

Insuring The New Uncertainty About Disclosing Tax Uncertainty

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IRS Commissioner Douglas H. Shulman calls it a “game changer.” For the first time in U.S. history, taxpayers (in this case, corporations that reach the applicable asset threshold) must disclose to the IRS in a narrative format a concise description of their uncertain tax positions. Will your corporation or corporate client be affected? Affected corporations must also rank the relative priority of their exposure among their disclosed tax positions. And they must do so as part of their federal income tax return filings!

This article briefly summarizes the “nuts and bolts” of the new filing requirements, describes what tax insurance is and how it can be used to mitigate the risk of adverse tax examinations.

1. Who Must File Schedule UTP. Will Your Corporate Entity or Client Be Affected?

Schedule UTP is applicable to most public or privately held corporations that issue audited financial statements, have one or more “uncertain tax positions” and meet the total asset threshold. Essentially, all subchapter C corporations, foreign corporations with US source income, life insurance companies and property-casualty insurance companies that meet the asset threshold, have uncertain tax positions and issue (or are included in) audited financial statements must file Schedule UTP.

The IRS is implanting a five-year phase-in of the reporting requirements imposed by Schedule UTP based upon asset size:

| <u>Tax Year Requiring Schedule UTP</u> | <u>Asset Size</u> |
|--|-------------------|
| 2010 | \$100M or more |
| 2012 | \$50M or more |
| 2014 | \$10M or more |

A corporation has an uncertain tax position if:

- (1) The corporation or a related party has recorded a reserve with respect to U.S. federal income tax position taken in its current tax year or a prior tax year in its audited financial statements or

- (2) The corporation or a related party has not recorded a reserve with respect to U.S. federal income tax position taken in its current tax year or a prior tax year in its audited financial statements on the basis that the corporation or related party expects to successfully litigate the tax position.

Tax positions taken in current year's tax return are reported in Part I of Schedule UTP. Tax positions taken in tax returns for prior tax years are reported in Part II of Schedule UTP. Once a position is reported in Part I, it need not be again reported in Part II. However, if a tax position affects current and past years (e.g., step-up in basis, loss carry-forward, etc.), the position must be reported in Part I for each such year.

Transition Rule May Be A Huge Break. Part II does not need to be completed for tax positions taken before the 2010 tax year began. Thus, a corporation is not required to report on Schedule UTP a tax position taken in a tax year beginning before January 1, 2010, even if a reserve is recorded with respect to that tax position in its audited financial statements issued in 2010 or later.

The IRS, however, is considering whether to extend Schedule UTP reporting requirements to include pass-through entities and tax-exempt entities and is expected to issue additional guidance on the extension during 2011.

1. What Must Be Disclosed in Schedule UTP

As to each uncertain tax position that either has a reserve or has no reserve because the taxpayer expects to litigate the position, Schedule UTP requires a concise description of the tax position, including a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue.

The IRS seeks a level of disclosure that would be consistent with the disclosure required under Form 8275, that is used to avoid certain accuracy-related and/or preparer penalties. The form is used when a taxpayer is taking a position that is contrary to a revenue ruling, for example.

The instructions for Form 8275 require a "description of the relevant facts affecting the tax treatment of the item. To satisfy this requirement you must include information that reasonably can be expected to apprise the IRS of the identity of the item, its amount (not required for UTP) and the nature of the controversy or potential controversy [which can include] a description of the legal issues presented by the facts."

The concise description need not include the rationale for the position, the basis for the uncertainty or the taxpayer's assessment of the position.

The Instructions for Schedule UTP offer the following examples of concise descriptions:

- “The corporation incurred costs of completing one business acquisition and also incurred costs investigating and partially negotiating potential business acquisitions that were not completed. The costs were allocated between the completed and incomplete acquisitions. The issue is whether the allocation of costs between incomplete acquisitions and the completed acquisitions is appropriate.”
- “The corporation is a member of Venture LLC, which is treated as a U.S. partnership for tax purposes. The corporation received a cash distribution during the tax year from Venture LLC. The issue is the potential application of section 707(a)(2) to re-characterize the distribution as a sale of a portion of the corporation’s Venture LLC interest.”
- “The corporation incurred costs during the tax year to clean up environmental contamination that was caused by its activities in prior years at site A, which contains both the manufacturing facility and its corporate headquarters. The issue is the allocation of the cleanup costs between X’s production and non-production activities under section 263A.”

