Automotive Tax Insights

July 22, 2011

IRS updates Schedule UTP FAQs

The IRS on July 19 released responses to some frequently asked questions (FAQs) that have been raised by taxpayers and practitioners with respect to the final Schedule UTP. Several of these responses are relevant to automotive companies. The release supplements the March 23, 2011, FAQs and addresses four primary issues with respect to Schedule UTP reporting.

The general disclosure requirements of Schedule UTP as originally released by the IRS remain unchanged. A corporate taxpayer meeting all other filing requirements is required to disclose tax positions on Schedule UTP if the following two conditions are met: (1) the corporation has taken a tax position on its U.S. federal income tax return for the current or for a prior tax year and (2) either the corporation, or a related party, has recorded a reserve with respect to that position for U.S. federal income tax in audited financial statements or did not record a reserve for the position because the corporation expects to litigate the position. The new guidance clarifies and explains many taxpayers' concerns and comments.

The FAQs on Schedule UTP and related guidance are posted on the IRS website and can be viewed via the attached link: http://www.irs.gov/businesses/article/0,,id=237538,00.html.

For prior discussion, see WNTS Insights, "IRS modified final Schedule UTP and instructions for reporting uncertain tax positions (UTPs); expands policy of restraint," September 24, 2010, and "IRS releases guidance on Schedule UTP and policy of restraint" March 31, 2011.

Definition of "record a reserve"

The FAQs define the term "record a reserve" as follows: *"A reserve is recorded when an uncertain tax position or a FIN 48 liability is stated anywhere in a corporation's or related party's financial statements, including footnotes and any other* *disclosures, and may be indicated by any of several types of accounting journal entries.*

Some of the types of entries that, entered alone or in tandem, indicate the recording of a reserve are: (1) an increase in a current or non-current liability for income taxes, interest or penalties payable, or a reduction of a current or non-current receivable for income taxes and/or interest with respect to the tax position, or (2) a reduction in a deferred tax asset or an increase in a deferred tax liability with respect to the tax position."

Observations: By referencing the footnotes, other financial statement disclosures, and adjustments to deferred tax assets and/or liabilities, the IRS definition is generally consistent with the financial reporting definition of uncertain tax positions (UTPs). This definition presupposes the disclosure of reserves related to both temporary and permanent UTPs in the year the items are reserved for financial statement purposes.

Definition of "line item on a return"

The final instructions to Schedule UTP stated that a tax position taken on a tax return means a tax position that would result in an adjustment to a line item on that tax return. After the release of the final instructions, there remained uncertainty whether this definition described line items affecting the calculation of taxable income and/or the calculation of income tax or whether the definition also included adjustments to informational reporting such as Form 5471, *Informational Return of U.S. Persons with Respect to Certain Foreign Corporations*. The FAQs emphasize the original IRS definition of "a tax position taken in a tax return" to include informational reporting.

Observation: Given this definition, it is possible that some UTPs will be required to be disclosed prior to the period in which the uncertainty would affect the taxpayer's calculation of U.S. federal taxable income or tax liability.

UTPs embedded in an NOL or credit carryforward

The guidance issued by the IRS provides a significant clarification related to UTPs taken in the 2010 and post-2010 tax years that are embedded in a net operating loss (NOL) or credit carryforward. A UTP that creates or increases an NOL or credit carryforward and for which a financial accounting reserve is recorded must be reported on Schedule UTP. When the corporation subsequently uses the NOL or credit carryforward, disclosure is NOT required on Schedule UTP so long as the UTP has been previously reported on Schedule UTP.

Observations: Although the economy is rebounding slowly, many automotive companies are beginning to utilize their net operating losses. This update provides clarity on whether automotive companies need to disclose pre-2010 uncertain tax positions. The uncertainty related to the UTP reporting of these carryforward attributes originally arose from Example 9 of the final instructions to Schedule UTP and appears to be removed as a result of the FAQ. Further, this result is consistent with an FAQ released March 23 related to the interplay between UTPs embedded in an NOL or carryforward attribute and the transition rule.

Purchase accounting

The original instructions to Schedule UTP were largely silent on reporting requirements related to purchase accounting issues. The IRS responded by providing some Schedule UTP disclosure requirements in a straightforward business combination accomplished via a merger. The FAQ indicates that a reserve recorded by a surviving company in a straight merger transaction that relates to the merged entity must be disclosed on Schedule UTP. If the reserve is recorded in an audited financial statement of the surviving company prior to the merged entity filing its final tax return, the merged entity should include the UTP on its tax return. If the reserve is not recorded in an audited financial statement prior to the filing of the final tax return for the merged entity, then the UTP must be reported by the surviving entity on its tax return.

Observation: More guidance from the IRS likely will be required to address the Schedule UTP reporting of more complex business combination issues involving consolidated tax return filings.

Final observations

Overall, the FAQs respond to many of the outstanding concerns and questions raised by taxpayers and practitioners and provide additional clarity prior to the federal extended filing date for calendar-year-end companies.

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For more information, please do not hesitate to contact:

Neil Bristol	*313-394-3915*	*neil.g.bristol@us.pwc.com*
Horst Raettig	*+49 30 2636 530*	*horst.raettig@de.pwc.com*
Brian Meighan	*202-414-1790*	*brian.meighan@us.pwc.com*
Linda Stiff	*202-312-7587*	*linda.stiff@us.pwc.com*
Matt Prescott	*202-312-7578*	*matthew.prescott@us.pwc.com*

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