Research, Analysis & Statistics

Tax Policy Center
Urban Institute and Brookings Institution

Advancing Tax Administration ■ June 19, 2014

Session 3: Tax Uncertainty and Corporation Compliance

Moderator:	***John Guyton*** *IRS, RAS, Office of Research*
Large Corporation Schedule M-3 Book-to-Tax Profiles of Schedule UTP (Uncertain Tax Position) Filers and Non-Filers: 2010 – 2011	***Lisa Rupert*** *IRS, Large Business & International*
Unintended Consequences of Linking Tax Return Disclosures of Tax Uncertainty to Financial Reporting for Tax Uncertainty	***Erin M. Towery*** *University of Georgia*
The Effect of CAP on Tax Aggressiveness	***Andrew Duxbury*** *University of Connecticut*
Discussant:	***Matt Smith*** *Department of the Treasury, Office of Tax Analysis*

Schedule M-3 Profile of Schedule UTP Filers and Non-filers

IRS Research Conference Extract from Boynton-DeFilippes-Legel-Rupert Paper on "Large Corporation M-3 Profile of UTP Filers and Non-filers for 2010-2011 Tax Years"

June 2014

IRS
Large Business & International Division
PLANNING, ANALYSIS, INVENTORY & RESEARCH

THE OPINIONS EXPRESSED ARE THOSE OF THE AUTHORS AND DO NOT NECESSARILY REPRESENT POSITIONS OF THE U.S. DEPARTMENT OF THE TREASURY OR THE INTERNAL REVENUE SERVICE.

Agenda

- History of Schedule UTP and Background
- 2010 - 2011 M-3 Data for UTP Filers and Non-filers
- 2010 - 2011 UTP and M-3 Data Design
- 2010 - 2011 Summary

HISTORY OF SCHEDULE UTP AND BACKGROUND

Schedule UTP Background

Introduced

- In 2010 for corporations with assets of $100M or more with audited Financial Statements (FS) reporting uncertain tax positions in the income tax footnote and for certain related corporations

Purpose

- To report some of the information from the FS income tax footnote

Goal

- To increase transparency

Income Tax Footnote

- Required by U.S. generally accepted accounting principles (GAAP) under FAS 109 (ASC 740) and FIN 48 (ASC 740-10)

Schedule UTP Requirements

Schedule UTP requires taxpayers to report:

- Positions that affect the U.S. federal income tax liabilities of certain corporations that issue or are included in audited FS
- Relevant code sections
- A concise description of the issue(s)
- *Dollar amounts are NOT required*

The corporate asset reporting threshold:

- Assets of $100M or more in tax years 2010 and 2011
- $50M or more in tax years 2012 and 2013
- $10M or more in tax years ending December 31, 2014 or later

Schedule UTP Comparison with Schedule M-3

Schedule UTP

- Reports the federal uncertain tax positions reserved on the FS with respect to items on the tax return the IRS may challenge on audit
- Generally relates to items reported on Schedule M-3 Parts II and III, tax credit amounts, and international issues reported on Forms 1118, 5471s, 5472s, etc.

Schedule M-3

- Part I reconciles worldwide consolidated book income to the book income reported on the consolidated tax return
- Parts II and III report the temporary and permanent adjustments from the various book income and expense items to the income and expense amounts for tax purposes

Schedule M-3 (M-3) and Schedule UTP (UTP) are complementary sources of taxpayer information

2010-2011 M-3 DATA FOR UTP FILERS AND NON-FILERS

2010 (2011) M-3 Data for Form 1120 Corporations

- 40,740 (41,636) corporations in 2010 (2011)

- 12,044 (12,307) corporations have total assets of $100M and potentially subject to UTP

- By FS Type
  - 3,446 (3,370) with SEC 10K/Public FS
  - 5,218 (5,396) with Audited FS
  - 3,380 (3,540) are Unaudited

2010 and 2011 UTP Filers

- All filers
  - 2010 - 1,856 (15.4%) and 2011 - 2,074 (16.9%)
- SEC 10K/Public corporations
  - 2010 - 1,093 (31.7%) and 2011 - 1,227 (36.4%)
- Audited corporations
  - 2010 - 493 (9.4%) and 2011 - 535 (9.9%)
- Unaudited corporations
  - 2010 - 269 (8.0%) and 2011 - 311 (8.8%)

UTP AND M-3 DATA DESIGN

2010 - 2011 UTP and M-3 Data Design

- 2010 - 2011 UTP and M-3 Tables
  - Distinguish UTP filer versus UTP non-filer by FS types
    - Non-filers include both those not required to file and those who fail to file
  - $100M or more in assets

- Adjusted 2010 - 2011 M-3 Parts II and III Data
  - Seven specified versus other-differences categories
  - For book income, tax income, and Book-Tax-Difference (BTD) amounts
  - By FS type (SEC 10K/Public, Audited, and Unaudited)
  - By the presence or absence of Schedule UTP

Special Adjustments to Three M-3 Lines

- Cost of Goods Sold (COGS) is adjusted to remove the cost of securities/commodities reported on Schedule A using SOI data
- Other-income-items-with-differences is adjusted to remove Gross Receipts related to the COGS adjustment
- Other-items-with-no-differences is adjusted to remove Gross Receipts related to the COGS adjustment
- Other-items-with-no-differences is adjusted to remove expenses/deductions-with-no-differences creating two lines:
  - Adjusted Other income with no differences
  - Adjusted Other expense/deduction with no differences

2010 - 2011 SUMMARY TABLES: COMPARISONS OF FS TYPES FOR UTP FILERS AND NON-FILERS WITH SIGNIFICANT M-3 BTD

Categories in Summary Tables

- By FS and UTP for filers and non-filers
  - M-3 categories with BTD
    - Adjusted COGS
    - Specified Income
    - Adjusted Other Income with differences
    - Specified Expense/Deduction
    - Adjusted Other Expense/Deduction with differences
  - Other items
    - Pretax income
    - Tax Net Income
    - BTD
    - Increase or Decrease to Taxable Income

Notes for Summary Tables

- UTP filers and non-filers with $100M or more in assets by FS types
- Significant BTD exceeding 1.5% of adjusted total book income
- BTD signs are positive and negative
  - Negative BTD reduce taxable income compared to book income
  - Table indicates significant BTD as T for Temporary and P for Permanent
- Red indicates negative BTDs and reductions in taxable income

