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New IRS Proposal Has Implications for Public and Private REITs

WHITE PAPER

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Background

Under current law, business tax returns do not require taxpayers to identify and explain uncertain tax positions. Many taxpayers, however, are required to disclose financial work papers prepared in compliance with Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48).

In January of this year, the Internal Revenue Service announced a proposal requiring certain business taxpayers to disclose uncertain tax positions on their annual federal tax return. This change was created to allow for greater corporate transparency of significant tax issues underlying the return and to increase efficiency of corporate audits (IRS Announcement 2010-9).

As a national leader in providing accounting, tax and business advisory services, Reznick Group believes it is critical that our corporate clients be made aware of this pending change to their annual tax returns. Additionally, the firm works with numerous public and private REITs that may be impacted by the new IRS announcement. There are specific items related to transfer pricing, like-kind exchanges and more that a REIT may encounter in making a FIN 48 determination based on the new IRS Announcement 2010-9.

It is important to note that IRS Announcement 2010-9 is intended to apply only to business taxpayers with total assets in excess of $10 million.

Annual Disclosure Schedule for Uncertain Tax Positions

IRS Commissioner Doug Shulman stated that requiring corporate taxpayers to disclose their uncertain tax positions would make IRS corporate audits more efficient. Shulman noted:, "Today, we spend up to 25% of our time in a large corporate audit searching for issues rather than having a straightforward discussion with the taxpayer about the issues." He went on to characterize the plan as a reasonable approach to the problem stating, "We believe we have crafted a proposal that gives us the information we need to do our job without trying to get in the head of taxpayers as to the strengths or weaknesses of their positions."[1]

In conjunction with the new proposal, the IRS is currently developing a schedule which would require the taxpayer to make an annual disclosure of uncertain tax positions. The taxpayer will be required to identify and quantify a tax position relating to a specific federal tax return for which a taxpayer (or a related domestic or foreign entity) is required to reserve an amount under either FIN 48 or other accounting standards (including International Financial Reporting Standards (IFRS) and country-specific generally accepted accounting standards).

Such "uncertain tax positions" will also include any position related to the determination of any U.S. federal income tax liability for which a taxpayer (or a related entity) has not recorded a tax reserve. This may be because the taxpayer expects to litigate the position or has determined that the IRS has a general administrative practice *not* to examine the position.

On March 10th, IRS Chief Counsel William J. Wilkins said he believes the second disclosure category (i.e., IRS administrative practice of no examination) was intended to be narrow. Wilkins also provided as

[1] "IRS Plans to Require Disclosure of Uncertain Tax Positions." Journal of Accountancy 26 Jan. 2010.

an example, namely, RICs and REITs, that may be concerned about setting up a reserve in a tax footnote of their financial reports because it could negatively affect their tax-advantaged status. Wilkins said, "A company might be relying on the fact that the IRS routinely provides avenues for relief for those kinds of situations to avoid setting up the reserve."[2]

Proposed Disclosure Items

The proposed annual disclosure schedule will require the following items:

- A concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements
- The maximum amount of potential federal tax liability attributable to each uncertain tax position.

To be sufficient, the description should contain:

- The Code sections potentially implicated by the position
- A description of the taxable year or years to which the position relates
- A statement that the position involves an item of income, gain, loss, deduction, or tax credit
- A statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both
- A statement whether the position involves a determination of the value of any property or right
- A statement whether the position involves a computation of basis

The schedule will also require a taxpayer to specify the entire amount of U.S. federal income tax that would be due if the position were disallowed in its entirety on IRS audit. This is a requirement for each uncertain tax position.

Explaining why the IRS decided to require a company to disclose its maximum exposure, Heather Maloy, commissioner of the IRS Large and Midsize Business Division said, "… the government wants to have some measure of materiality regarding an issue. There have been some suggestions that materiality should be reported on the basis of a range, or by ranking issues, and the government is considering those suggestions during the comment phase. The IRS is following the financial statement concept of materiality, rather than creating an overlay of other materiality reporting."[3]

The IRS anticipates publishing proposed regulations to provide more guidance and is also currently evaluating various options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure.

