



Public Policy Alert

Public policy impacting business

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Evolving Policies Impact Board Oversight of Tax Risk

A series of recent evolving tax policy developments may prompt boards and their companies to revise their tax risk oversight policies, procedures, and governance in order to minimize tax exposures and to avoid incurring new penalties for noncompliance.¹

These developments are aligned with the Administration's focus on increased transparency and effective enforcement. The Internal Revenue Service (IRS) recently received several important tools that will help the IRS plan and prioritize audits, identify key issues for examination, and facilitate enforcement activities, particularly with respect to multinational companies.² Importantly, the developments underscore the need for boards to increase their participation in tax risk oversight.

IRS Commissioner Douglas Shulman has commented publicly that "...I am suggesting that you, the leaders of your organizations, should have a mechanism to oversee tax risk as part of your governance process..."³. The

new provisions encourage a level of transparency that will assist the IRS in its enforcement initiatives; however, not all companies are prepared to meet the higher disclosure expectations, which may also have unintended consequences. Leading companies are rethinking their policies for developing and documenting tax positions as well as engaging their boards in the dialogue.

Focus on Transparency and Effective Enforcement

While tax rules have changed considerably since last November, several key developments underscore the trend toward more taxpayer transparency and stronger enforcement of the rules.⁴

Executives and board members ask, "Have we adapted our tax risk management planning for this new tax environment?"

1. Have new and evolving tax policies such as the proposed tax return disclosure of uncertain tax positions and their implications for tax audits been incorporated into the company's tax risk planning and oversight process?
2. Has the company considered the potential impact of a new law that gives the IRS an additional tool for challenging the "economic substance" of transactions?
3. Is the company aware that, as a result of newly enacted legislation, failure to report certain information regarding foreign entities will extend the period of limitations with respect to the company's entire tax return, which in turn could extend the period that companies will maintain tax provisions for financial statement purposes?

¹ For more insights on evolving tax policies see: *The Increasing Importance of Tax Risk Oversight: Recent Perspectives from Tax Administrators*, KPMG LLP, January 2010.

² The IRS is interested in "learning what issues are there so that resources can be devoted to issues that are important and not wasted on issues that are not important.", Chief Counsel, IRS, William J. Wilkins, November 2009.

³ Doug Shulman, IRS Commissioner, addresses the National Association of Corporate Directors (NACD) Governance Conference, IR-2009-95, October 19, 2009, www.irs.gov.

⁴ For more information on the Administration's theme of enforcement see: *Public Policy Alert: Preparing for Increased Regulatory Oversight and Enhanced Enforcement*, KPMG LLP, October 2009.

IRS Commissioner's Expectations for Board Oversight

"My goal is to promote good corporate governance on tax issues and engage the corporate community in a dialogue about the appropriate role of the board of directors in tax risk oversight. This will continue to be a theme of ours."

Doug Shulman, IRS Commissioner, addresses the New York State Bar Association Tax section annual meeting, January 27, 2010. www.irs.gov.

IRS Policy Goals: Effective Enforcement

"It would add efficiency to the process if we had access to more complete information earlier in the process regarding the nature and materiality of a taxpayer's uncertain tax positions. The goals of our process are simple: to cut down the time it takes to find issues and complete an audit.... and help us to prioritize selection of issues and taxpayers for examination."

Doug Shulman, IRS Commissioner, addresses the New York State Bar Association Tax section annual meeting January 27, 2010, www.irs.gov.

Uncertain Tax Positions (UTP)

In a series of Announcements, the IRS set forth a proposal that would require certain corporate taxpayers to file a new schedule, "Schedule UTP."⁵ Required filers would have to disclose any tax position for which the taxpayer or a related entity has recorded, or in some cases not recorded, a reserve on its financial statements.⁶

As currently proposed, a taxpayer must also provide a concise statement for each disclosed tax position that explains why that position was disclosed as uncertain. These disclosures precipitate several new considerations.

First, the proposed requirement to disclose the maximum tax adjustment may cause examining agents to assume tax risk where no such risk actually exists because the calculation assumes total disallowance.⁷ In addition, depending on the detail ultimately required for Schedule UTP, additional resources may be needed to prepare information not already required by Financial Accounting Standards Board Interpretation No. 48 (FIN 48) *Accounting for Uncertainty in Income Taxes*.⁸

Second, since a UTP disclosure may implicitly expose a taxpayer's own assessment of risk for that tax position, it raises concerns about potential disclosures of privileged information.

