



# MULTISTATE TAX REPORT



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## I.R.C. Conformity

With the recent release of a draft “Schedule UTP,” the IRS continues its agenda to require disclosure of uncertain tax positions on federal corporate income tax forms. While the new schedule appears to exclude state-related uncertain tax positions, the question remains whether states will follow suit and require such disclosures on their own corporate income tax forms. In this article, the authors offer their assessment of what states are likely to do and discuss steps taxpayers could take to mitigate exposure.

## The Proposed Federal Schedule UTP and State Conformity: Implications for Taxpayers if States Require Similar Disclosure

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### INTRODUCTION

**M**uch to the chagrin of the accounting profession and U.S. business, the Internal Revenue Service continues its agenda to require disclosure of ASC §740-10 (formerly FIN 48) uncertain tax positions (UTP) on federal corporate income tax forms. On April 19, 2010, the IRS unveiled a draft “Schedule UTP” and clarifying instructions that would require taxpayers to report a position if they made a decision to record a reserve at least 60 days before filing a tax return.

Taxpayers also would have to report a position if they made a decision not to record the reserve, at least 60 days before filing, based on an expectation to litigate

or an IRS administrative practice. These reporting requirements apply to current and prior year tax positions, with a transition rule so tax positions taken in prior years need not be reported.

Per IRS Announcement 2010-30, the reporting requirement, if approved, would apply to all Federal Form 1120 filers<sup>1</sup> beginning with 2010 returns that have both:

- uncertain tax positions, and
- assets equal to or exceeding \$10 million.

The Schedule UTP has several components that could prove challenging for taxpayers. The most significant of these likely is the inclusion of a “maximum tax adjustment,” which is defined as “an estimate of the maximum amount of potential federal income tax liabil-

<sup>1</sup> In addition to the Form 1120, Forms 1120L (Life Insurance Company Income Tax Return) and 1120 PC (U.S. Property and Casualty Insurance Company Income Tax Return) would be required to file Schedule UTP.

ity associated with the tax year for which the tax position was taken.” Not only is this amount difficult to understand per the draft instructions, but it presents a “red flag” for auditors and offers a “road map” for a company’s key federal income tax positions. Also significant is the “concise description of uncertain tax position” requirement. Again, the instructions are lengthy and vague, presenting not only an administrative burden to taxpayers, but also a trap for those new to this schedule and its implications.

Despite its many challenges, there is a favorable aspect to the proposed Schedule UTP in that it appears to exclude state-related uncertain tax positions and the effects of a federal tax position on state income taxes. The question then becomes whether states will follow the IRS’s lead and require similar disclosures within state income tax returns and/or the inclusion of the federal Schedule UTP.

In this article, we will analyze which states are likely to follow the IRS’s lead and require state-related uncertain tax position disclosures in some form. Specifically, we will review which states conform to federal law as well as which states require inclusion of the federal return with state forms, in order to obtain some indication of state conformity. We will then analyze the most common federal uncertain tax positions in which states

likely will be interested, as well as typical state-specific uncertain tax positions that ultimately may require disclosure in state income tax returns. Finally, we will discuss strategies to potentially mitigate exposure if a federal and/or state Schedule UTP is ultimately approved.

## BACKGROUND

Although determining state conformity is challenging at this stage of the IRS Schedule UTP proposal, there are indicators of state conformity that may be considered. General state conformity to federal tax law is one indicative factor. In addition, state requirements to include all or a portion of the federal return along with the state income tax return also is indicative of those states that will not only be able to leverage the federal Schedule UTP for state audit purposes, but also may be more inclined to follow their federal counterpart in creating a similar schedule of their own.

The following table summarizes both of these indicators for all states imposing an income based tax:<sup>2</sup>

<sup>2</sup> The table was adapted from Thomson Reuters/RIA and BNA. The information within the table is current as of 4/28/2010.

