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Tax Aggressiveness and the Effects of Potential Detection for Uncertain Tax Position Reporting

Robert Lee

Anthony P. Curatola*

INTRODUCTION

Firms have an incentive to minimize expenses, especially income taxes, and thereby increase profits and cash flows to satisfy corporate investors. One way to achieve this objective is by selecting various tax favored activities that produce deductions, exclusions, or credits, all of which result in lower taxes. Some tax favored activities, however, are seen as aggressive tax avoidance activities while others are simply mishandled as a result of the ambiguity and complexity of the Internal Revenue Code (Code). In these situations, the Code and its interpretations cause firms to question whether their tax position is in compliance with the Code or its interpretation by the courts, Treasury or the IRS. The overall result is the likely underreporting of taxable income on a firm's income tax return.

According to the U.S. Government Accountability Office (GAO), corporate tax noncompliance remains a significant component that contributes to the tax gap.[1] Slemrod (2004) finds that corporate tax noncompliance has been a growing issue and involves complex transactions such as abusive tax shelters. In 2006, the GAO found that the corporate tax gap was approximately $71 billion and was mainly caused by firms underreporting their income.[2] The IRS released a new set of tax gap estimates for tax year 2006 in December 2013.[3] The new tax gap estimate shows the nation's voluntary compliance rate is essentially unchanged at about 83.1% from the last review covering tax year 2001, which was estimated to be 83.7%.

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*The authors are, respectively, Assistant Professor at Pepperdine University and Joseph F. Ford Professor at Drexel University.

[1] The tax gap is the amount that is legally owed by firms compared to what is actually reported or paid by firms.
[2] Source available at http://www.gao.gov/assets/600/590215.pdf

[3] IR-2012-4, Jan. 6, 2012.

One challenge facing the IRS is the minimization of time spent investigating areas within a firm for compliance with the Code. Given the simple fact there are millions of firms reporting numerous transactions annually on their income tax return, the IRS faces quite a challenge attempting to process and efficiently attest to the corporation's tax compliance. In January 26, 2010, former IRS Commissioner Douglas H. Shulman stated, "we (the Service) spend up to 25 percent of our time in large corporate audit searching for issues rather than having a straightforward discussion with taxpayers about the issues.[4]"

The IRS sought to gain additional insight in identifying uncertain tax positions by requiring firms to file a new tax form "Schedule Uncertain Tax Position (UTP)" with their corporate tax return. This new form identifies specific transactions "of particular interest or of sufficient magnitude to warrant Service inquiry." Thus, firms are being required to highlight all uncertain tax positions that are recorded in their audited financial statements or that are expected to be litigated by the IRS.

As expected, the business and tax communities were jolted by this new self-reporting requirement. In fact, the announcement generated the largest number of comments within the Tax Executives Institute community since the Tax Reform Act of 1986.[5] Schedule UTP received a great deal of attention because it provides the Service a road map to a firm's potential tax noncompliance transactions. Thus, the IRS no longer has to search for audit issues; rather, firms are providing a list of potential transactions that may warrant further investigation. As stated by former IRS Commissioner Douglas Shulman, this disclosure requirement is a "real game-changer."

The objectives of this paper are to discuss the implications of how financial and tax reporting regarding tax compliance by firms may be affected by this new disclosure requirement. The remainder of this paper is broken into three sections. First, the background to uncertain tax position reporting in the financial accounting statements and in the tax returns is discussed. Second, the implications and potential scenarios are presented of

[4] From New York State Bar Association Taxation Section Annual Meeting in New York City, January 26, 2010

[5] From Tax Executives Institute, Inc. President's Corner by Paul O'Conner September - October 2010

how firms may alter their reporting behavior to reduce the likelihood of an IRS audit. Finally the overall conclusions are drawn.

UNCERTAIN TAX POSITIONS

Generally, firms want to decrease their taxable income so that they can increase their cash flow. One way to achieve this objective is to reduce their income tax liability to the federal, state and local treasuries. A reduction in one's tax liability is achieved by taking advantage of deductions or exclusions provisions, which reduces the amount of taxable income and thereby reduces the income taxes owed by the firm. Likewise, a firm can look to other tax provisions that provide a tax credit, which reduces the firm's tax liability directly. Common examples of uncertain tax positions include characterizing gains or losses as capital gains or losses, claiming a tax credit, exclusion of income that is thought to be tax exempt by managers, and taking a tax deduction in the current period. All tax favored transactions provide a tax savings to the firm. But, due to the complexity of the Code and even its interpretations by Treasury and the Courts, questions still remain as to the total compliance of some transactions with the Code.