The corporation must separately flag transfer-pricing positions and must rank (“1” for the largest, “2” for the next largest, etc.) by size each tax position listed in Part I of Schedule UTP. Size is determined by the amount of reserve taken for a position (which may include the interest and penalties, if reserved for the position) or (with respect to positions not reserved because of an expectation to litigate) relative exposure. If the relative size of the tax position is equal to or greater than 10% of the aggregate tax reserves for U.S. income tax uncertainty, it must be separately flagged as a major tax position.

2. Potential Impact on Public Companies and Likely Affected Industries

The requirement to “confess and rank” required under Schedule UTP can be particularly problematic for public companies. Companies with large reserves for U.S. tax positions may not have the liquidity required to suddenly pay over such reserves to the IRS.

And as for amounts not reserved, the interplay between GAAP, Schedule UTP, securities law, and corporate governance can be particularly complex. To the extent that the discrepancy between tax reserves taken for financial statements and the actual exposure under Schedule UTP widens, and imposes liquidity problems, the “duty to speak” and/or implement proper corporate governance would appear to heighten.

IRS Commissioner Doug Shulman has indicated that directors are legally charged with oversight of their company’s compliance with tax laws. He has proposed a number of detailed inquiries that should be made by audit committees. These suggested inquiries could well become the standards that a plaintiffs’ attorney will

seek to impose upon the board after an IRS examination of Schedule UTP leaves the company with a significant liquidity problem or diminished net worth/significant charge to earnings.

3. Mitigating the Risk of Adverse Tax Consequences through Tax Insurance

Tax insurance is a loss transfer technique. The risk that one or more uncertain tax positions will be successfully challenged is transferred to an insurance carrier in exchange for a premium. The Treasury somewhat cautiously supports tax insurance by requiring compliance with the “material advisor regulations” only when “tax result protection” insures some or all of the benefits of a “reportable transaction.” Treas. Reg. 301.6113(b)(2)(ii)(A). For this reason, most carriers will not insure a “reportable transaction.”

Tax insurance can provide needed liquidity, as well as additional expertise, in the event an uncertain tax position is challenged. Tax insurance typically covers the amount of additional taxes, penalties, and interest on additional taxes and penalties. Tax insurance typically also covers the costs of defending a challenge after administrative recourse is exhausted – allowing the insured to control the audit. Lastly, tax insurance can also pay a “gross-up” – *i.e.*, the approximate amount of tax incurred by the receipt of tax insurance proceeds.

Many believe that tax insurance is a complement or alternative to a tax opinion. Consider:

- A “covered” tax opinion (that adequately addresses the law that opposes the tax position) is required to avoid penalties. Tax insurance will cover penalties if assessed and the need to disclose the covered opinion is obviated.
- Even a “covered” tax opinion that is disclosed to the IRS with respect to a tax position does not protect against the assessment of additional taxes and interest arising from the disallowance of that position. Tax insurance allows the legal argument to be made plus provides indemnity and liquidity if the position is disallowed.

Tax insurance is expected to provide particular utility with respect to uncertain tax positions that have not been reserved but must be disclosed under Schedule UTP. To the extent insurance covers tax positions not reserved but disclosed under Schedule UTP, the taxpayer has adequately addressed any risk of non-compliance with tax laws and/or securities laws if an adverse determination is subsequently rendered.

As part of its loss mitigation services, the tax insurance underwriter will suggest language for how a covered tax position should be disclosed under Schedule UTP.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. Pursuant to U.S. Treasury Department Circular 230, unless we expressly state otherwise, any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing or recommending to another party any matter(s) addressed therein. No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

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