawal from a multiemployer plan even if they have no intention of withdrawing. "As stated in the FASB's Guiding Principles, to be neutral, 'information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction,'" one critic writes (Kraw). "The FASB proposals, if adopted, are by their very construct biased against the continuation of multiemployer defined benefit plans. They inevitably will produce large amounts of inaccurate information that exaggerate pension plan liabilities, encourage short term thinking and push employers to exit." Other letters addressed the fact that information about assets and accumulated benefit obligations of defined benefit plans is difficult to collect and contingent upon decisions made by labor unions with little forewarning and thus would be dated and allegedly useless if presented in financial statements. One critic described the proposed disclosures as "inherently capable of misinterpretation, at best, and utterly meaningless, at worst" (Potts-Dupre).

Though the issues and potential impacts of the proposed multiemployer plan disclosure amendment are different from those associated with uncertain tax positions, the debate regarding when, if ever, to report prospective liabilities that have a remote chance of actually occurring. While it is true that companies choosing to withdraw from an underfunded pension plan must typically pay large withdrawal liability assessments or "exit fees," it is unreasonable to ask companies to report those amounts if the chance of ever having to pay those amounts is remote. Many businesses are susceptible to the impact of natural disasters and war, but a quantification of those kinds of risks would be misleading to a prospective investor if the businesses were otherwise financially secure.

Convergence with International Standards

The U.S. and the FASB are in discussions with the International Accounting Standards Board to eventually converge the guidelines of GAAP with those of International Financial Reporting Standards so that there will exist a set of unified global accounting policies. The SEC has indicated that the largest U.S. corporations will not be required to adopt IFRS until 2015 or 2016 at the earliest, if at all (Tweedie), and a final decision on whether or not to officially incorporate IFRS into the U.S. domestic reporting system may come during 2011.

If convergence does occur, it may yield an entirely new set of standards related to accounting for UTPs. Should ASC 740 be altered, Schedule UTP would have to be reevaluated. It is currently based on the MLTN test, a test that could be superseded or altered by new income tax accounting requirements. Schedule UTP is now justified on the basis that companies do not incur significant costs in preparing Schedule UTP because they already analyze the sustainability of tax positions in order to comply with GAAP. If the requirement to analyze the sustainability of all tax positions ceases, Schedule UTP compliance would become more costly for companies.

Accounting for UTPs Under IFRS

International Accounting Standard No. 12, "Income Taxes," currently advises that unresolved disputes with tax authorities be handled in accordance with IAS 37, "Provisions, Contingent Liabilities and Contingent Assets" (IAS 12, 88). IAS 37 advocates an expected outcome approach that uses the probability-weighted average of a variety of possible outcomes to calculate the amount that should be recorded as a tax benefit or liability. The standard requires separate treatment of provisions, defined as "liabilit[ies] of uncertain timing or amount" and contingent liabilities, defined as "a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity" or a present obligation not recognized because resource outflow is improbable or the amount of the obligation is uncertain (IAS 37, 10). UTPs would likely be treated as contingent liabilities because the obligation to pay the tax is dependent upon the actions of regulatory agencies and courts.

IAS 37 does not require entities to recognize contingent liabilities (27), but does require disclosure "unless the possibility of an outflow of resources embodying economic benefits is remote" (28). Contingent liabilities must be continually assessed and recognized as a provision in the financial statements "if it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability" (30). The standard instructs: "Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities … The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used" (39). Disclosure must include a brief description of the nature of the obligation and an indication of the uncertainties about the amount or timing of outflows (85). The standard does not explicitly state the extent to which individual liabilities must be separately identified, stating, "It is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements" (87).

At a July 2005 meeting of the IASB, the Board agreed that enterprises should presume that taxing authorities will review a tax positions when evaluating whether the position is probable of being sustained and that consideration of detection risk is inappropriate (IASB Agenda Project). An exposure draft proposing to replace IAS 12 was issued in March 2009. It included the following guidance: "Uncertainty about whether the tax authorities will accept the amounts reported to them by the entity affects the amount of current tax and deferred tax. An entity shall measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the tax authorities will examine the amounts reported to them and have full knowledge of all relevant information. Changes in the probability-weighted average amount of all possible outcomes shall be based on new information, not a new interpretation by the entity of previously available information" (Exposure Draft 26).