Significant BTD Exceeding 1.5% of Adjusted Total Book Income for Public Corporations

FS TYPE	2010 SEC		2011 SEC	
	Filer	NonFiler	Filer	NonFiler
COGS	--	+1.90T	--	-1.54T
Spec Inc	-2.99T	-3.46P	-2.02T	--
Oth Inc	-1.52P	-2.89T	--	--
SpecExp	--	-1.94T	--	-3.74T
Oth Exp	--	--	--	--
Pretx Inc	17.88	16.75	17.82	12.04
Tax Inc	12.91	10.52	14.18	7.17
Total BTD	-4.97	-6.23	-3.64	-4.87
Inc/Decr	-27.8	-37.2	-20.4	-40.5

Significant BTD Exceeding 1.5% of Adjusted Total Book Income for Audited Corporations

FS TYPE	2010 Audited		2011 Audited	
	Filer	NonFiler	Filer	NonFiler
COGS	+2.17T	--	+2.12T	--
Spec Inc	+1.67T -1.95P	--	+1.57T -2.31P	--
Oth Inc	-2.72T	--	-2.35T	--
SpecExp	+1.54P	-1.61T	-5.95T +2.30P	-2.35T
Oth Exp	+3.51T	--	--	--
Pretx Inc	5.58	6.98	10.72	7.73
Tax Inc	9.21	4.90	5.70	4.05
Total BTD	+3.63	-2.08	-5.03	-3.67
Inc/Decr	+65.1	-29.8	-46.9	-47.6

Significant BTD Exceeding 1.5% of Adjusted Total Book Income for Unaudited Corporations

FS TYPE	2010 Unaudited		2011 Unaudited	
	Filer	NonFiler	Filer	NonFiler
COGS	--	--	--	--
Spec Inc	+1.85T +3.66P	-3.74P	+4.13P	--
Oth Inc	--	--	--	--
SpecExp	+1.70P	-1.86T	-2.40T	-2.87T
Oth Exp	--	--	1.58P	26.50T
Pretx Inc	4.84	13.53	5.63	-23.09
Tax Inc	10.81	4.81	10.19	3.23
Total BTD	+5.98	-8.72	+4.57	+26.33
Inc/Decr	+123.6	-64.5	+81.2	+114.0

Thank you!

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PLANNING, ANALYSIS, INVENTORY & RESEARCH

Unintended consequences of linking tax return disclosures of tax uncertainty to financial reporting for tax uncertainty

Erin Towery
University of Georgia

IRS Research Conference

June 19th, 2014

The University of Georgia
Terry College of Business

Research question

- Broad: How do tax return disclosures linked to financial reporting disclosures affect firms' reporting decisions?

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- Specific: How does Schedule UTP affect:
  - Tax reporting decisions
  - Financial reporting decisions

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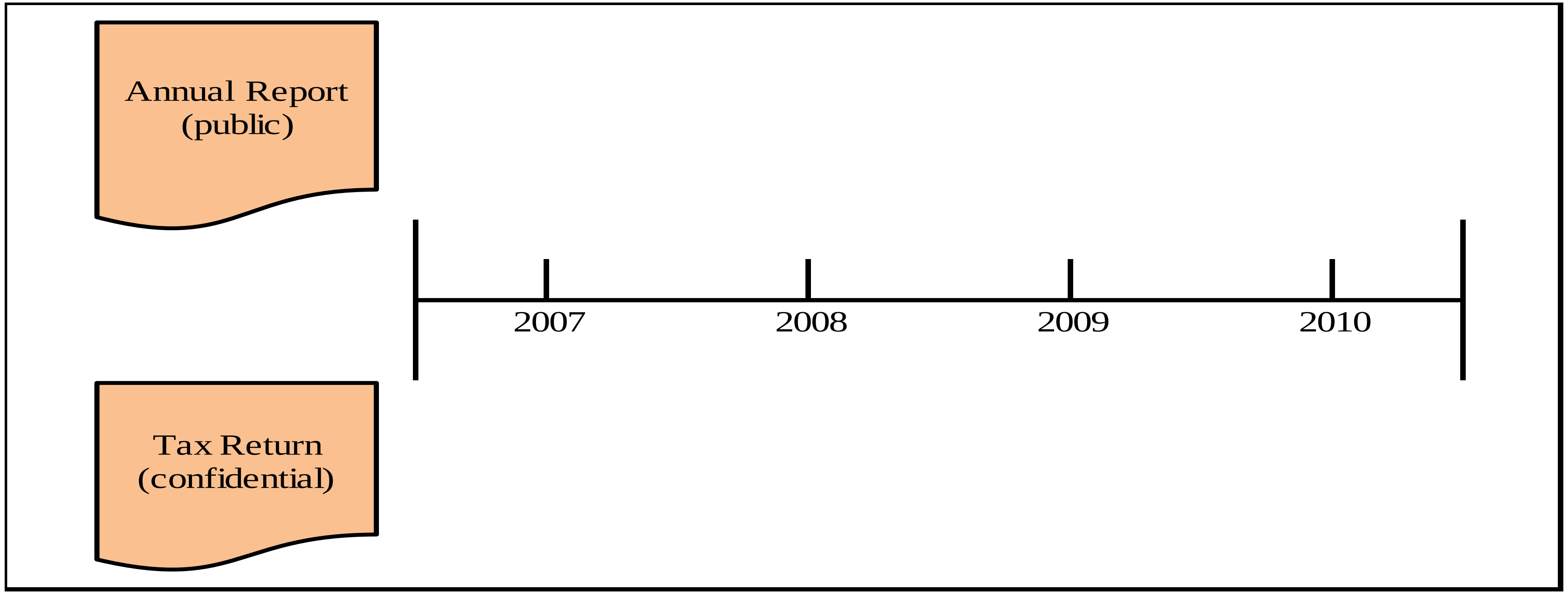
- Specific: How does Schedule UTP affect:
  - Tax reporting decisions
  - Financial reporting decisions

<u>Uncertain tax position</u>: A position, such as a deduction or a credit, that might not be sustained if challenged by the tax authority.