A firm may claim the tax benefits associated with an uncertain tax position transaction today, but the Service is not likely to challenge the transaction for several years when an audit is conducted. If the IRS challenges the integrity of an uncertain tax position, the firm will incur additional legal costs defending their position. Furthermore, if the Service should prevail on their challenge of the transaction, the firm will incur further costs in paying back the tax benefits claimed as well as accrued interest to date and any penalties assessed.

For example, a firm may claim a tax credit on the cost of its R&D project even though some uncertainty may exist concerning the classification of some costs associated with the project. A tax manager can research the interpretation issued by Treasury and the holding of the Courts. But even with such available tax resources for established tax provisions through regulations, rulings, and case law, the facts associated with a particular transaction may still leave a tax manager in a quandary as to the proper handling of the tax transaction. Even further, the transaction remains open for 3, or 6 years, whereby the IRS can challenge the transaction. Thus, the initial challenge to an uncertain transaction has a relatively lengthy life.

In the case of a newly or recently enacted tax provision, the tax manager has limited resources to check out since the only insight available is generally found in Congressional reports, which may not totally agree with the final written tax provision or the interpretations by Treasury or the Courts at a later date. In September 2010, former IRS Commissioner Douglas Shulman stated that tax uncertainty arises because of the "ambiguity in tax law and lack of published guidance." The Service acknowledges that at times, the tax law is difficult to fully comprehend and comply to specific transactions.

The area of uncertain tax positions is a challenging one for firms. Prior to 2007, there was great discrepancy between how firms recognized and accounted for uncertain tax positions. Since *Statement on Financial Accounting Standards No. 109* (SFAS 109) provided no guidance on how to account for uncertain tax positions, firms were forced to turn to other pronouncements for guidance. In particular, firms turned to *Statement on Financial Accounting Standards No. 5* (SFAS 5) as guidance on whether or not to accrue a liability. Another method firms have utilized to record and measure tax reserves was the expected value approach. Under this method, firms record a liability based upon its expected value and probability of the tax position being challenged and reversed.

FIN 48

The ability of firms to choose different methods such as SFAS 5 guidelines or the expected value approach created an inconsistent reporting environment for uncertain tax position reporting (FASB 2006). In response, *FASB Interpretation No. 48* (FIN 48) was announced in June 2006; it became effective for firms after December 15, 2006. The purpose of FIN 48 according to the FASB is to improve consistency in the reporting of uncertainty in income taxes by firms in their financial statements.

FIN 48 requires a two-step procedure: recognition and measurement. The recognition step is based upon a more likely than not (MLTN hereafter) threshold where there is a 50 percent probability or greater that the firm will sustain a tax position based upon technical merits after a review by the tax authority. This assumes that the Service has full knowledge of all the relevant information pertaining to the tax position. If the tax position does not meet the 50 percent threshold and is below, then the tax benefit may not be recognized and no reserve is recorded. If the firm determines that the tax position meets the MLTN threshold, then management must use the measurement step to determine the tax reserve. The measurement step is determined by using the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement.

After a firm assesses each uncertain tax position, it is required to disclose several pieces of information. First, the sum of all uncertain tax positions is disclosed in a tabular reconciliation in its annual financial statements. The aggregate amount has been found to be approximately 1 to 2 percent of the total assets of the firm by prior studies (Blouin, Gleason, Mills, and Sikes 2007; Dunbar, Kolbasovsky, and Phillips 2007, Edwards, Koester, and Shelvin 2010). Thus, a tax reserve can range from millions to billions of dollars depending on the size of a firm. Second, firms are required to disclose the total amount of unrecognized tax benefits that would affect the effective tax rate. Third, firms must disclose the total amounts of interest and penalties as well as the change of uncertain tax positions that could result within the next 12 months. Finally, firms are required to disclose the open tax years that are available for examination by major tax jurisdictions.

