

Tax Alert

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New IRS approach to FIN 48 reporting requirements

What are the implications for Canadian transfer pricing?

In an address to the New York State Bar Association on 26 January 2010, Internal Revenue Service (IRS) Commissioner Doug Shulman made a significant announcement regarding corporate tax reporting in the United States. Commissioner Shulman announced that the IRS is developing a new schedule intended for use by business taxpayers with assets over US\$10 million to report uncertain tax positions on their tax returns. The schedule, to be filed with the corporate tax return, will require a concise description of each uncertain tax position and the maximum amount of potential US federal tax liability attributable to those positions (determined without regard to the taxpayer's risk analysis of its likelihood of prevailing on the merits).

For purposes of the schedule, uncertain tax positions will include those positions for which a tax reserve must be established under FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, (FIN 48) or other accounting standards such as International Financial Reporting Standards. It will also apply to any position related to the determination of US federal income tax liability for which the taxpayer or a related entity has not recorded a tax reserve because it either expects to litigate the position or has determined that the IRS has a general administrative practice not to examine the position.

The IRS contemplates that the concise description will include the rationale for the position and a concise general statement of the reasons for determining it is an uncertain tax position, a description of the tax year(s) to which the position relates, as well as statements about certain details of the position. The IRS

intends to mandate that the new schedule be included with returns filed after the release of the schedule. A non-compliance penalty is also under consideration.

While the commissioner did not comment on the financial impact of this additional disclosure, he suggested there would be little additional compliance burden on taxpayers, as these taxpayers are already required to establish their uncertain tax positions for financial reporting purposes.

In conjunction with this new reporting requirement, the commissioner's speech also addressed increased IRS efforts on transfer pricing enforcement. Commissioner Shulman announced that the IRS is establishing a dedicated transfer pricing practice within the Large and Mid-Size Business division to strategically and systematically administer transfer pricing issues. The stated goal is to increase IRS expertise in the transfer pricing area, to identify trends earlier and to provide consistent levels of enforcement and outcomes across the US.

The IRS has called for comments on the reporting proposal by 29 March 2010. Ernst & Young will be making a submission to voice the significant concerns of its clients.

What does it mean in Canada?

While the reporting proposal focuses on US federal tax, it will nonetheless have a significant and predictable domino effect in Canada. Canadian entities should be aware of the following potential consequences:

- ▶ **Increased risk of audit:** It is anticipated that the Canada Revenue Agency (CRA) will use the FIN 48 disclosure and related US tax reporting obligations to assist in guiding its transfer pricing audits. Canadian taxpayers can expect that any significant transaction with a US-resident entity will be examined and closely scrutinized.
- ▶ **Increased analysis and reporting:** In certain circumstances, the US reporting requirement

may force Canadian subsidiaries or affiliates of US tax reporting entities to perform significantly more analysis regarding uncertain tax positions. Materiality levels for Canadian subsidiaries or affiliates regarding uncertain tax positions may be reduced in conjunction with the expected additional IRS scrutiny.

- ▶ **Potential US bias:** This additional US reporting requirement may lead to a bias toward US over-compliance as taxpayers favour the US entity over the Canadian entity in pricing intercompany transactions. As stated above, it is anticipated that the CRA will be actively seeking out such bias during the course of Canadian transfer pricing audits.
- ▶ **More conservative tax environment:** The additional scrutiny of uncertain tax positions will likely cause US reporting entities to become much more conservative in taking positions that could impact their potential US tax liabilities. This may create a schism between US-based multinational entities and entities based in jurisdictions outside the US.
- ▶ **Possible replication in Canadian reporting:** There is a long history of the CRA replicating policies originally developed by the IRS. Accordingly, it is anticipated that the CRA will replicate this IRS initiative and will demand that similar information be reported in Canadian corporate tax returns.
- ▶ **Increased APAs likely:** These new US reporting requirements are likely to foster additional interest in advance pricing arrangements (APAs) as the only mechanism to provide certainty in relation to transfer pricing.

If implemented, the new IRS reporting requirements for FIN 48 will dramatically increase the visibility of uncertain tax provisions as they relate to transfer pricing. This increased visibility — in conjunction with the IRS investment in additional transfer pricing audit resources — will result in increased transfer pricing controversy in the US and abroad as various tax administrations battle over the relative allocation of profits within multinational groups.

The domino effect in Canada created by this proposed reporting requirement will have a significant impact on Canadian subsidiaries of US multinationals, as well as Canadian affiliates of US multinationals.

If history is any indication, we may expect to see a similar reporting requirement in Canada in the near future. For now, Canadian taxpayers can expect additional scrutiny and exposure as a result of the IRS proposal.

Learn more

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