In November 2009, the IASB found that support from respondents was limited and decided that the project would not proceed in its then-current form (IASB Agenda Project). On its website, the IASB writes: "The project originally started as a convergence project with US GAAP. However, in the light of responses to an exposure draft published in 2009, the Board has narrowed the scope of the project. The Board may consider a fundamental review of the accounting for income taxes after 2011" (Work plan for IFRSs). Though the Board intends to consider uncertain tax positions separately from IAS 12 as a whole, it will not visit the issue until the revision of IAS 37 is finalized; that project will not be finished until after June 2011 according to the work plan website.

Another point of distinction to be resolved between GAAP and IFRS involves the reporting threshold. While ASC 740 disallows companies from recording any portion of a tax benefit that is less than 50% likely to be sustained, IFRS tends to utilize an expected-outcome method. Consider a tax benefit of $100 that the company believes has a 20% chance of being completely sustained, a 40% chance of being reduced to $60 and a 40% chance of being completely disallowed. The FIN 48 test would require that the company record a tax benefit of $60, since the probability that the benefit will be at least $60 is 60%: 40% plus 20%. An expected-outcome calculation would yield a tax benefit of $48: 0.20*100 + 0.40*60 + 0.40*0.

If there was no chance that the $100 benefit would be disallowed entirely but a 40% chance it would be reduced to $50, the FIN 48 test would still yield a $60 tax benefit but an expected-outcome approach would yield a recordable benefit of $62: 0.20*100 + 0.40*60 + 0.40*50. Though an expected-outcome calculation incorporates a wider range of possible outcomes, critics argue that it requires companies to estimate the probability that remote and highly certain positions will be sustainable. The Tax Executives Institute commented on the IAS 12 exposure draft: "The absence of a recognition threshold (as proposed in the Exposure Draft) would result in potential inaccuracies by requiring companies to recognize tax benefits that are highly uncertain or even those for which no or only meager authority exists. Likewise, reserves would have to be provided for highly certain positions if there are possible outcomes yielding less than 100 percent of the tax benefits. The measurement of tax positions that are at the highly certain or highly uncertain ends of the probability spectrum should not be skewed by outcomes that are remote" (TEI Comments).

IAS 12 is silent on UTPs in its existing form, so the ultimate IFRS will likely have a significant impact on the future of Schedule UTP if the U.S. does adopt international reporting standards in the future.

Conclusions

The FASB defines a liability as a "probable future sacrifice of economic benefits arising from a present obligation." The legal requirement to pay taxes clearly creates a liability, and stakeholders of a company need to be aware of that company's liabilities in order to make an informed decision regarding whether or not to enter into a financial relationship with the company. What FIN 48 attempts to address, though, are those situations in which it is unclear whether or not the obligation to pay taxes exists. U.S. tax law includes a large number of provisions governing income and expense classification as well as policy-driven deductions, credits and penalties that require tremendous compliance efforts. When tax laws do not neatly correspond to the events and transactions undertaken by a given corporation, the managers of that business must interpret applicable laws and decide whether or not to report taxable income.

If corporations report to the IRS and other regulatory agencies tax benefits that are likely to be challenged and reversed, investors should be made aware of those potential liabilities. The problematic side effect of reporting such liabilities, though, is the possibility that doing so may actually trigger scrutiny of the positions that would not have taken place absent the financial reporting. The statute of limitations for tax reporting far exceeds the time period companies are afforded to prepare financial statements, and so regulators will always be able to refer to a company's financial statements in inspecting that company's tax return. Though FIN 48 was originally intended to clarify reporting practices related to income taxes and has been successful in creating more consistency than existed previously, it has also created a tool through which regulators can garner a peek into the perspective of the taxpayer – an advantage not reciprocated. The requirements of FIN 48 make it far more difficult for tax-aggressive companies to underreport tax liability, but at the cost of potentially influencing, for better or worse, the economic realities that GAAP purports to reflect.

While the disclosures required by FIN 48 are theoretically flawed because detection risk is ignored, an aggregated presentation of potential tax liability is not egregiously harmful. Though some distortion occurs in estimating tax position sustainability without regard to audit probability, the distortion is likely less significant than that created by the misuse of reserves and reporting policy discrepancies that were permissible under SFAS 109.