Lastly, companies are concerned that the IRS's new window into its tax risk through Schedule UTP will be distorted

because the disclosures may exaggerate the company's tax risk profile. In anticipation of this, corporate boards should consider various steps they can take to ensure proper oversight. For example, a company's tax department should be able to show objective evidence to the IRS that the company employs sound management and governance of its internal tax processes. And, as suggested by Commissioner Shulman, a company's board of directors might want to consider establishing a confidence level threshold for taking a tax position as part of the company's tax practices governance process.⁹

The IRS is still considering what penalties or sanctions may be imposed if a taxpayer fails to adequately disclose the information that must be reported on Schedule UTP. However, anticipating that Schedule UTP will give rise to increased enforcement, leading companies are taking steps now to reconsider existing and new transactions in light of the proposed disclosure obligation.

Codification of Economic Substance

A new law gives the IRS an additional tool to encourage transparency around transactions. This often-overlooked new law, enacted as part of the healthcare reform legislation,¹⁰ allows the IRS to disallow tax benefits associated with transactions lacking economic substance (even if the transactions satisfy the technical tax rules), and imposes a substantial strict liability penalty on these transactions thereby introducing

⁵ Announcement 2010-9, 2010-7 I.R.B. 408, www.irs.gov.

⁶ The draft instructions to a publicly released, draft version of Schedule UTP state that a taxpayer that has assets exceeding \$10 million is required to file Schedule UTP if it (or related entity) determines reserves for tax positions that affect the U.S. federal income tax liability of such taxpayer under U.S. GAAP, IFRS, or other country-specific accounting standard. Under the current proposal, the Schedule UTP will require disclosure of any tax position for which the taxpayer or a related entity has not recorded a reserve because (i) the taxpayer expects to litigate the position, or (ii) the taxpayer has determined that the IRS has a general administrative practice not to challenge the position.

⁷ The Schedule UTP generally is expected to require taxpayers to specify the maximum U.S. federal income tax liability that would arise if a tax were disallowed by the IRS in its entirety.

⁸ Financial Accounting Standards Board Interpretation No. 48, June 2006, *Accounting for Uncertainty in Income Taxes*, amends Statement of Financial Accounting Standards (SFAS) 109 and specifies the accounting and reporting requirements for the uncertainty in tax positions an entity may take. FIN 48 has been incorporated into Topic 740 of the FASB's Accounting Standards Codification.

⁹ Doug Shulman, IRS Commissioner, October 19, 2009, *ibid*.

¹⁰ *President Obama Signs Second Part of Health Care Reform Legislation*, KPMG Tax News Flash, March 30, 2010.

additional uncertainties and complexity into transaction structuring.

These uncertainties can affect a company's overall tax risk exposure, as well as its financial statements.

The new law strengthens the IRS's hand and raises the stakes in the event of a tax dispute. Very generally, a transaction must meaningfully change the taxpayer's economic position (apart from federal income taxes) and the taxpayer must have a substantial nontax purpose for entering into the transaction. Achieving a financial accounting benefit is not taken into account in determining if the taxpayer had a substantial nontax purpose if the origin of such benefit is simply a reduction of federal income tax.

The stakes associated with the new economic substance provisions are high. Transactions lacking economic substance can be subject to a penalty of 40 percent of the amount of the tax underpayment attributable to the disallowance of tax benefits.¹¹ Because the penalty is a strict liability penalty, a company cannot protect itself by securing an opinion from its tax advisor or by otherwise demonstrating that it acted reasonably and in good faith. However, a company may be able to mitigate the amount of the potential penalty by carefully considering the impact of the legislation on existing transactional arrangements. In addition, any recalibration or changes in the company's appetite for risk should be reviewed with the board in light of the penalties as well as the potential brand and reputational risk associated with IRS challenges to their tax positions.

Significant questions remain as to the scope of this new law and when or if the IRS will provide related guidance, so the

very presence of the law has created increased tax uncertainty and risk. As a result, executives may want to start the process of assessing the impact of the new law on their companies' decision-making processes and reviewing oversight emphasis relating to activities potentially impacted by this new law.