Schedule UTP



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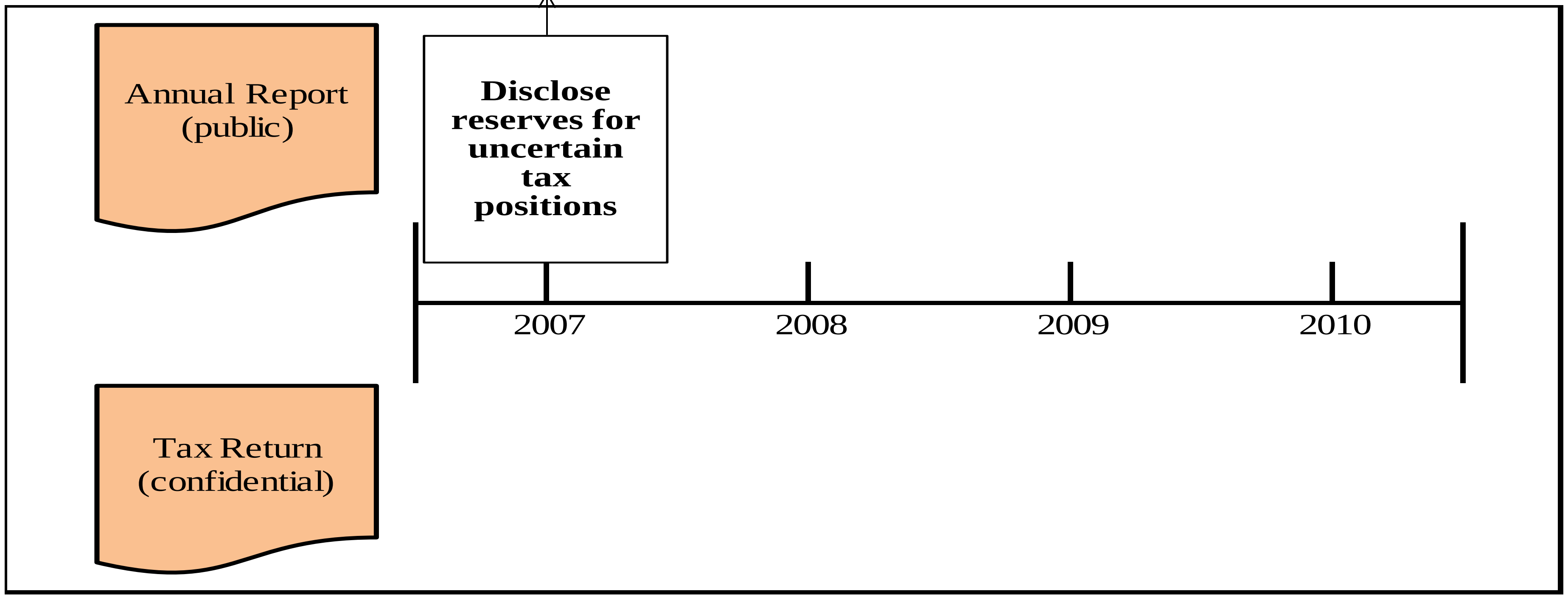
Schedule UTP

Reserves aggregated across jurisdictions



Schedule UTP

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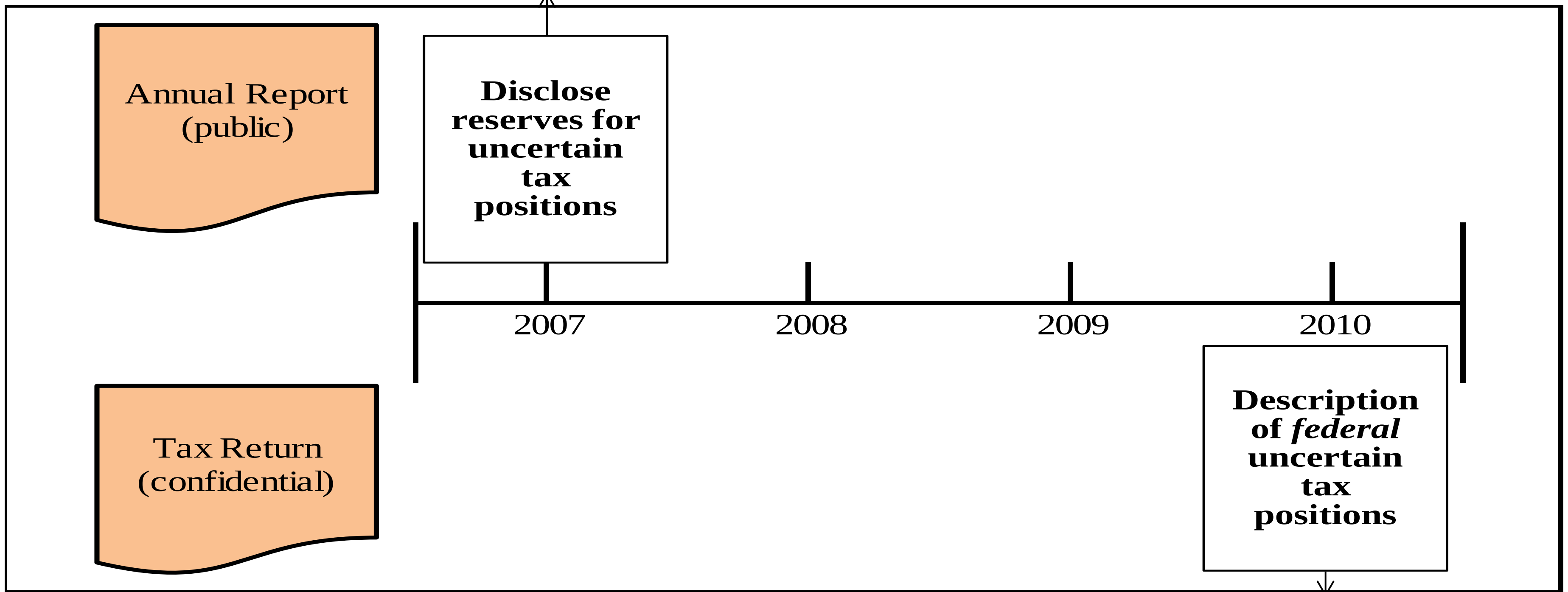

Must disclose description, but not magnitude

Motivation & Contribution

- Abernathy et al. (2012) & Ferraro (2012) document decrease in reserves for UTBs in Schedule UTP regime
  - Confidential corporate tax return data uniquely enable me to disentangle tax and financial reporting decisions