**Table 1: State Conformity to I.R.C.**

State	I.R.C. Conformity	Federal Return Required
Alabama	Current I.R.C.	Yes
Alaska	Current I.R.C.	Yes
Arizona	I.R.C. in effect on 1/1/2010.	Yes
Arkansas	I.R.C. in effect on Jan. 1, 2009.	Yes
California	I.R.C. as amended through 1/1/2009, applies for tax years starting on or after 1/1/2010; as amended through Jan. 1, 2005, for prior years.	Yes
Colorado	Current I.R.C.	No
Connecticut	Current I.R.C.	Yes
Delaware	Current I.R.C.	Yes
District of Columbia	Current I.R.C.	No
Florida	I.R.C. as of 1/1/2009.	Yes
Georgia	I.R.C. as enacted on or before 1/1/2009.	Yes
Hawaii	I.R.C. as amended through 12/31/2008.	No
Idaho	I.R.C. as amended through 2/17/2009.	Yes
Illinois	Current I.R.C.	Yes
Indiana	I.R.C. as amended and in effect on 1/1/2010.	Yes
Iowa	I.R.C. in effect on 1/1/2008.	Yes
Kansas	Current I.R.C.	Yes
Kentucky	I.R.C. in effect on 12/31/2006.	Yes
Louisiana	Current I.R.C.	No
Maine	I.R.C. as amended as of 3/2/2010.	Yes
Maryland	Current I.R.C.	Yes
Massachusetts	Current I.R.C.	No
Michigan	I.R.C. as amended through 1/1/2008.	Yes
Minnesota	I.R.C. as of 3/18/2010.	Yes
Mississippi	Current I.R.C., to extent that MS law incorporates provisions by reference.	Yes
Missouri	Current I.R.C.	Yes
Montana	Current I.R.C.	Yes
Nebraska	Current I.R.C.	Yes
New Hampshire	I.R.C. as amended through 12/31/2000.	Yes

**Table 1: State Conformity to I.R.C. – Continued**

State	I.R.C. Conformity	Federal Return Required
New Jersey	Current I.R.C., except bonus depreciation and expensing provisions.	No
New Mexico	Current I.R.C.	Yes
New York	Current I.R.C. generally.	Yes
North Carolina	I.R.C. as of 5/1/2009; decoupled from bonus depreciation provisions.	No
North Dakota	Current I.R.C.	Yes
Ohio	I.R.C. as of 10/16/2009.	No
Oklahoma	Current I.R.C.	Yes
Oregon	I.R.C. as of 12/31/2009.	Yes
Pennsylvania	Current I.R.C. for specific provisions adopted.	Yes
Rhode Island	Current I.R.C.	No
South Carolina	I.R.C. as amended through 12/31/2009.	Yes
Tennessee	Current I.R.C.	No
Texas	I.R.C. in effect for federal tax year beginning on 1/1/2007.	Yes
Utah	Current I.R.C.	Yes
Vermont	I.R.C. in effect on 1/1/2008.	Yes
Virginia	I.R.C. as amended through 1/22/2010.	Yes
Wisconsin	I.R.C. as amended through 12/31/2008.	Yes
West Virginia	I.R.C. as amended through 12/31/2009.	Yes

Per the table, of the 46 states (and the District of Columbia) that impose a corporate income tax, 20 automatically conform to the latest version of the I.R.C. and, thus, adopt a “rolling” conformity date. Twenty-three states adopt a fixed or static I.R.C. conformity date and, thus, apply the I.R.C. in effect as of a particular date. Three states take a selective approach to federal conformity by adopting only certain provisions or certain provisions as of certain dates.

The table also indicates that a majority of states (35 out of the 46 listed above) require all or a portion of the federal Form 1120 to be included with the respective state income tax return.

### **A majority of states will have access to the federal Form 1120 via their state income tax filings.**

Based on data presented in the table, we believe state conformity to the federal Schedule UTP is a possibility at some point in the future, if the Schedule UTP is approved by the IRS. Even if many of the states ultimately do not create a similar Schedule UTP of their own, most will have access to the federal Schedule UTP by requiring inclusion of the federal income tax return with the state income tax return.

The table indicates a majority of states will have access to the federal Form 1120 via their state income tax filings. Since many federal uncertain tax positions mirror state uncertain tax positions and the majority of state taxable income calculations begins with federal taxable income, this effectively means state auditors will be apprised of many state-related uncertain tax positions via the federal Schedule UTP.

## **UNCERTAIN TAX POSITIONS OF INTEREST TO STATES**

### **Federal UTPs of State Interest**

As with IRS auditors, state auditors will be interested in those federal uncertain tax positions potentially resulting in the greatest adjustment favorable to the government. Following is a list of federal uncertain tax positions likely of importance to state auditors, along with a discussion of each tax position:

- **Federal Tax Credits.** Adjustments to income tax credits generally offer lucrative audit potential because credits, unlike deductions, are “dollar-for-dollar.” This means credits are a direct reduction to a company’s tax liability, as opposed to a deduction which reduces taxable income and is effectively haircut by a relatively low corporate income tax rate.

Various state credits conform to their federal counterpart, with certain modifications. One of the most common state credits that conforms to federal law is the research and development tax credit. Approximately 35 states offer some form of research-related income tax credit, with some states conforming to the federal research credit calculation and/or qualified research expenditures definitions. Therefore, if a state auditor reviews a federal Schedule UTP and finds the federal research credit listed, the state auditor likely will investigate the company’s state research credit as well.

