June 2010

State Tax Return

Volume 17 Number 2

UNCERTAIN TAX POSITIONS, AND THE "OTHER SHOE"

Carolyn J Lee
New York
1.212.326.3966
cjlee@jonesday.com

In January the IRS issued Announcement 2010-9,[1] heralding the requirement that corporate taxpayers disclose to the IRS, beginning with their 2010 federal income tax return, "uncertain tax positions" in respect of which reserves have been established for financial accounting purposes. Demonstrating a lovely sense of irony, the IRS has described this as part of a "policy of restraint,"[2] under which they will not generally seek to discover the work papers underlying financial reserves for tax positions, a policy that is of heightened interest given the U.S. Supreme Court's recent denial of cert. in *Textron*.[3]

In its most recent, and increasingly controversial guidance, issued in April,[4] the IRS has formalized the disclosure proposal by proposing a specific form (and instructions) on which taxpayers will disclose Uncertain Tax Positions.[5] The form contemplates that taxpayers will provide, among other things, (i) a statement of the rationale for the tax position; (ii) a statement of the reasons that position is uncertain; and (iii) a quantification of the maximum tax adjustment associated with the position in respect of which the reserve was established.

Linking income tax reporting to financial accounting raises a variety of issues, not simply in understanding what the IRS thinks it wants, but also in evaluating the content and tenor of a taxpayer's response, as well as deeper questions of the wisdom, long-term, of deriving tax reporting obligations from financial accounting principles. Given the vast expanse of the federal corporate income tax in which even well-intentioned, diligent and thoroughly advised taxpayers simply have no guidance, there is a certain *je ne sais quoi* in asking that taxpayers self-report to those who should be interpreting the tax law the taxpayers' unknowns, and the consequent financial tax exposures.

---

[1] I.R.S. Announcements 2010-9, 2010-7 I.R.B. 408, 2010-17, 2010-13 I.R.B. 515; and 2010-30, 2010-19 I.R.B. 668.

[2] See I.R.S. Announcement 2010-9, *supra*, I.R.S. Announcement 2002-63, 2002-2 Cum. Bull. 72.

[3] *U.S. v. Textron, Inc*., 577 F 3d 21 (1st Cir. 2009), *cert. denied*, No. 09-750, May 24, 2010.

[4] I.R.S. Announcement 2010-30, *supra.*

[5] I.R.S. Draft Schedule UTP (Form 1120), issued April 19, 2010.

But the scope of the IRS' disclosure requirements is only one part of the puzzle.[6] States have, in recent years, initiated their own disclosure and reporting requirements, for example California's required disclosure of their "listed transactions,"[7] and New York's reporting requirements for reportable transactions.[8] States have similarly responded to the offshore account mess, for example, by "fess up"[9] shots across the bow, and through explicit reminders that federal disclosures do not resolve state taxes.[10]

The question, then, is where states might go with the IRS's UTP disclosure concept. A simple scenario is that states might require, directly or as a consequence of requiring a copy of the federal return, copying the states on the federal disclosures. That may be relevant in some circumstances; substantive federal income tax positions obviously can materially impact state income taxes, especially when the underlying question is not *when* (timing) but *who* (allocation) or *whether* (deductibility/income in the first place). But there are many federal corporate tax issues that have no meaningful analog in state taxation—in particular for taxpayers with foreign operations.

By the same token, there is a forest of state tax issues for which federal IRS disclosure of federal corporate income tax reserves means nothing. Nexus; combination; allocation; apportionment; the composition of factors; throw-outs; throw-backs; Public Law 86-272 issues; non-income taxes—these are the things SALT advisors spend their days (and nights) addressing. The possibility that SALT issues sufficiently material to require a reserve might soon require state disclosure, and how disclosure might work—especially in circumstances where a reserve relates to not filing at all—raises the specter of significant complexity in SALT compliance, as well as another series of tax pressures that may affect financial reporting.

The IRS Commissioner has opened Pandora's box. The reverberations throughout the tax compliance community are only beginning to be understood. As taxpayers and their advisors process the federal guidance, and the compliance delivered in response, we should also contemplate where the other shoe will lead us.

[6] On this subject generally, the Report of the Tax Section of the New York State Bar Association on Announcement 2010-9 offers some interesting observations. NYSBA Tax Section Report #1208, March 29, 2010.

[7] See Cal. Rev. & Tax Code §19164(b).

[8] N.Y. Tax Law §25(a)(3).

[9] www.tax.state.ny.us/e-services/vold/program_info.htm.

[10] See, *e.g.*, Connecticut's SN 2009(5), relating to the disclosure of offshore accounts.