Extension of Statute of Limitations

A new law contains a key provision under which a failure to properly disclose certain cross-border information keeps the statute of limitations for assessment open for a company's entire income tax return.¹²

Perhaps the most important nontax ramification is its effect on financial statement reporting. Specifically, as long as even a simple failure to comply with one of the specified foreign information reporting requirements exists, the limitations period for that tax return remains open indefinitely. Any prior year tax reserve subject to this new section that the taxpayer thought would have closed under the general three-year limitations period now cannot be released if there is any failure to comply with a reporting rule covered by the statute.

Another key ramification is the effect that this extended period of limitations could have on buyers and sellers of businesses. In the past, buyers and sellers may have taken comfort in the fact that certain tax years were closed for further tax assessment and need not be taken into account in indemnification agreements or other provisions. However an inadvertent failure to complete one of the required forms may keep a tax year open that the parties otherwise thought to be closed. For some companies, the

Another Tax Policy Impacting Business Decisions

"Codification [of Economic Substance] will have a dramatic effect on what taxpayers do, requiring them to carefully review each transaction to determine what risks might apply and if penalties could be imposed. It will slow transactions down quite significantly."

News Analysis: Will Economic Substance Codification Be Worth It? Tax Law Community, Posted 04/30/2010 05:22:00 PM EST.

¹¹ The penalty is reduced to 20 percent if the taxpayer adequately discloses the transaction on its tax return.

¹² [Hiring Incentives to Restore Employment] *HIRE Act Dramatically Changes the Potential for an Indefinite Statute of Limitations*, Paul Manning, Harve Lewis, Lauren Roberts, KPMG's What's News in Tax, April 19, 2010. Under additional proposed legislation in the American Jobs and Closing Tax Loopholes Act (H.R. 4213), the taxpayer can demonstrate reasonable cause for a failure to comply with an information reporting requirement; the statute of limitations would remain open solely with respect to the item or items for which there is such a failure to comply.



change to the statute of limitations could significantly impact negotiations with third parties. Pending guidance from Treasury and the IRS, taxpayers, and their advisors must also consider the implications of this rule on periods prior to the new rules.

Careful consideration of risk and rewards involving an open dialogue between and among a company's board of directors, tax leadership, and other relevant stakeholders may provide an opportunity to reduce the potential impact of this new tax development.

Implications to Board Oversight

Taken together, these tax developments underline how critical it is that a company's tax risk governance and management process is an ongoing topic of discussion at board meetings. Leading governance practices include a review of the mission and strategy of the tax department; a current evaluation

of the tax profile of the entity; the process by which tax uncertainties are identified, documented, and evaluated; the procedures that exist to integrate tax analysis into business decisions; the adequacy of tax department personnel; and the process to monitor major public policy developments.¹³

These developments also reflect the importance of making sure a company's overall risk management and governance programs address tax risk. As an example, leading companies typically carefully examine transfer pricing practices, which focus on business transactions across borders. The IRS has embraced the Advance Pricing Agreement program that provides for an agreement on pricing methodology between the IRS and the taxpayer prior to filing a return. Arguably, this practice could have a positive impact on a tax risk profile.

Leading companies are incorporating this broader interpretation of governance and tax risk into a natural part of the wider corporate governance agenda in order to meet the higher demands of transparency and effective enforcement in the new economy.¹⁴

KPMG Tax Governance Institute Survey says Many Tax Issues Are Not Elevated to the Board

While the IRS believes that the Board of Directors is an "important player in the tax system," a survey by the KPMG Tax Governance Institute indicates that 59 percent of the over 1,800 executives and tax professionals polled were uncertain as to whether the Schedule UTP policies had been elevated to the attention of their board of directors, and 13 percent would not elevate this topic to the board at all.

Disclosing Uncertain Tax Positions to the IRS – A Conversation with the Chief Counsel of the IRS, KPMG Tax Governance Institute, March 2, 2010.

¹³ For more information on the appetite for risk, see *What's Your Company's Risk Culture?*, Farrell, John Michael and Hoon, Angela, directorship.com, April 15, 2009.

¹⁴ *Boards and the Oversight of Tax Risk – An International Perspective* by Shaun Kelly, Vice Chair, Tax, KPMG in the United States and Loughlin Hickey, Global Head of Tax, KPMG in the United Kingdom, Directorship, November 11, 2009.

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