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- Linking tax return disclosures to financial reporting disclosures can distort financial reporting decisions

Motivation & Contribution

- Abernathy et al. (2012) & Ferraro (2012) document decrease in reserves for UTBs in Schedule UTP regime
  - Confidential corporate tax return data uniquely enable me to disentangle tax and financial reporting decisions

- Linking tax return disclosures to financial reporting disclosures can distort financial reporting decisions

- Tax disclosure initiatives increasingly common

Predictions

Benefits if undetected
VS.
Costs if detected

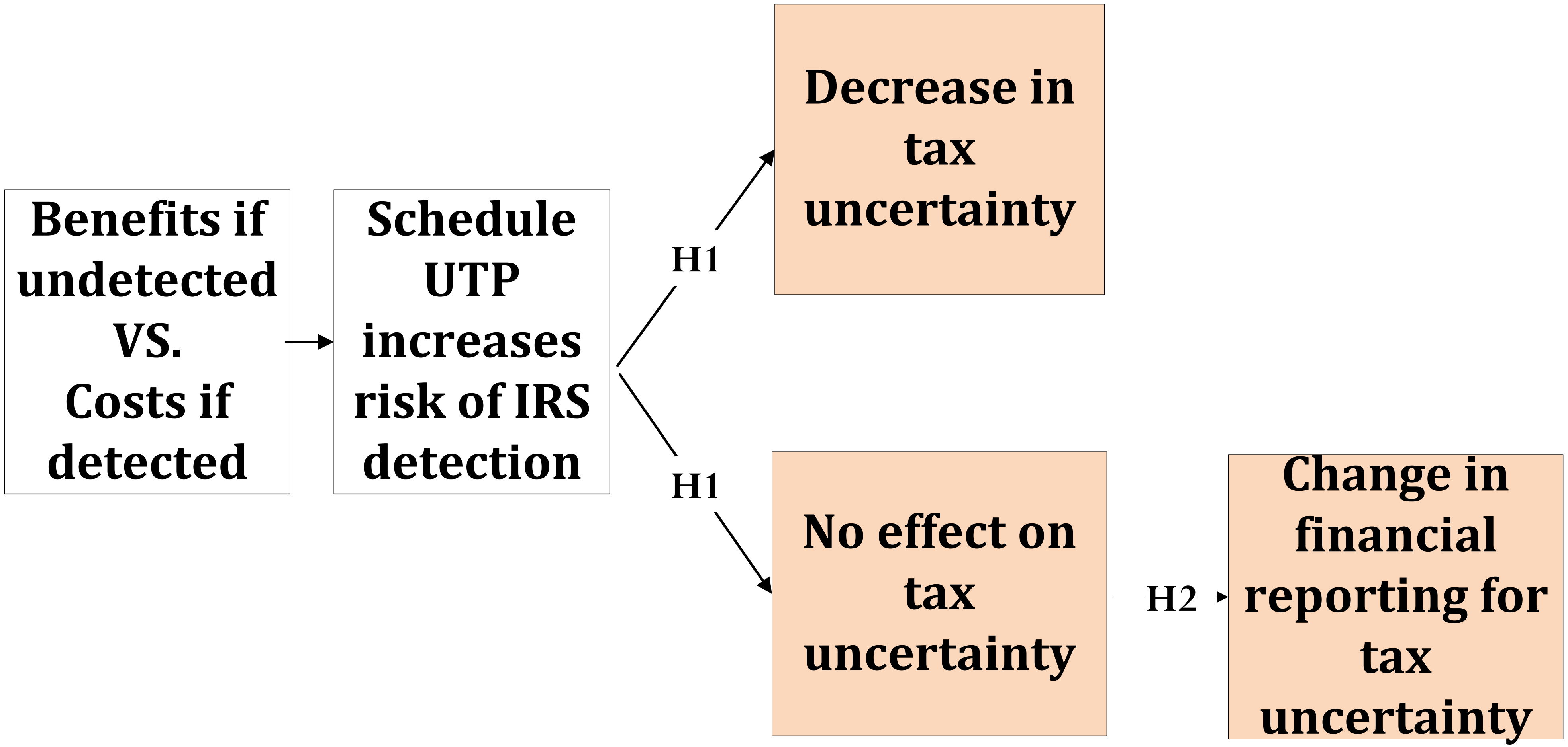
Predictions

Benefits if undetected VS. Costs if detected	→	**Schedule UTP increases risk of IRS detection**

Predictions

Benefits if undetected VS. Costs if detected → Schedule UTP increases risk of IRS detection → (H1) → Decrease in tax uncertainty

Predictions



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Research design

- Model

$$\textit{FederalTaxPaid} \,/\, \textit{TaxReserves} = \beta_0 + \beta_1 * \textit{UTPRegimeInd} + \beta_2 * \textit{UTPFirmInd} + \beta_3 * \textit{UTPRegimeInd} * \textit{UTPFirmInd} + \text{Controls} + \text{FE}$$

  - Sample: Firm-years from 2007-2011 with F/S and tax return data
  - Pre versus post; Treatment versus non-treatment