- **Federal Tax Attribute Limitations.** Limitations on income tax attributes, such as net operating losses and tax credits, also offer lucrative audit potential. As with federal income tax credits, some states conform to federal income tax attribute limitations. Specifically, various states conform to I.R.C. §§382/383 net operating loss and tax credit limitations. These tax attribute limitations apply when a company experiences a greater than 50 percent ownership change over a three-year period, either by an acquisition, disposition, or shift in equity ownership. These sections limit the amount of post-

change taxable income that may be reduced by pre-change tax attributes such as net operating losses and tax credits. Therefore, as with income tax credits, if a state auditor finds a federal tax attribute limitation on the federal Schedule UTP, it is likely that uncertain tax position will be reviewed for state income tax purposes as well.

- **Federal Transfer Pricing.** Related-party transactions are another area of lucrative audit potential, and since most states follow federal transfer pricing laws and regulations, state auditors will be interested in federal uncertain tax positions related to transfer pricing that are disclosed in a federal income tax return.

- **Other Items Impacting Federal Taxable Income.** Generally, state income tax conformity to the federal income tax treatment of a transaction or item is more the rule rather than the exception. Most states define “state taxable income” as federal taxable income plus or minus certain additions or subtractions, while other states may define certain terms, such as “income,” “deduction,” etc. as being the same as defined in the I.R.C. The high level of state conformity is most clearly evidenced in the states’ income tax forms, where state taxable income is often computed by beginning with federal taxable income which is then adjusted for various items, rather than making a separate calculation of state taxable income.<sup>3</sup> Therefore, most state auditors will be interested in any federal uncertain tax position that potentially adjusts the state’s federal taxable income starting point.

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state-related uncertain tax positions via the federal  
Schedule UTP.**

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### Potential State UTPs

In addition to the federal uncertain tax positions listed above, state auditors likely would be interested in the following areas of potential state-specific uncertain tax positions, which we believe would require disclosure on any state created Schedule UTP:

- **State Adjustments/Modifications.** Various states make adjustments to their federal taxable income starting point. State adjustments to federal taxable income generally fall into two categories: depreciation and state-specific tax issues. Depreciation adjustments generally occur where federal and state depreciation rules differ, such as a state’s nonconformity to federal bonus depreciation or state adoption of differing depreciation methods and/or class lives. State specific tax issues take many forms, but the most common are typically state tax deduction adjustments that occur where states do not allow all or part of the state deduction for state tax.

- **State Transfer Pricing.** States have enacted various transfer pricing guidelines to prevent related parties from shifting income from higher state tax jurisdictions to lower state tax jurisdictions. It is likely separate re-

porting states will require disclosure of any uncertain tax positions related to their transfer pricing laws.

- **State Nexus.** State income tax nexus, which is often used to mean a state’s jurisdiction to impose an income tax, is another typical state-related UTP that likely would require disclosure on a state Schedule UTP. FIN 48 analyses often uncover requisite minimum connections with states in prior tax years resulting in a state income tax filing requirement where a return was not previously filed. A related reserve is then established for the uncertainty of whether a state will ultimately require a state income tax filing for prior tax years. This UTP can be especially problematic to companies as generally the state-related statute of limitations does not toll in the event of failure to file a state return.

- **State Apportionment.** Once a company is determined to have nexus with a state, it must apportion taxable income to that state based on the state’s requisite apportionment factor. The widely accepted formula of allocation and apportionment of operating income and losses consists of the three factors of property, payroll, and sales. However, various states deviate from the typical three-factor apportionment formula. If a company is applying an incorrect apportionment formula and/or is calculating the individual apportionment factors in a way that is not representative of state tax law, a state uncertain tax position may arise. We believe such exposure is likely to require disclosure on any state Schedule UTP.

- **State Filing Methodologies.** A state Schedule UTP also is likely to require any uncertain tax positions related to applying correct state filing methodologies. Approximately half of states require separate reporting, so assuming your company is filing accurate separate returns in these jurisdictions, filing methods for these states should not be a material uncertain tax position. It is the other half, the half that either allows or mandates combined or consolidated reporting, that is problematic and may result in FIN 48 uncertainty due to the potentially very different tax liabilities associated with application of these three methods, *i.e.*, separate, combined, or consolidated reporting.

- **Capital Stock/Franchise Tax.** It is important to note that states may impose capital stock/franchise taxes that are often included along with the state corporate income tax return. Therefore, any potential state Schedules UTP may require disclosure of uncertain tax positions related to capital stock/franchise taxes. However, we do not believe states will include these taxes as FIN 48 and the federal Schedule UTP apply to only income-based taxes.