In the first year of implementation, FIN 48 received a significant amount of attention from the tax community. Firms were concerned about the compliance costs of disclosing their aggregate tax reserve and the potential audit costs that are associated with FIN 48 disclosure. FIN 48 has been referred to as a "road map" because a firm's disclosure here was expected to aid the Service in detecting specific audit issues that were not in compliance with the Code.

However, the Service realized that after FIN 48 was implemented, it failed to provide the road map everyone assumed it would provide. Part of its failure was attributable to the fact that aggregated data does not easily translate for the Service to identify specific issues. An advisor to the IRS Large and Mid-Size Business division stated that FIN 48 disclosures "were not very helpful in the context of trying to assess if companies had

U.S. tax contingencies that we should focus on (Coder 2008, page 678)." FIN 48's aggregate disclosure has been claimed to be a noisy variable because impounded within the aggregate tax reserve includes a large quantity of tax positions that vary in quality and size. Due to the ineffectiveness of FIN 48, the IRS elected to create their own road map (i.e., Schedule UTP) for companies to provide them. But IRS Chief Counsel Donald Korb stated that the IRS is "not going to turn a blind eye" to FIN 48; they will continue using FIN 48 disclosures as an enforcement tool.

SCHEDULE UNCERTAIN TAX POSITION

In 2010, the IRS issued Announcements 2010-9, which introduced Schedule UTP. Former IRS Commissioner Douglas Shulman stated that some of the goals for Schedule UTP are to "cut down the time it takes to find issues and complete an audit" and "help us prioritize taxpayers for examination." FIN 48 can be seen as a starting point for Schedule UTP because it is based upon FIN 48 disclosure requirements where all uncertain tax positions disclosed relating to FIN 48 must be included in the Schedule. In addition, Schedule UTP requires the inclusion of all tax positions that are expected to be litigated by the Service. So even if the tax position has no reserve because the firm plans to litigate the tax position, the tax position still has to be disclosed on the Schedule UTP. This ensures that tax positions that do not satisfy the MLTN threshold per FIN 48's guidelines are included within the Schedule UTP.

Schedule UTP requires firms to disclose individual uncertain tax position to the reporting authorities. This disclosure is significantly more information than the aggregate amount required by FIN 48. Further, Schedule UTP requires a detail listing of all uncertain tax positions that a firm has taken, beginning with the 2010 tax year.[6] Within the Schedule, firms must rank order all uncertain tax positions within Schedule UTP, based on the U.S. federal income tax reserve and provide a concise description of each tax position. In addition,

[6] Although the uncertain tax position filing requirement begun for the 2010 tax year, a 5 year phase in process has occurred. For the first year, only firms with assets equal or greater than $100 million were required to file a Schedule UTP. In 2012, firms with assets over $50 million or more were required to report Schedule UTP, and in 2014, the threshold decreased to $10 million.

taxpayers must disclose major tax positions, which encompass uncertain tax positions in which the reserves make up 10 percent or more of the aggregate reserve. Finally, taxpayers must disclose whether the tax position will create a permanent or temporary difference.[7]

Similar to the initial reaction of disclosure requirements of FIN 48, taxpayers became even more concerned with this new detailed level of information begin required by the IRS. The apparent signal is the tax authorities are planning to conduct more intense audit. Hank Gutman, director of KPMG's Tax Governance Institute and former chief of staff to the Joint Committee on Taxation stated that "this scenario (implementation of Schedule UTP) clearly underscores that in the more assertive regulatory environment, the financial penalties and reputational risks of tax noncompliance are going to be high for a company." Firms are concerned that the compliance, reputational and investor valuation costs will increase as a result of disclosing additional uncertain tax position information.

The initial response by firms may be to decrease their tax aggressiveness reporting behavior. However, the need for cash within a firm is likely to keep uncertain tax position reporting attractive over time. This need is based on the fact that uncertain tax positions are inherently ambiguous and subject to the judgment of firms when being recorded and measured. This uncertainty provides firms the flexibility in determining which uncertain tax positions are disclosed and how they are presented to reporting authorities. Firms are being required to assess and report their firm's tax compliance using a self-reporting process. Although this self-reporting may taint one's view on the need to report some transactions as aggressive, one must recognize that there are provisions in the Code that penalize a company for underreporting one's tax liability.

