



FIN 48: Will It Be a Roadmap To the IRS?

Much has been discussed about the painstaking process GAAP financial statement filers are going through to prepare for their adoption of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). The effective date is for fiscal years beginning after December 15, 2006, and as a result, year-end filers are in the process of documenting their tax positions before review by external financial auditors.

Disclosures

One thing to keep in mind while going through the process of determining your uncertain tax positions under FIN 48 is how your financial statement disclosures might impact future tax authority examinations. FIN 48 requires financial statement filers to provide the following annual disclosures:

- a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period of review
- the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate
- amounts of interest and penalties recognized
- description of tax years that remain subject to examination by major tax jurisdictions
- significant detail related to positions where it is reasonably possible (roughly 30 percent chance) that the total amounts of unrecognized tax benefits will increase or decrease significantly within 12 months of the reporting date, such as from the lapse of a statute of limitations or close of an IRS audit.

The threshold question is whether any of these disclosures will provide the IRS with a roadmap to a taxpayers tax positions. At first glance, the tabular reconciliation and footnote disclosures would not be of concern since the tabular reconciliation does not provide specific tax position information, and thus, may not reveal anything specific that might catch the IRS's attention. The IRS's access to the underlying workpapers used to support the disclosures, however, may provide the type of

speakers' corner

- **Philip Cook** will be presenting a state and local tax update for the Community College of Allegheny County (CCAC) CPE Program on February 10, 2007.
- **Lance Jacobs** will be presenting a Virginia sales tax litigation update at the Institute for Property Taxation on February 20, 2007.
- **David Kaplan** will be speaking at the University of Pennsylvania Law School Symposium on Executive Compensation on February 27, 2007. He will be discussing disclosure of executive compensation and taxation of deferred compensation.
- **David Young** will be a panelist at the CXO Forum at the Tower Club in Vienna, VA, on March 8, 2007. The panel is titled "CEOs Update on Company Valuation."
- **Christian Wood** will be on the Section 263(a) Tangible Property Regulations panel at the 31st Annual Tax Law Conference presented by the Section of Taxation of the Federal Bar Association in Washington, D.C., on March 9, 2007.

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specific information that might be used to challenge a taxpayer's position.

The IRS generally has followed a policy of restraint in requesting a taxpayer's accrual workpapers when conducting an examination. There are very limited circumstances where the IRS requests the tax accrual workpapers, including situations in which the tax accrual workpapers relate to listed transactions. So it would seem that the underlying documentation required by FIN 48 is subject to the same standards as before. FIN 48 may, however, raise new questions about what is an appropriate request by the IRS for detailed financial statement workpapers. For example, what is to stop the IRS from requesting a mere list of a taxpayer's uncertain tax positions in an information document request as part of an examination? Also, IRS officials recently commented that the restraint policy is always under review and subject to change. Thus, the real impact of FIN 48's supporting documentation may still be unknown.

Benefit Recognition

Another area that could result in major controversy is the effect that future recognition of uncertain tax positions will have on IRS examinations. Paragraph 10 of FIN 48 requires that if a more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, the financial statement filer must recognize the benefit of the tax position in the first interim period if (among other events) the matter is ultimately settled through negotiation or litigation.

FASB has received numerous comments about the meaning of "ultimately settled" and directed its staff to write new guidance to clarify this statement. Many have interpreted ultimately settled to mean that if an examination is closed and an uncertain tax issue has not been challenged, the position is considered ultimately settled. In this case, the uncertain position then would be recognized for financial reporting purposes.

The question that this raises is what disclosures must a financial statement filer make when an IRS examination is closed and uncertain tax positions are left on the table? As discussed above, a significant decrease in the uncertain tax positions that will occur within 12 months must be disclosed. Thus, a disclosure of a decrease in uncertain tax positions following a closed examination may send a red flag to the IRS that it missed something.

Some may argue that the IRS could reopen the examination after a taxpayer discloses the decrease in uncertain positions because without it, "a serious administrative omission" would have occurred.

Although relatively unused, the IRS does have the authority under Rev. Proc. 2005-32, 2005-23 IRB 1206 (5/20/05) to reopen a closed case if:

- there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of material fact;
- the closed case involved a clearly defined, substantial error based on an established Service position existing at the time of the examination; or
- other circumstances exist indicating that a failure to reopen the case would be a serious administrative omission.

Some may argue that the IRS could reopen the examination after a taxpayer discloses the decrease in uncertain positions because without it, "a serious administrative omission" would have occurred. With Congress currently very concerned with the tax gap, it seems the IRS would be under severe scrutiny if a large taxpayer disclosed the release of an uncertain tax position following an examination, and the IRS did not pursue every opportunity to assess additional taxes from a taxpayer. It seems likely that the IRS would have an incentive to reopen the closed case if such a disclosure were to occur.