Research design

➢ Model

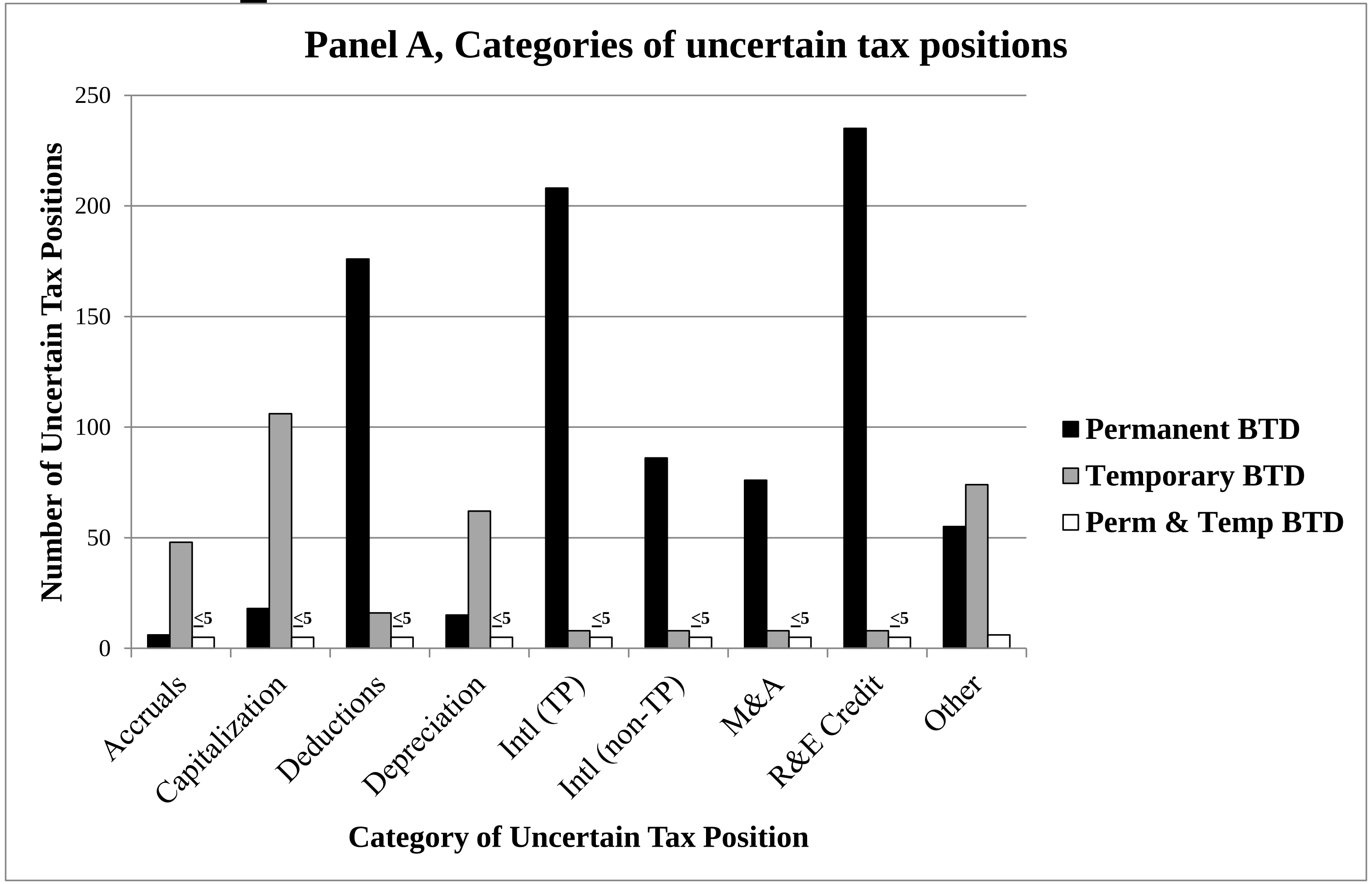
$$FederalTaxPaid \ / \ TaxReserves = \beta_0 + \beta_1 * UTPRegimeInd + \beta_2 * UTPFirmInd + \beta_3 * UTPRegimeInd * UTPFirmInd + \text{Controls} + \text{FE}$$

- Sample: Firm-years from 2007-2011 with F/S and tax return data
- Pre versus post; Treatment versus non-treatment

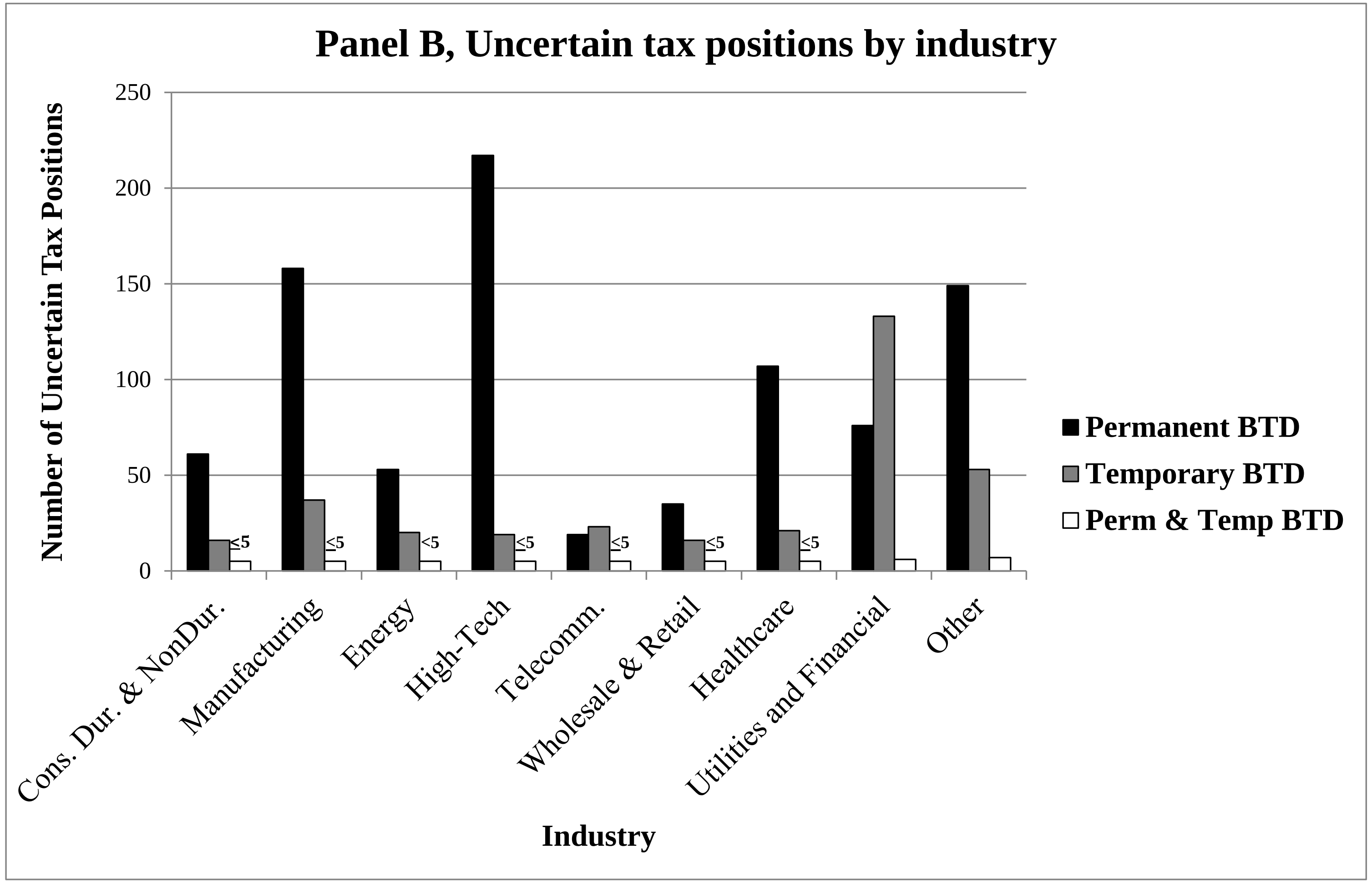
➢ Dependent variables

- *FederalTaxPaid*: Federal taxes paid from tax return
- *TaxReserves*: Current year increases in tax reserves