Of greater concern from a policy standpoint is the IRS's new Schedule UTP. Though the schedule will undoubtedly improve the U.S. government's ability to target its audits toward likely tax evaders and thereby increase corporate collections, it holds the capacity to alter the dynamics of the taxpayer-government relationship significantly. Even if the IRS upholds its policy of restraint and chooses not to seek explicitly privileged documentations and opinions, it will now have at its disposal a tool that allows it to target those tax benefits that a company's managers, lawyers and accountants believe are susceptible to successful challenge, even if those parties all believe that the position has standing supportable by law. While decisions regarding tax law will ultimately be made in the courts, the fact that the IRS will have undue insight into the strength of taxpayer positions means it can potentially strong-arm companies into reaching settlements or sway a judge knowing that the company's management has exposed internal doubts on the sustainability of a position.

Of course, that the IRS merely has the ability to take maximal advantage of Schedule UTP disclosures does not mean that it will do so, just as not all corporations will play the "audit lottery" or take potentially risky tax positions simply because they have the option to do so. Checks on each party are important to maintaining the integrity of a taxation system born out of democratic processes and based on self-reported liabilities versus government-imposed assessments. The IRS – an agent of the public itself – needs to retain the ability to effectively audit individual and corporate taxpayers so that tax burdens are effected in the manner that the legislative branch of government has instructed. Similarly, taxpayers must be afforded the ability to dispute IRS decisions and have contentions resolved by a neutral third party, the judicial branch. These checks allow the need of both parties to pursue their respective interests to be balanced by a public-demanded fairness.

If the IRS is going to ask corporate taxpayers to disclose information intended for internal use, the agency should provide a similar level of disclosure regarding its interpretations of its own policies and case assessment strategies. Taxpayers should have plentiful opportunities to solicit guidance from the IRS and seek preliminary interpretations of policy without the possibility that such inquiries will color subsequent, formal assessments. In 2005, the IRS piloted the Compliance Assurance Process, a program that allowed some large business taxpayers to identify and resolve complicated tax issues prior to filing their tax return. The program allows the IRS to use audit resources more efficiently, gives the taxpayer more certainty and a reduced compliance burden and provides financial statement users with more precise and reliable tax information than is available when a company's tax return is completely subject to challenge by regulatory agencies. The CAP, though, is currently optional and Schedule UTP is not. The IRS should continue to make guidance publicly available so that taxpayers, if they so choose, can satisfy themselves as to a tax position's sustainability before taking the position and deciding whether or not to record it in the financial statements.

The issues associated with accounting for income taxes also need to be part of a larger, ongoing conversation about revisions to the U.S. tax code. Many cite the financial burden of complying with the current system and high marginal corporate tax rates as reasons to modify the system so that top marginal rates are lower but fewer deductions and credits are available. A simpler tax code could reduce the incidence of uncertain tax positions altogether, a trend that would benefit the IRS, taxpayers and financial statement preparers and users.

Works Cited

American Institute of Certified Public Accountants, "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals." March 2001.

Bank, Steven. "Entity Theory as Myth in the Origins of the Corporate Income Tax." 43 Wm. & Mary L. Rev. 447 (2001), <http://scholarship.law.wm.edu/wmlr/vol43/iss2/3>

Bartlett, Bruce. "The Federal Tax Debate: How Much Should Corporations Pay?" Prepared for The Heritage Foundation. Jan. 8, 1985.

Bernasek, Anna. "Should Tax Bills Be Public Information?" *The New York Times*. Pub. Feb. 13, 2010.

Blouin, Jennifer, Cristi Gleason, Lillian Mills and Stephanie Sikes. "Pre-Empting Disclosure? Firms' Decisions Prior to FIN No. 48." *The Accounting Review*. May 2010.

Congressional Budget Office Paper: The Incidence of the Corporate Income Tax. March 1996.

Congressional Budget Office Testimony: Trends in Federal Tax Revenues and Rates. Statement of Douglas Elmendorf, CBO Director, before the United States Senate Committee on Finance. Dec. 2, 2010.

Dhaliwal, Dan, Cristi Gleason and Lillian Mills. "Last-Chance Earnings Management: Using the Tax Expense to Meet Analysts' Forecasts." *Contemporary Accounting Research* Vol. 21 No. 2. Summer 2004.