SCHEDULE UTP: IMPLICATIONS

The firms' response to Schedule UTP is important because it will influence the strategic interaction between firms and the IRS and financial reporting, which will ultimately affect firms' reporting tax compliance. As one might suspect, there is disagreement among the tax community on the impact of uncertain tax positions.

Some members believe the new form of reporting will decrease aggressive tax reporting because of the increased audit risk, while other members see it differently. The interesting component of Schedule UTP is the inherent nature of uncertainty within uncertain tax position reporting. Uncertain tax position reporting is based upon a firm's interpretation of the tax position and tax code, which is a debatable topic in itself. A simple review of many court cases illustrates the different interpretations between taxpayers, the IRS and even justices in the form of split and dissenting opinions. But a better illustration of this appears when Congress issued a refundable excise tax credit for alternative fuel mixture in 2009. According to DeSimone, Robinson and Stomberg (2011), nineteen firms claimed this credit. It was expected that all 19 firms would have recorded the refundable credit in the same manner, but interestingly, this was not the case. The difference was five out of 19 firms included the refundable credit in the firm's taxable income while the other 14 firms did not. Within the 14 firms, nine firms recorded the tax position as an uncertain tax position and either recorded a partial or full reserve; whereas the remaining five firms did not record a reserve at all. This is a prime example of how provision in the Code is interpreted differently even within the same industry and time frame. This phenomenon allows firms the flexibility to record and measure uncertain tax positions, which determines if the information will be disclosed to the IRS and how it will be presented.

If firms are seeking all potential tax positions that can reduce the firm's overall tax expense, they are going to inevitably run into uncertain tax positions that need to be reported. But, firms can enact counter measures to this new form of audit risk by altering the two components of uncertain tax position reporting: the nature of the tax position and the respective tax reserve. The first counter measure is the ability of firms to determine whether to classify the tax position as an uncertain tax position. This decision should be made in accordance with FIN 48's guidelines. If the tax position is not deemed by the firm to be an uncertain tax position, then the firm will not be required to report the tax position on Schedule UTP. Moreover, one might reasonably conclude that firms can continue participating in tax aggressive behavior. While one may question the likelihood of this reporting behavior by firms, the alternative fuel mixture tax credit example does lend support toward this practice. Firms clearly vary how they classify the same tax position as either a certain or an uncertain tax position.

As a deterrent to this overly aggressive tax behavior, the Code presently provides the IRS with the ability to assert penalties for accuracy related underpayments of taxes under IRC §6662. In addition, penalties can be assessed for negligence or disregard of rules or regulations. Finally, the IRS could petition Congress to provide stiffer penalties for continuous underreporting or aggressive reporting behavior by firms.

This new level of reporting provides the IRS additional insight into aggressive tax behavior by providing them with a listing of uncertain tax positions by firms within and across industries. IRS agents can now analyze and examine the uncertain tax position disclosed. Thus, the Service is able to determine the common uncertain tax positions disclosed within an industry and by company size. So the IRS can focus its efforts on firms within an industry regardless of whether they disclose or fail to disclose an uncertain tax position.

The IRS has reported the filing statistics for the first 3 years of firms filing Schedule UTP. The results are not clear cut. To begin, the average uncertain tax position per firm ranges is 2.3 in TY2010, 2.6 in TY2011 and 2.5 in TY 2012. The most common uncertain tax positions over the same time frame are the research credit, transfer pricing, and capitalization.[7] [8] This information provides the IRS a benchmark to base their audits. Firms that fail to fall in line with the industry benchmark will be easily identified as outliers that may suggest abnormal tax reporting behavior. In either case (disclose or fail to disclose), firms may become targets of specific audits.

Two additional pieces of information arising from the three year time frame pertain to the tax position information being reported. The first piece of information shows the number of UTP filers reporting only one tax position dropped from 47% in TY 2010 to 41% in TY 2011, but then the percentage rebounded to 49% in

[7] Source available at: http://www.irs.gov/Businesses/Corporations/UTPFilingStatistics

[8] The IRS also noted that based on FDRA analysis of UTP concise descriptions, IRC 263 "capitalization is the 3rd most common tax position reported. However, IRC sections reported by taxpayers on Sch. UTP indicate that IRC 162 "trade or business expenses) was the 3rd most common tax position.