Composition of UTBs



Composition of UTBs



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Effect of Schedule UTP

	DV: *Federal TaxPaid*	DV: *Tax Reserves*	DV: *Federal TaxPaid*	DV: *Tax Reserves*
Intercept	0.4365 ***	-0.0437 ***	0.4393 ***	-0.0429 ***
	(0.0319)	(0.0047)	(0.0335)	(0.0051)
UTPRegimeInd	**-0.0235 *****	**-0.0037 *****	-0.0021	0.0001
	(0.0033)	**(0.0005)**	(0.0114)	(0.0016)
UTPFirmInd			0.0224 *	0.0043 **
			(0.0121)	(0.0017)
*UTPRegimeInd*UTPFirmInd*			**-0.0237 ****	**-0.0041 ****
			(0.0119)	**(0.0017)**
Controls				
N	5,121	5,121	5,121	5,121
R-squared	0.1279	0.1071	0.1288	0.1084

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CIC versus Non-CIC

	DV: *Federal TaxPaid*	DV: *Tax Reserves*
Intercept	0.4154 ***	-0.0295 ***
	(0.0502)	(0.0075)
UTPRegimeInd	-0.0248 ***	-0.0032 ***
	(0.0043)	(0.0007)
CICInd	-0.0072	0.0036 **
	(0.0093)	(0.0015)
*UTPRegimeInd*CICInd*	**-0.0058**	**-0.0024 ***
	(0.0073)	**(0.0012)**
Controls		
N	4,579	4,579
R-squared	0.1291	0.109

CIC versus Non-CIC

	DV: *Federal TaxPaid*	DV: *Tax Reserves*
Intercept	0.4154 ***	-0.0295 ***
	(0.0502)	(0.0075)
UTPRegimeInd	-0.0248 ***	-0.0032 ***
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	(0.0073)	**(0.0012)**
Controls		
N	4,579	4,579
R-squared	0.1291	0.109

Sensitivity analyses

- Results robust to:
  - Changes specification
  - Including measure of earnings management in model
  - Quantile regression
  - Holding sample constant over time period
  - Removing firms with large consolidation differences
  - Alternative winsorization levels
  - Holding GAAP pretax income constant

Conclusion

- Use confidential corporate tax return data and public financial statement data to investigate the effect of Schedule UTP on reporting decisions

Conclusion

- Use confidential corporate tax return data and public financial statement data to investigate the effect of Schedule UTP on reporting decisions

- Results suggest firms found ways to avoid recording reserves to avoid disclosing positions on Schedule UTP
  - Linking tax return disclosures to financial reporting disclosures can distort financial reporting decisions

University of Connecticut
School of Business

The Effect of CAP on Tax Aggressiveness

Amy Dunbar and
Andrew Duxbury
University of Connecticut

What is CAP?

- Collaborative process to identify and resolve potential issues before the tax return is filed

- IRS goal is to conduct and efficient and focused audit

- Began in 2005 and made permanent in 2011

Research Question

- Are CAP taxpayers more compliant before admission to CAP?
- Do they become more compliant after admitted?
  - Compliance is difficult to measure
  - We use the opposite of compliance - tax aggressiveness

Motivation

- GAO has recommended a CAP evaluation to determine effectiveness

- If effective, expansion can result in more efficient use of IRS resources

- If ineffective, specific goals can be defined

Who can be in CAP?

- Assets at least $10M
- Public entity with SEC financials
- Not be in litigation with government agency
- Transparent and cooperative with IRS

Who does the IRS select?

- Did the IRS choose tax “angels”?

- Do firms become more “angelic” after entering CAP?

- Research Design:
  - Use a matched sample of CAP and nonCAP firms
  - Compare proxies for tax aggressiveness

CAP Benefits

- Benefits IRS
  - Lowers cost of audits
  - Voluntary compliance
  - Early ID of emerging Issues
- Benefits Taxpayers
  - Certainty Sooner
  - Reduces F/S Risk

Prior Research

- Strategic Game
  - Graetz, Reinganum and Wilde (1986)
- Voluntary disclosure
  - Penalty Protection (Beck, Davis and Jung 2000)
  - If detection is high, taxpayers will be transparent (DeSimone, Sansing, and Seidman 2013)
- Beck and Lisowsky (2014)
  - Moderate sized FIN 48 reserves are more likely to participate
  - Moderate sized reserve balances decreased

Descriptive Statistics – Firm Characteristics: 2004-2012

	CAP			NonCAP	
	N	mean		N	mean
SIZE	979	**9.108**		1421	8.861
FOREIGN	979	**0.529**		1421	0.602
CFO	978	**0.100**		1421	0.108
ROA	979	**0.008**		1421	-0.020
NOL	979	**0.381**		1421	0.480
Leverage	973	**0.216**		1419	0.194
MTB	956	4.096		1358	3.531
RD	979	0.013		1421	0.015
CAPINT	952	**0.571**		1308	0.544
INTAN	969	0.198		1412	0.205

Firm Characteristics

- CAP firms are larger and more leveraged
- CAP firms are – as expected:
  - Lower foreign income percent
  - Lower cash flow
- CAP firms are – as not expected
  - Higher ROA
  - Lower NOL
  - Higher Capital Intensity