Drucker, Jesse. "Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes." Bloomberg. Oct. 21, 2010. <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>

Exposure Draft ED/2009/2. Income Tax. Issued March 2009. International Accounting Standards Board.

Federal Accounting Standards Board. Current Technical Plan and Project Updates. <http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1218220137074> Accessed March 16, 2011.

Federal Accounting Standards Board Exposure Draft. Compensation – Retirement Benefits – Multiemployer Plans (Subtopic 715-80). Disclosure about an Employer's Participation in a Multiemployer Plan. Issued Sept. 1, 2010.

Federal Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. June 2006. Financial Accounting Standards Board.

Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. Financial Accounting Standards Board. Issued February 1992.

Fiscal Year 2008 IRS Enforcement Results. Internal Revenue Service. <irs.gov/pub/irs-news/2008_enforcement.pdf>

Flora v. United States, 362 U.S. 145, 176 (1960).

General Accounting Office of the United States, Testimony before the Committee on Finance, U.S. Senate. "Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters." Statement of Michael Brostek, Director, Tax Issues. Oct. 21, 2003.

Gleason, Cristi and Lillian Mills. "Materiality and Contingent Tax Liability Reporting." *The Accounting Review.* April 2002.

Gravelle, Jane and Thomas Hungerford. "Corporate Tax Reform: Issues for Congress." Congressional Research Service. Oct. 31, 2007.

Hanlon, M., and J. Slemrod. 2006. What does tax aggressiveness signal? Evidence from stock price reactions to news about tax aggressiveness. University of Michigan working paper.

Helman, Christopher. "What the Top U.S. Companies Pay in Taxes." *Forbes*. April 1, 2010. <http://www.forbes.com/2010/04/01/ge-exxon-walmart-business-washington-corporate-taxes_2.html>

Higgins, Anthony. Statement. 26 Cong. Rec. 6874. 1894.

IASB Agenda Project. Convergence Issues – IFRSs and US GAAP: Income Taxes. Deloitte Global Services Limited.

Internal Revenue Manual. Internal Revenue Service.

Internal Revenue Service Advisory Council. Large Business and International Subgroup Report. Nov. 17, 2010. <irs.gov/taxpros/article/0,,id=231502,00.html>

Internal Revenue Service Announcement 2010-76.

Internal Revenue Service Data Release. "Corporation Income Tax Brackets and Rates, 1909-2002."

Internal Revenue Service Notice 2002-50, "Tax Shelter." Issued May 24, 2005.

Internal Revenue Service Notice 2005-83, "KPMG to Pay $456 Million for Criminal Violations." Issued Aug. 29, 2005.

International Accounting Standard 12, Income Taxes. As amended up to Dec. 31, 2009. Issued Oct. 1996. International Accounting Standards Committee Foundation.

International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets. As amended up to Dec. 31, 2009. Issued Sept. 1998. International Accounting Standards Committee Foundation.

Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002.

Jones, Andrew. “FASB – The IRS’s New Best Friend: How FIN 48 Affects the Taxpayer-IRS Relationship and Potential Taxpayer Challenges.” Georgia State University Law Review, Vol. 25, Issue 3.

Kraw, George. Comment Letter to the Financial Accounting Standards Board. Sept. 15, 2010.

Kwiatek, Harlan. “FIN 48 and State and Local Income Taxes.” Ed. Scott Salmon. *The Tax Adviser*. Sept. 1, 2007.

Lenter, David, Douglas Shackelford and Joel Slemrod. “Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives.” *National Tax Journal*. Dec. 1, 2003.

Levinsohn, Alan. “Shuttering Tax Shelters.” *Strategic Finance*. Oct. 1, 2005.

Levitt, Arthur. “The ‘Numbers Game.’” Remarks to the Securities and Exchange Commission at the New York University Center for Law and Business, New York, NY. Sept. 1998.

Lisowsky, Petro. “Seeking Shelter: Empirically Modeling Tax Shelters Using Financial Statement Information.” Sept. 13, 2010.

McGill, Gary and Edmund Outlsay. “Did Enron Pay Taxes? Using Accounting Information to Decipher Tax Status.” *Tax Notes*, Vol. 96, No. 8, Aug. 2002.

Miller, Steven. Directive for All Large Business and International Division Personnel. Sept. 2010.

Mills, Lillian. “Book-Tax Differences and Internal Revenue Service Adjustments.” *Journal of Accounting Research*. 1998.