TY 2012. The second piece of information shows the number of UTP positions reported increased from 4,882 in TY 2010 to 5,784 in TY 2011, but then the number dropped to 4,774 in TY 2012. Albeit a small sample of information, data does begin to show some reaction by the firms.

What remains unclear is whether firms will collectively or individually change their uncertain tax position reporting under Schedule UTP. The data is still novel and the IRS is learning how to fully integrate Schedule UTP into their audit process. If firms collectively change their uncertain tax position reporting behavior along similar lines (i.e., change common risky uncertain tax positions to certain tax transactions), then the IRS may be seen to be losing their advantage in detecting these specific issues. Conversely, if only a few industries change their reporting behavior, the IRS may be able to use that data to establish benchmarks for particular industries to concentrate their audits. In sum, a vital component within this strategic interaction between the IRS and firms is how each firm within an industry is going to respond to Schedule UTP.

Secondly, a firm may take a more conservative approach. That is, they can classify a tax position as an uncertain tax position, but then strategically measuring the tax reserve to their preference. The process of determining the amount to record as a tax reserve is a subjective task. As evidenced by the refundable excise tax credit for alternative mixture, firms have varied their tax reserves from none to partial to fully reserving an uncertain tax position. Interestingly, under Schedule UTP, uncertain tax positions are disclosed in rank order based upon the tax reserve, from the largest to the smallest. So if a firm believes the rank order is a relevant measure, they may choose to record a smaller tax reserve for the respective tax position. But again, this belief is pure speculation on whether the Service will target larger uncertain tax positions first to maximize their revenue.

The Service has repeatedly announced that they will be using FIN 48 disclosures as an enforcement tool. The question is how? On the one hand, Schedule UTP does not include any specific dollar amounts. Hence, the IRS can utilize FIN 48 disclosure to gather and determine the overall magnitude of the uncertain tax positions. While FIN 48 may be considered a noisy variable when it is utilized alone, in conjunction with

Schedule UTP, FIN 48 disclosure becomes more informative. For example, if the IRS obtains a Schedule UTP with five uncertain tax positions listed, they will know the specific nature surrounding the uncertain tax positions because the uncertain tax position will be disclosed with a concise description. But the IRS will not know the individual tax reserve for each uncertain tax position. To help determine whether these five uncertain tax positions warrant further inquiry, the IRS can look at the firm's FIN 48 disclosure to gauge the overall tax reserve for the respective five uncertain tax positions. Thus, the Service can use this aggregate tax reserve to provide a general basis to help prioritize and conduct audits. Generally, firms with larger tax reserves and multiple uncertain tax positions may suggest that they are practicing aggressive tax reporting behavior, raising potential red flags during the audit process. As a result, firms will be motivated to record smaller tax reserves to decrease the probability of an IRS audit.

Thirdly, Schedule UTP puts pressure on individuals at the managerial level. The Service's ability to detect tax noncompliance issues more efficiently allows firms to match tax actions with tax consequences. Prior to Schedule UTP, there was a lag in time between tax actions and tax consequences. Managers can make tax decisions for the current period, and the tax consequences if any, would incur in latter periods. In 2005, former IRS Commissioner Mark W. Everson stated, audits "on average, take five years to complete for large corporations." This significant time lag makes it difficult for a firm to pair a tax penalty to an individual, allowing management's personal wealth of a firm to be unaffected. Individuals can choose aggressive tax positions to minimize their tax expense in the current period and receive a positive performance evaluation, when in fact the tax actions create a compliance risk for their firm. But with Schedule UTP, the IRS claims that they will be able to detect tax noncompliance issues more timely, narrowing the gap between tax actions and tax consequences. Schedule UTP is intended to allow the Service to "work cases as effectively and efficiently as possible." If this claim is true, then Schedule UTP will provide an additional incentive for managers to adopt a more conservative tax practice to avoid any personal consequences.