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**State specific tax issues take many forms,  
including adjustments to federal taxable income,  
transfer pricing, nexus, apportionment, and filing  
methodologies.**

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## POTENTIAL MITIGATION STRATEGIES

Irrespective of whether the federal Schedule UTP and/or state-related Schedule UTPs ultimately are ap-

<sup>3</sup> Excerpt from Ernst & Young LLP’s “State Conformity to Federal Provisions in General.”

proved, there are procedures a company can establish now that may assist in mitigating the impact of these proposed schedules on future federal and/or state income tax audits. Following is a list of these mitigating strategies, along with a brief discussion on each.

■ **Reduce Uncertain Tax Positions.** In adopting FIN 48, many companies applied a cost/benefit approach. For example, depending on a company's status (profitable or loss), extensive analysis around state tax matters may have been applied or foregone. In cases where extensive analysis was foregone resulting in a higher FIN 48 reserve, it may be prudent to apply the necessary underlying analysis to reduce the current FIN 48 reserve such that it is immaterial from a federal and/or state audit perspective. Such reduced tax return UTP disclosures may no longer create a red flag for audit purposes.

■ **Eliminate Uncertain Tax Positions.** A company also may find it prudent to take necessary steps to eliminate an uncertain tax position. For example, a company having a state nexus related FIN 48 tax reserve may want to file requisite returns to eliminate this exposure. Tax planning applied in conjunction with the state filings may serve to eliminate and/or reduce the associated tax expense. For example, nexus could be established earlier in loss tax years, those losses then being carried forward to eliminate subsequent state income tax, along with the state UTP.

■ **Regularly Evaluate Factual/Legal Changes.** Another means of mitigating impacts from potential federal and state Schedules UTP is to evaluate uncertain tax positions for changes in law and/or facts on a regular basis. Perhaps a statute of limitations lapsed, a court case settled, an audit settled, or a new tax law became effective. Any changes in tax law or facts may serve to eliminate or reduce an uncertain tax position that would otherwise require disclosure on a federal or state income tax return.

■ **Read the Fine Print.** It is easy to assume that the FIN 48 reserves required for financial reporting purposes will be the same as the "maximum tax adjustment" required for Schedule UTP purposes. However, the detailed instructions to Schedule UTP suggest there may be some differences. Therefore, it is prudent to read the final Schedule UTP instructions carefully to ensure your company is not disclosing more than it is required to for tax return purposes. Likewise, the "description of uncertain tax position" instructions should be read carefully to ensure each UTP disclosed for federal purposes also requires disclosure for state purposes. As discussed earlier, the federal Schedule UTP does not require disclosure of any state-related income tax uncertain tax positions, nor state impacts from federal uncertain tax positions.

■ **Extend 2010 Corporate Income Tax Return Filings.** It may be prudent to apply a "wait and see" approach to better understand how other companies are interpreting the Schedule UTP and its instructions. Therefore, we recommend extending the federal Form 1120 (and state corporate income tax returns where applicable) filing date for the full six-month allotted time period to allow sufficient time to evaluate how businesses in general approach the Schedule UTP. This approach may help in mitigating additional administrative burdens from Schedule UTP preparation, assuming other companies have developed a simplified approach to filing the necessary schedule. This approach also may assist in limiting audit exposure by allowing evaluation of many company approaches to the Schedule UTP to determine which one covers the filing obligation without concurrently establishing an audit road map.

## CONCLUSION

We believe there is a high probability that the IRS will require filing of a Schedule UTP disclosing federal uncertain tax positions as early as 2010 Form 1120 filings. Although the draft federal Schedule UTP instructions do not require disclosure of any state-related uncertain tax positions, we believe a majority of states will have access to the federal Schedule UTP as they require inclusion of the federal return with the state income tax return. As most states begin their taxable income calculations with federal taxable income and have similar tax laws to those established within the I.R.C. (e.g., tax credits, tax attribute limitations), we believe states may utilize the federal Schedule UTP for audit purposes.

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### States may utilize the federal Schedule UTP for audit purposes.

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We also believe that various states may follow their federal counterpart and develop a Schedule UTP of their own further requiring disclosure of state specific uncertain tax positions such as nexus, apportionment, and filing methodologies. We recommend mitigating audit exposure from the proposed federal Schedule UTP and potential similar state schedules by re-evaluating uncertain tax positions on a regular basis to determine whether there is justification for elimination or reduction of the uncertain tax position. We also recommend reading the fine print of the Schedule UTP instructions to ensure only that information required is disclosed, as well as extending 2010 filing dates in order to incorporate industry standards that may alleviate some administrative burden and audit exposure.



