# Unintended Consequences of Linking Tax Return Disclosures of Tax Uncertainty to Financial Reporting for Tax Uncertainty

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Firms face increasing pressure to disclose information about their uncertain tax positions.[2] Beginning in 2007, U.S. financial reporting rules require firms to disclose reserves for uncertain tax positions in their public financial statements (Financial Accounting Standards Board (2006)/ASC 740-10). Although the FASB issued that Financial Interpretation No. 48 (FIN 48) to make tax contingencies more transparent to investors, tax authorities can use the reserves to identify and assess tax uncertainty. However, a tax authority cannot observe whether the reserves relate to positions claimed in its jurisdiction because firms aggregate the reserves across jurisdictions. As a result, a growing number of tax authorities now require firms to disclose detailed information about the tax positions underlying financial statement reserves, essentially linking tax return disclosures of tax uncertainty with financial reporting for tax uncertainty. Understanding how firms respond to such tax disclosure requirements is important because the requirements can affect firms' tax and financial reporting decisions. The IRS created Schedule UTP *(Uncertain Tax Position Statement)* in 2010, which requires a firm to list and describe to the IRS Federal income tax positions for which the firm has recorded a reserve in its audited financial statements.[3] Using confidential corporate tax return data and public financial statement data, I use the implementation of Schedule UTP to examine how linking tax return disclosures of tax uncertainty to financial reporting for tax uncertainty affects firms' reporting decisions.

Theoretical models of tax compliance predict that Schedule UTP disclosures will affect a firm's decision of whether to claim an uncertain tax position. In the most basic model, a firm's decision to claim an uncertain position entails a tradeoff between: (i) the benefit of lower tax liability if undetected by the tax authority; and (ii) the costs, such as penalties and interest, if detected by the tax authority (Allingham and Sandmo (1972)). If disclosing such a position on Schedule UTP increases the probability that the IRS will audit the position, a firm should become less willing to claim the position. Indeed, game-theoretic models of tax compliance predict that increasing audit probability decreases firms' willingness to claim uncertain tax positions (e.g., Graetz, Reinganum, and Wilde (1986)), and recent empirical evidence supports this prediction (Hoopes, Mescall, and Pittman (2012); DeBacker, Heim, Tran, and Yuskavage (2013)). Further, former IRS Commissioner Doug Shulman acknowledged in remarks to the American Bar Association in September of 2012 that one purpose of the Schedule UTP was to deter firms from "pushing the envelope too far."

However, if the IRS is already aware that a firm is claiming an uncertain tax position via other tax return disclosures or prior audits, disclosing the existence of the position on Schedule UTP should be costless to the firm. Even if the IRS is not aware of a position, the net present value of the position could still be positive after taking into account a higher likelihood of audit. In these cases, Schedule UTP would not affect firms' willingness to claim an uncertain tax position. Alternatively, because Schedule UTP requires a firm to disclose only positions underlying financial statement reserves, the firm could find ways to avoid reserving for an uncertain tax position provided management can provide the external auditor with sufficient evidence for why the position does not warrant a reserve (Harvey (2010, 2013); Sheppard (2013)).

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[2] I refer to uncertain tax positions as those that might not be sustained if challenged by a tax authority.

[3] A firm must also disclose any position that the firm expects to litigate even if the firm has not recorded a reserve. Thus, even if a firm does not record a reserve for uncertain tax positions in its financial statements, the firm could still report a position on Schedule UTP.

In sum, the effect of Schedule UTP on firms' tax and financial reporting decisions is an empirical question. Abernathy, Davenport, and Rapley (2013) and Ferraro (2012) both document a post-Schedule UTP decrease in financial statement reserves for uncertain tax positions. However, because firm-level Federal tax payments are not publicly available, the studies cannot determine whether the decrease in reserves results from: (i) an actual reduction in Federal tax uncertainty due to changes in underlying tax positions; or (ii) a change in financial reporting for tax uncertainty with no change in underlying tax uncertainty. Understanding which of these explanations drives the decrease in reserves is crucial to assessing the effect of the standard on tax and financial reporting. This study disentangles the two explanations by combining confidential Federal tax return data with public financial statement data.

I construct a sample of firm-year observations over the period 2007 to 2011 at the intersection of three data sources: (i) the IRS corporate tax return dataset; (ii) the Compustat Fundamentals Annual dataset; and (iii) the IRS Large Business & International (LB&I) Division's FIN 48 registry. I measure claims for uncertain tax positions using Federal tax payments reported on the corporate tax return and I measure financial reporting for tax uncertainty using reserves for uncertain tax positions. Schedule UTP became effective for firms with at least $100 million in total assets in 2010 and for smaller firms starting in 2012. The phase-in enables me to compare behavior both across time and in the cross-section to test the effect of Schedule UTP on Federal tax payments and financial reporting reserves for uncertain tax positions.

I find that although firms report lower reserves in their publicly-available financial statements, they do not claim fewer benefits on their Federal income tax returns. These results imply that firms modified their financial reporting for tax uncertainty to avoid disclosing positions to the IRS on Schedule UTP. Thus, the post-Schedule UTP decrease in reserves represents a change in financial reporting with no change in underlying claims for uncertain tax positions. To further investigate the change in behavior post-Schedule UTP, I test whether the results are stronger for firms under continual audit by the IRS. Because of limited resources, the IRS cannot audit every taxpayer who reports a position on Schedule UTP. Therefore, firms under continual IRS audit face the greatest risk of Schedule UTP positions being audited because the IRS has already committed to auditing their tax returns. Consistent with this argument, I find that relative to firms not under continual audit, firms under continual audit by the IRS report even lower reserves post-Schedule UTP.

My findings are important to tax administrators, policymakers, and financial statement users. First, learning that firms appear to modify their financial reporting for tax uncertainty in order to avoid disclosing positions on Schedule UTP affects how tax authorities interpret tax return disclosures of tax uncertainty. Specifically, my results suggest that firms avoid disclosing some uncertain tax positions on Schedule UTP. Second, the FASB and the International Accounting Standards Board are currently considering international standards for tax contingency reporting. My findings suggest that if the standards enable discretion, managers will use that discretion. Finally, financial statement users and researchers should be aware that financial statement reserves for tax uncertainty are not consistent across pre- and post- Schedule UTP environments because Schedule UTP appears to have changed some firms' reserve decisions.

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