Pepper Perspective

In light of the possibility of future exam issues that now may have been created under FIN 48's adoption, taxpayers may consider seriously existing IRS programs to gain clarity for certain positions prior to reporting them on their financial statements, such as private letter rulings, pre-filing agreements, early referrals to appeals and accelerated issue resolution. By getting the certainty upfront, financial statement filers also can avoid wasted time fighting with their external auditors about the appropriate level of comfort for tax issues that have no overwhelming clear

answers. In fact, taxpayers may find themselves in the strange position of working with the IRS to fairly resolve a technical tax issue under their facts, because it is easier and more certain than dealing with the IRS than their external financial auditor.

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Have You Spoken to Your Accounts Payable People Lately?

If not, perhaps you should. The IRS has announced plans to audit 100 percent of all taxpayers that file forms 1042 – the forms that evidence payment of U.S. source fixed, determinable annual, periodic income (FDAP) to non-U.S. persons. The first batch of audit letters has been sent out to 5,000 taxpayers. Such payments are generally subject to a 30 percent withholding tax, unless there is an applicable treaty or statutory exemption. In order to claim the benefits of a treaty, or some of the statutory exemptions, the payor must have on file properly executed documentation. Absent having the documentation, the 30 percent rate applies. While the tax is the liability of the foreign person, if the US payor fails to withhold, the U.S. payor is liable for the full amount of the taxes and associated penalties.

More Than Just a Financial Institutions' Concern

The withholding rules are often thought of a problem for the banks – regular payors of FDAP type income. The concern, however, is not restricted to financial companies. The IRS instituted a voluntary compliance program in September 2004, which ended in June 2006. Approximately 1/3 of those who entered the program were non-financial multinationals.

Royalties, Interest, Dividends and Consulting Fees

What type of payments may be at risk? Does your company pay cross border royalties for the use of property in the U.S.? Those are subject to the withholding tax, unless a treaty applies. Many treaties will reduce the tax to zero. But, if you do not have on file the correct documentation, withholding at 30 percent is required. Does your U.S. company pay interest on a loan from a non-U.S. related party? The interest payments are subject to the 30 percent withholding tax unless a treaty reduces or eliminates the tax. Again, in order to claim the treaty benefits, the proper documentation is needed. Did your U.S. company pay a dividend to non-U.S. shareholders? The dividend is generally subject to a 30 percent withholding tax unless an applicable treaty reduces the rate. Did your U.S. company pay a non-U.S. consultant for work done in the U.S.? You guessed it – those payments are generally subject to the 30 percent withholding tax unless you have on hand appropriate documentation to claim an exemption.

Sufficient Documentation

Appropriate documentation is generally one of the Forms W-8, or for the consultant claiming benefits of a tax treaty, a Form 8233.

Many of the types of payments that are subject to the withholding tax are handled in a mechanical manner by the administrative units responsible for processing invoices. Experience is showing, however, that they may not have been given sufficient guidance on how to apply the withholding tax.

Failure to have systems in place to assess the need to withhold is becoming an issue under the Sarbanes-Oxley Act. In addition, once you do find out there is an issue, the exposure needs to be considered in light of FIN 48, as the tax is an income tax.

Pepper Perspective

The IRS expects to impose rigorous audit standards; partially completed forms or mis-completed forms will not be acceptable. Penalties are being emphasized. Taxpayers would be well advised to clean up before the IRS knocks by determining:

*The IRS and Treasury have requested comments on the proposed regulations and other approaches that might be adopted. Such comments must be received by April 23, 2007.*⁶

1. if the taxpayer is making payments of FDAP to non-U.S. persons
2. if the proper forms are being obtained, and they are correctly filled out
3. if withholding has occurred where needed
4. if Forms 1042 and 1042-S have been filed
5. if withheld taxes have been timely deposited with the IRS.

If there is an issue, there is still some benefit to voluntary disclosure, but the time for that is now, not after the audit notice is received.

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Proposed Loss Disallowance Rules Break Cover

On January 16, 2007, the IRS and the Treasury Department issued proposed regulations addressing, among other things, the circumvention of *General Utilities* repeal and the duplication of loss by consolidated groups.¹ The proposed rules are designed to provide an integrated approach to address both of these concerns while preserving the result of the *Rite Aid* decision.²

The proposed regulations are the result of an extensive study by the IRS and the Treasury Department. They consist of three principal rules that apply when a member transfers a share of subsidiary stock with a basis in excess of its value – known as a “loss share.”