Mills, Lillian, Leslie Robinson and Richard Sansing. “FIN 48 and Tax Compliance.” March 2009.

Montgomery, Lori. “Volcker-led economic panel pushes lawmakers to simplify U.S. tax code.” *The Washington Post*. Aug. 27, 2010.

Pollock v. Farmers’ Loan & Trust Company, 157 U.S. 429 (1895), aff’d on reh’g, 158 U.S. 601 (1895).

Potts-Dupre, David. Comment Letter to the Financial Accounting Standards Board. Sept. 20, 2010.

Public Law 86-272. 15 U.S.C. §381.

Report of the Commissioner of Corporations on the System of Taxing Manufacturing, Mercantile, Transportation, and Transmission Corporations in the States of Ohio, Indiana, Illinois, Michigan, and Wisconsin. Taxation of Corporations: Part III – Eastern Central States 3. 1911.

Robinson, John, Stephanie Sikes and Connie Weaver. “Performance Measurement of Corporate Tax Departments.” Sept. 2009.

Schedule UTP Instructions, 2010. Internal Revenue Service, Department of the Treasury.

Shulman, Douglas. “Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman before the Tax Executives Institute 60th Mid-Year Meeting.” April 12, 2010.

“State Tax Nexus: Nexus, Multistate Tax and State Net Operating Loss Issues Practice Guides.” AICPA. 2007.

Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises. Financial Accounting Standards Board. Nov. 1978.

Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information. Financial Accounting Standards Board. May 1980.

Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements. Financial Accounting Standards Board. Dec. 1985.

Statement of Financial Accounting Standards No. 5, Accounting for Contingencies. Financial Accounting Standards Board. March 1975.

Statement of Financial Accounting Standards No. 143, “Accounting for Asset Retirement Obligations.” Financial Accounting Standard Board. June 2001.

Stecker, J. Howard. Letter of Comment No. 61, FIN 48. Sept. 12, 2005.

Stromsem, William. “Private Companies and FIN 48.” *Journal of Accountancy*. Jan. 17, 2009.

Taft, William. Statement. 44 Cong. Rec. 3344. 1909.

Tax Policy Center: “The Numbers: What Are the Federal Government’s Sources of Revenue?” April 22, 2009. Accessed Jan. 9, 2011. <taxpolicycenter.org/briefing-book/background/numbers/revenue.cfm>

TEI Comments on IASB Income Tax Exposure Draft (IAS12). Vincent Alicandri, Tax Executive Institute. Aug. 7, 2009.

“The Constitution of the United States.”

Treasury Department, “The Problem of Corporate Tax Shelters, Discussion, Analysis and Legislative Proposals.” July 1999.

Tweedie, David. “The Future of Financial Reporting: Convergence or Not?” Address to the U.S. Chamber of Commerce. March 10, 2011.

United States of America v. Textron Inc. and Subsidiaries. United States Court of Appeals For the First Circuit No. 07-2631. 2009.

United States Code: Title 26, Subtitle F, Chapter 61, Subchapter B, §6103. “Confidentiality and disclosure of returns and return information.”

U.S. Congress. House. Corporate Accountability Tax Gap Act of 2003. 108th Congress, 1st sess., 2003. H.R. 1556.

United States Department of the Treasury. “History of the U.S. Tax System.” <https://ustreas.gov/education/fact-sheets/taxes/ustax.shtml> Accessed Dec. 18 2010.

United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs. “U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals.” 2003.

United States v. Arthur Young & Co., 465 U.S. 805, Volume 465. 1984.

Wei, Ronald. “IRS Additional Guidance on Uncertain Tax Positions Still Concerns Financial Executives.” *Financial Executive* Dec. 2010: 13-14.

Wessel, David. “Tax Redo Seeks ‘Level Playing Field.’” *The Wall Street Journal*. Jan. 27, 2011.

Work Plan for IFRSs. Income Taxes. International Financial Reporting Standards Foundation. Accessed March 20, 2011. <http://www.ifrs.org/Current+Projects/IASB+Projects/Income+Taxes/Income+Taxes.htm>

Yrjanson, Carla and Jeff Tuthill. “Leveraging the Knowledge of Complementary Tax Groups.” *Financial Executive* Dec. 2010: 24-28.