Tax Aggressiveness Measures: 2004-2012

	CAP			NonCAP	
	N	mean		N	mean
ETR	368	0.314		645	0.308
CETR	368	0.297		645	0.294
TXWW_ETR	368	0.273		645	0.270
TXFED_ETR	368	**0.272**		645	0.299
TXFO_ETR	362	**0.312**		619	0.274
CashETR	365	0.254		643	0.253
LRCashETR	290	0.257		495	0.26
BTD	213	0.035		419	0.035
PBTD	213	0.027		419	0.03
UTB	226	**0.009**		398	0.014
UTB-ETR	226	**0.006**		398	0.011

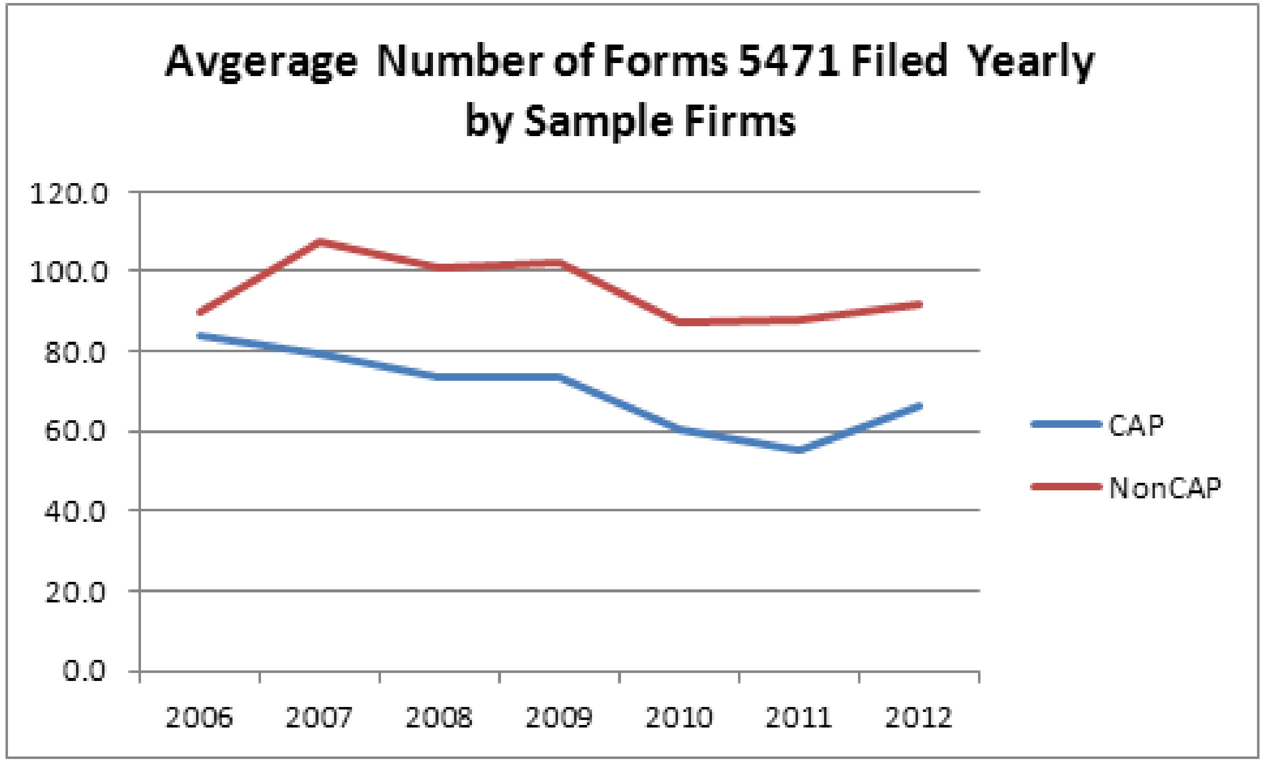
CAP/NonCAP Sample UTB

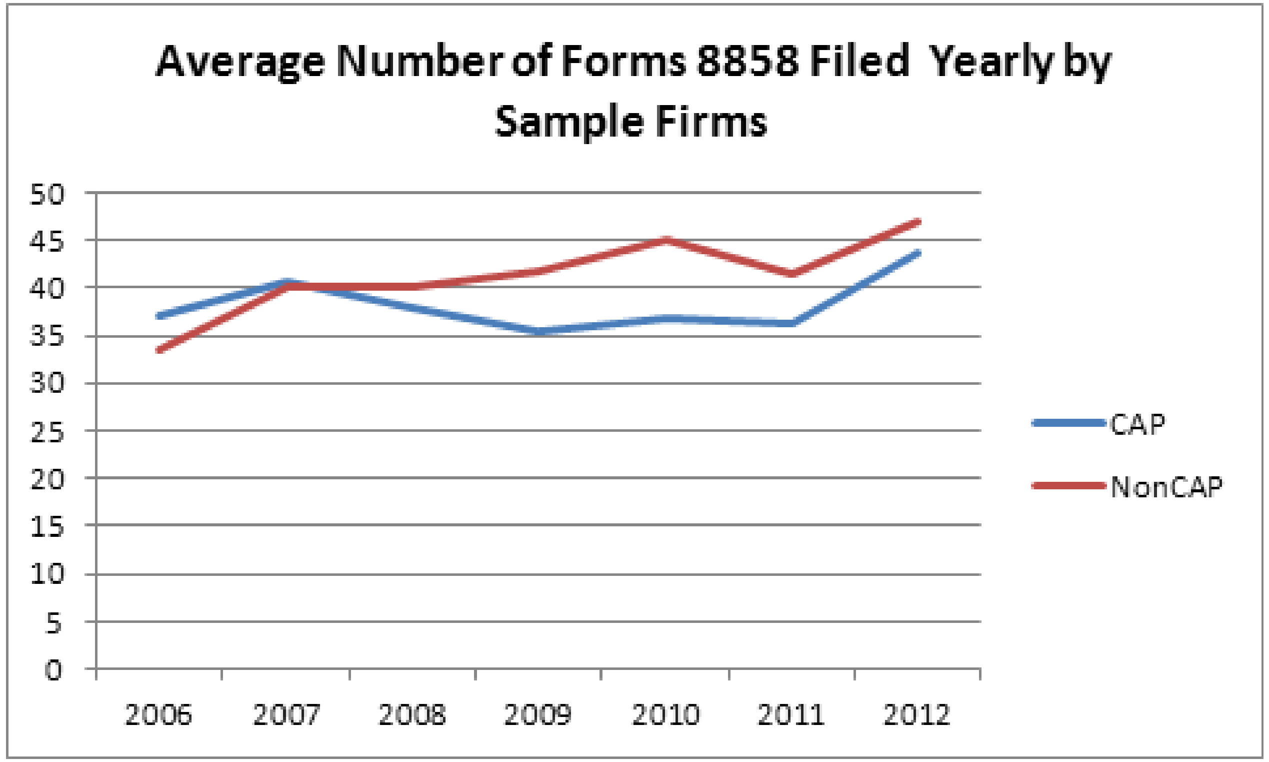
	2007				**2010**	
NonCAP	139	0.012		NonCAP	160	0.011
CAP	95	0.011		CAP	110	**0.008**
CAP years	42	0.009		CAP years	86	**0.007**
	2008				**2011**	
NonCAP	160	0.012		NonCAP	156	0.011
CAP	110	0.01		CAP	110	**0.006**
CAP years	66	**0.01**		CAP years	108	**0.006**
	2009				**2012**	
NonCAP	160	0.012		NonCAP	152	0.011
CAP	110	0.01		CAP	105	0.01
CAP years	79	**0.009**				