Basis Redetermination

The first rule, referred to as the “basis redetermination rule,” reallocates consolidated return investment adjustments, to the greatest extent possible – first to eliminate loss on preferred shares and then to eliminate basis disparity on all shares.³ This rule is designed to “bring members’ bases closer into alignment with the assumptions underlying the investment adjustment system.”⁴

Basis Reduction

The second rule, referred to as the “basis reduction rule,” reduces the basis of each transferred loss share, but not below value, by the lesser of the share’s “net positive adjustment” and its “disconformity amount.”⁵ This rule is intended to eliminate presumed noneconomic stock loss.⁶

A share’s “net positive adjustment” is generally the greater of zero or the sum of all investment adjustments applied to the basis of the transferred loss share, including those made under the “basis redetermination rule.”⁷ This amount reflects the extent to which a share’s basis has been increased by the investment adjustment provisions.⁸

A share’s “disconformity amount” is the excess of its basis over its allocable portion of the subsidiary’s “net inside attributes” at the time of the transfer.⁹ The subsidiary’s “net inside attributes” generally is the sum of the subsidiary’s loss carryovers, deferred deductions, cash and asset basis.¹⁰ The rationale behind limiting the amount of basis reduction to the share’s “disconformity amount” is that such amount identifies the minimum amount of unrecognized appreciation actually reflected in the basis of such share at the relevant time.¹¹

Attribute Reduction

The third rule, referred to as the “attribute reduction rule,” reduces the subsidiary’s attributes by the lesser of the “net stock loss” and the “aggregate inside loss.”¹² This rule is intended to insure that the group does not recognize more than one loss with respect to a single economic loss regardless of whether the subsidiary remains a member of the group.

The “net stock loss” is the excess of the sum of the bases (after application of the above rules) of all subsidiary shares transferred by members in the same transaction over the value of such shares.¹³ The “aggregate inside loss” is the excess of the subsidiary’s “net inside attributes” over the value of all of the subsidiaries shares.¹⁴ For this purpose, “net inside attributes” is similar to the amount computed for purposes of the “basis reduction rule,” subject to special rules for lower-tier subsidiaries.¹⁵

The IRS and Treasury recognize that this approach allows taxpayers to accelerate the recognition of losses that a subsidiary has chosen not to recognize.¹⁶ Nevertheless, they “believe that this approach best preserves the result in *Rite Aid* while addressing loss duplication.”¹⁷

The attribute reduction rule also allows the common parent of a group to elect to reduce stock basis, reattribute attributes, or do some combination of basis reduction and attribute reattribution, if the subsidiary ceases to be a member of the group, in order to prevent the reduction of attributes otherwise required under these rules.¹⁸

Special Rules

These rules generally are applied in the order described.¹⁹ Special rules are provided to determine application in the case of transfers of stock of multiple subsidiaries.²⁰ Additionally, the rules contain safe-harbor provisions that call off application in certain situations.²¹ Further, a general “anti-abuse and anti-avoidance” provision provides that “appropriate adjustments” will be made if a taxpayer attempts to avoid the application of these rules.²²

These proposed regulations would be effective on the date they are published as final regulations in the Federal Register.²³ The IRS and Treasury have requested comments on the proposed regulations and other approaches that might be adopted. Such comments must be received by April 23, 2007.²⁴

Pepper Perspective

These proposed regulations are the result of extensive study by the IRS and Treasury and represent an attempt to address both the circumvention of *General Utilities* repeal and the duplication of losses by consolidated groups. Given the history of prior regulatory attempts to address these issues, the IRS and Treasury are likely to receive substantial comments on the approach adopted in these proposed regulations and other possible approaches that should be

considered. Until final regulations are issued, taxpayers should continue to apply the existing loss disallowance regulations.

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Endnotes

- 1 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 2 *Rite Aid Corp. v. U.S.*, 88 AFTR 2d 2001-5058; 255 F.3d 1357 (July 6, 2001). IRS and Treasury Department interpret the preservation of the result of *Rite Aid* to mean that regulations addressing loss duplication by consolidated groups must not disallow a deduction for an economic loss on subsidiary stock solely because the stock loss duplicates unrecognized or unabsorbed losses that later could be used outside the group.
- 3 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 4 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 5 Prop. Treas. Reg. § 1.1502-36(c)(1)(B)(2).
- 6 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 7 Prop. Treas. Reg. § 1.1502-36(c)(3).
- 8 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 9 Prop. Treas. Reg. § 1.1502-36(c)(4).
- 10 Prop. Treas. Reg. § 1.1502-36(c)(5).
- 11 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 12 Prop. Treas. Reg. § 1.1502-36(d)(3).
- 13 Prop. Treas. Reg. § 1.1502-36(d)(3)(ii).
- 14 Prop. Treas. Reg. § 1.1502-36(d)(3)(iii).

- 15 Prop. Treas. Reg. § 1.1502-36(d)(3)(iii)(B).
- 16 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 17 *Id.*
- 18 Prop. Treas. Reg. § 1.1502-36(d)(6).
- 19 Unified Rule for Loss on Subsidiary Stock, 72 Fed. Reg. 2963 (January 23, 2007).
- 20 *Id.*
- 21 *Id.*
- 22 *Id.*
- 23 *Id.*
- 24 *Id.*

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