Certified public accountants are expected to act ethnically by their code of professional conduct. Although accountants are expected to act as advocates for their firm, they are contemporaneously required to remain objective with integrity. This dilemma can be especially a difficult task for individuals because of the uncertainty surrounding the Code. One accountant may argue a tax position abides with the given language of the Code and its interpretations and as such, exhibits advocacy and integrity while another may disagree.

Klepper et al. (1991) argue that tax preparers have two duties to their client, one is being "exploiters" and the other is being "enforcers." On one hand, tax preparers are expected to decrease their firm's taxable income by seeking all applicable tax avoidance transactions, hence serving as an exploiter of the tax code. However, tax preparers also have a fiduciary duty as tax professional to abide by and comply with the Code. The professional code of conduct requires that tax preparers adhere to the ethics of their profession and comply with the Code.

Some may contend Schedule UTP may cause the tax preparers role to shift toward an enforcer rather than an exploiter. Tax professionals are aware of the compliance costs associated with Schedule UTP and may naturally be inclined to adopt a more conservative reporting behavior because their personal reputation and career are at stake. If a firm's tax position resulting from Schedule UTP is reversed, the tax preparer's welfare will be directly affected.

However, contemporaneously, tax preparers also are compensated by the client, creating an economic bond between the client and the tax preparer. Although tax preparers are expected to abide by the Code and be an enforcer of the Code, the tax preparer is also dependent on the client because they are compensated by the client. If the tax preparer does not decrease the tax liability as expected by the client, the client can seek another tax preparer. This tension creates an incentive for tax preparers to still play the role of an exploiter.

Another layer of complexity is that research has found that individuals view corporate crime different than individual crime (Clinard and Yeager 1980). The intuition is that corporate misconduct is more acceptable than individual misconduct because in the corporate context, the action is associated with the firm, rather than the individual. The firm acts as a buffer for the misconduct and becomes more acceptable to society. Conley and O'Barr (1997, page 7) state that "we have in mind stepping back from the usual assumptions (misconduct is clearly a crime) and treating the corporation as if it were exotic, a part of unfamiliar culture rather than our own." This assertion argues that individuals may view corporate tax noncompliance as less of a crime than individual crime.

Finally, Schedule UTP has potential implications on legislation that encourages firms to participate in certain tax incentives that will result in a beneficial tax provision. Tax provisions that are naturally appealing to firms will now be more thoroughly evaluated. For example, the credit for increasing research activities (research credit hereafter) found in Internal Revenue Code Section 41 was enacted to promote innovation and advancement for firms. It is an attractive tax incentive for various industries that helps both the economy and firms. However, the Service has strict guidelines for qualifying for this tax benefit, such as what qualifies as research expenditures and what is sufficient documentation. The IRS has stated that the research credit has suffered from "high level estimates" and "biased judgment samples." Since 2007, the IRS has designated the research credit as a Tier I audit issue for the Large Business and International Sector, expressing its concern that firms were not properly claiming the credit. Now with the Schedule UTP, firms will reconsider the tax benefits and tax costs of tax provisions, such as the research credit. Although the tax benefit has remained the same, the potential compliance costs have increased. Schedule UTP increases the probability of detection, which increases the potential compliance costs such as penalty, interest, and reputation. Naturally, firms want to elect tax positions where the overall tax benefits exceed the potential tax costs. Uncertain tax positions that firms are not confident with should be reconsidered to determine whether the tax benefits exceed the tax costs. The risk of electing an uncertain tax position that has a low probability of being sustained may be too high for firms. As a result, the firm may forego the tax benefit for the benefit of not having any red flags on their Schedule UTP. Firms must strategically select uncertain tax positions that they are confident they can defend if challenged by the Service, which means they may have to forego certain tax provisions set by Congress.

CONCLUSION

The implementation of Schedule UTP is expected to change firms' reporting behavior and their tax compliance. Firms are expected to be motivated to alter their tax strategies so that they minimize red flags to the IRS, which could result in further scrutiny by the Service. This added form of technical reporting will more than likely create a new level of tension between firms and the IRS and result in ultimately affecting how uncertain tax positions are measured and recorded.

Second, another level of tension is likely to be created between tax managers and top management as they requiring more aggressive tax behavior in order to provide a better net income to their investors. As such, it remains uncertain how effective Schedule UTP will be for the IRS as an audit tool.

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