Tax Aggressiveness

- CAP firms have lower federal but higher foreign ETRs compared to nonCAP firms
- CAP firms have lower UTBs and UTB-ETR than non-CAP
- Overall, univariate results suggest that CAP firms are similar to but perhaps slightly less aggressive than nonCAP firms.

CFCs versus Disregarded Entities





Tax Havens: 2006-2012

	CAP				NonCAP		
Countries	**Big 7**	**Dots**	**Dyreng**		**Big 7**	**Dots**	**Dyreng**
Cayman Islands		1,636	1,636			1,574	1,574
Bermuda		997	997			692	692
Hong Kong	807				1,891	5,673	
Singapore	693	693	693		1,673	0	1,673
Switzerland	552	552	552		1,450	0	1,450
Ireland	461	461	461		1,121	0	1,121
Luxembourg		441	441			861	861
Haven Percent	**9.1%**	**19.5%**	**19.5%**		**8.5%**	**13.5%**	**13.3%**

Tax Havens

- CAP firms have substantially more subsidiaries in dot havens and Dyreng and Lindsay tax havens
- CAP firms have higher ETR in tax haven countries and lower tax rates in non-haven countries
- Less aggressive income shifting?

Multivariate Results:
Estimates of Tax Rates on Pretax Income

	TXWW	**TXFED**	**TXFO**
PI/PIDOM/PIFO	**0.2843**	**0.3068**	**0.2109**
CAP	0.001	-0.0009	**0.0007**
PI/PIDOM/PIFO *CAP	0.013	-0.0107	**0.0358**
SIZE	**-0.0008**	**-0.0002**	**-0.0002**
FOREIGN	-0.0014	-0.0004	**0.0014**
NOL	**-0.0024**	**-0.0024**	0.0002
Leverage	-0.0047	**-0.0048**	0.0007
MTB	**0.0001**	**0.0001**	0.0000
RD	**-0.0411**	**0.0183**	**-0.0149**
CAPINT	-0.0015	**-0.0052**	**0.0018**
INTAN	-0.0011	**-0.0048**	**0.0014**

Multivariate Results

- Inconclusive results
- Higher tax rates on foreign income
  - Suggests CAP firms engage in less income shifting
  - Mitigates incentive to shift income out of the U.S.
- RD is negative for foreign and positive for domestic
  - Suggests CAP offshore less IP

Conclusion

- Descriptive statistics indicate that CAP firms are may be more compliant than non-CAP firms
- CAP firms have more tax haven subsidiaries
  - But they have higher ETRs which suggest they shift less income
- Multivariate results suggest CAP firms may engage in less income shifting

Discussion

Matt Smith
Office of Tax Analysis
US Dept of Treasury

CAP & Tax Aggressiveness

- Are CAP firms less tax aggressive?
  - Mixed evidence: tax haven activity vs ETR
  - Domestic ETR is unaffected
  - Propensity to identify income as domestic?

CAP & Tax Aggressiveness

- Does CAP change firm behavior?
- Options:
  - Pre/post summary stats
  - Difference -in-difference
  - Interesting question: do firms dispose of CFCs and foreign disregarded entities?

Uncertain Tax Positions

- FIN 48 (2007) & Schedule UTP (2010)
- Towery: Does schedule UTP influence financial reporting?
- Boynton, Rupert, *et al*.: Does schedule UTP help identify tax aggressive firms?

Yes and No

Towery:

- Main results:
  - Financial reported tax reserves decrease in response to UTP requirements
  - Tax aggressiveness ***does not*** decrease in response to UTP requirements.
  - Does tax aggressiveness increase?
    - ETR measure: federal tax / book income
    - mechanical change in income due to fewer reserves?

Towery

Potential updates:

- Discontinuity design: compare firms just above and below threshold of $100 million
- Link between tax reserves and tax aggressiveness for 2007-2009.
- Meaningful intercepts

Boynton, Rupert, et al.

Main Findings

- Schedule UTP filers are no more likely to reduce taxable income through BTDs
- In 2010, UTP filers ***less likely*** to reduce taxable income through BTDs.

Boynton , Rupert, et al.

Remaining Questions:

- Relationship between UTP filing and BTD by line item.
  - Do UTP filers identify items with large BTD as uncertain benefits?
- UTP and domestic vs foreign income.
  - Does UTP help identify income that should be attributed to tax entity? Or identified as domestic?

Research, Analysis & Statistics

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Session 3: Tax Uncertainty and Corporation Compliance

Moderator:	***John Guyton*** *IRS, RAS, Office of Research*
Large Corporation Schedule M-3 Book-to-Tax Profiles of Schedule UTP (Uncertain Tax Position) Filers and Non-Filers: 2010 – 2011	***Lisa Rupert*** *IRS, Large Business & International*
Unintended Consequences of Linking Tax Return Disclosures of Tax Uncertainty to Financial Reporting for Tax Uncertainty	***Erin M. Towery*** *University of Georgia*
The Effect of CAP on Tax Aggressiveness	***Andrew Duxbury*** *University of Connecticut*
Discussant:	***Matt Smith*** *Department of the Treasury, Office of Tax Analysis*