Originally, the IRS invited the public to submit comments on this proposal by March 29, 2010. However, in Announcement 2010-17, the IRS extended the time to submit comments to June 1, 2010.

[2] Elliott, Amy S. "Wilkins Describes Uncertain Tax Positions Under New Requirements." Taxanalyst Tax Notes Today 11 Mar. 2010.

[3] Coder, Jeremiah. "LMSB Commissioner Fields Questions on Reporting Uncertain Tax Positions." Taxanalyst Tax Notes Today 23 Feb. 2010.

Consequences for Public and Private REITs

When FIN 48 was introduced, many REITs were in denial that FIN 48 would be applicable to them. This stirred a broader effort among REITs to implement FIN 48 as compared to other industries. It was unclear how REIT shareholders and the IRS might react to FIN 48 disclosures when a REIT is generally not expected to pay taxes at the REIT level.

In general, public REITs were the first to experience the impact of FIN 48 and to enter into extensive discussions with their auditors and tax advisors as to the specific items that should be reported. It's now incumbent on the non-public, or private REITs, who are adopting FIN 48 to initiate frank discussions with their auditors and tax advisors. With the issuance of Announcement 2010-9, there is some concern that this proposal will create conflict between taxpayers, their accountants, other tax advisors, and the IRS as nonpublic companies including private REITs may push back on the items to be reported.

REITs, as well as other businesses, are quickly learning that the quantification of uncertain tax positions requires professional judgment. Often, tax issues are based on factual determinations rather than issues of law. Since the issuance of FIN 48, REITs have been struggling to identify which items they must disclose in their financial statements because they appear to have a lot more at stake.

There are a number of key items a REIT may encounter in making a FIN 48 determination based on the new IRS Announcement 2010-9:

Transfer Pricing

With the IRS looking closer at transfer pricing, care should be taken in any transaction assessment between the REIT and the taxable REIT subsidiary (TRS). Additionally, a REIT and a foreign related entity should be never less than the "more likely than not" (MLTN) standard. Currently, IRC § 857(b)(7)(F) permits REITs and their taxable REIT subsidiaries (TRSs) to base their allocations on any reasonable method to avoid the 100% tax on redeterminations. In this case, one may inquire as to whether this should be interpreted as any reasonable method or any reasonable method permitted by IRC § 482. Most transfer pricing reports do not provide an opinion and internal allocations often do not use reasonable method under IRC § 482. Given this, it is uncertain whether a MLTN position can be reached.

Like-Kind Exchanges

Like-kind exchanges pose another potential source of a FIN 48 liability, especially if the like-kind exchange does not meet a safe harbor or contains an identified risk.

Prohibited Transactions

Prohibited transactions are also affecting REITs. Three common approaches seem to prevail in how REITs document the FIN 48 liability with respect to prohibited transactions:

- A template approach used to document compliance with the safe harbor;
- Reliance on facts and circumstances coupled with widely understood administrative practices for measuring little or no liability
- Documenting every transaction in open years.

Unit of Account
REITs also have grappled with defining the unit of account, typically following one of two methodologies:

- considering each property transaction as a unit of account
- grouping similar fact patterns into a single unit of account

A good example of the latter may be seen in instances where a REIT is exiting a particular market and groups all property sales as a single unit of account.

Dividends Paid Deduction

REITs must consider how to document the effect of a disallowance on the dividends paid deduction.

Joint Ventures
Joint ventures can impose a burdensome task on the REIT in trying to ensure all material tax positions are identified. This is especially true in situations where the REIT does not have control of the financial information.

Additional Issues REIT Must Consider:

- Documenting REIT qualification when investing in another REIT
- State and local tax issues
- Foreign tax issues
- Alternative minimum tax
- Limitations on deductions allocable to property used by governments or other tax-exempt entities - IRC § 470
- Contributions to capital - IRC § 118 positions
- Cost segregation studies
- Built-in gains tax
- Disguised sales

NAREIT intends to setup a task force to prepare and submit comments to the IRS allowing REITs to be heard before the June 1, 2010 IRS Regulatory comment deadline.

For More Information

To learn more about IRS Announcement 2010-9 and its potential implications for your company's financial reporting requirements, please contact us at www.reznickgroup.com/contact-us.