

Client Alert.

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Schedule UTP: The IRS's Most Aggressive Tax Position To Date

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On September 24, 2010, the Internal Revenue Service released the anxiously anticipated final version of Schedule UTP (Uncertain Tax Positions) and associated instructions. The final version differed significantly from the original draft Schedule due in large part to extensive comments from the tax bar, the accounting profession and other interested parties. The proposed effective date of Schedule UTP is for tax years beginning after December 15, 2009 and ending after the date of publication of final regulations. See Prop. Reg. § 1.6012-2(a)(5). The documents issued on September 24 are:

- Announcement 2010-75, which explains the changes the IRS made to the proposed draft Schedule in reaching the final version
- Schedule UTP and Instructions
- Announcement 2010-76, which sets forth a modification to the policy of restraint regarding requests for tax accrual workpapers
- An IRS internal directive regarding policy of use of the UTP
- Commissioner Shulman's prepared remarks to the ABA Tax Section

These can be accessed at the IRS website at <http://www.irs.gov/businesses/corporations/article/0,,id=221533,00.html>.

HIGHLIGHTS OF SIGNIFICANT CHANGES

Many of the major changes announced by the IRS were welcomed by tax practitioners:

1. Eliminating the intrusive request for work product or privileged information by no longer requiring the taxpayer to explain why a position is an "uncertain tax position" and to state the "maximum tax adjustment" relating to such position. Furthermore, the Commissioner and the instructions specifically state that no risk analysis is required to be produced in the UTP schedule.
2. Providing for many taxpayers, but not all, that the IRS in the course of an examination will not assert that the taxpayer has waived the attorney client, Section 7525 or work product privileges by producing information to its audit firm in connection with a financial statement audit.
3. Eliminating the requirement that positions for which a financial statement reserve is not established because of the administrative practice exception be reported on the UTP schedule.
4. Deferring any requirement that pass-through entities prepare a UTP schedule as well as any proposal to impose additional penalties based upon the manner in which a UTP schedule is prepared.

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We discuss these in more detail below, but we note that although these changes are welcome, they do not resolve all concerns about maintaining confidentiality in view of the requirement to file Schedule UTP.

WHICH TAXPAYERS ARE AFFECTED?

Form 1120, 1120 L, 1120 PC and 1120 F filers that issue or are included in audited financial statements and that have total assets equal to or exceeding \$100 million must attach the Schedule to their annual income tax return. The asset threshold will be reduced to \$50 million and then \$10 million for the 2012 and then 2014 tax years, respectively. Consolidated return taxpayers file one UTP schedule and are not required to identify particular members with respect to the positions that are reported. Compliance Assurance Program (CAP) and Coordinated Industry Cases (CIC) taxpayers are not excluded from the obligation to file a UTP schedule.¹

The IRS previously announced that it will not require a Schedule UTP from Form 1120 series filers other than those identified above (such as real estate investment trusts or regulated investment companies), pass-through entities, or tax-exempt organizations. See Announcement 2010-30. After receiving comments on this issue, the IRS stated that it will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers for 2011 or later years. See Announcement 2010-75. If the IRS decides to go forward with Schedule UTP for other taxpayers it is not clear how it will apply to pass-through entities, such as subchapter S corporations or partnerships. An uncertain tax position is relevant only to entities that have to establish reserves with respect to income tax liabilities, but pass-through entities do not have income tax liabilities and therefore no uncertain income tax positions.

WHAT IS A REPORTABLE UNCERTAIN TAX POSITION?

The final Schedule requires two types of uncertain tax positions to be reported: (1) a tax position for which a reserve was recorded, and (2) a tax position for which no reserve was recorded based on an expectation to litigate. The IRS dropped a proposed additional category of positions for which no reserve was established because of the administrative practice of the IRS. The Commissioner explained that, in consideration of comments received, this category was not sufficiently administrable and may have determined that such positions were not likely to be a source of significant noncompliance.

With regard to each position the following information must be provided on the Schedule:

- UTP number – a serial numbering for each position
- Primary Code sections relating to the position
- Ranking of the tax position relative to the other positions where the size of a tax position is the amount of reserve recorded for that position
- Whether the position is a “Major Tax Position” – if the position represents 10% or more of the entire aggregate of all reported positions determined by size of reserve
- The taxable year to which the position relates
- Whether the position involves a permanent inclusion or exclusion of any item and/or the timing of that item

¹ In Ann. 2010-75, the IRS stated that additional guidance for UTP compliance for CAP taxpayers would be provided in upcoming CAP permanence guidance.

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- Pass-through entity EIN where the reporting corporation has an uncertain tax position that relates to a pass-through entity
- Concise description

The information requirements in the final UTP are much simplified and streamlined in comparison to the draft schedule, most notably in dropping special reporting rules for transfer pricing and valuation positions, the abandonment of the requirement to identify the maximum tax adjustment for general tax positions, and the simplified concise description.

It is worth some reflection regarding the continued requirement to identify positions for which no reserve is taken due to the taxpayer's expectation to litigate. The IRS expressly declined to provide guidance on how a corporation should document these positions, saying that it "expects that a corporation would continue to document its decision in the same way as it substantiates any decision not to record a reserve in its financial statements." Announcement 2010-75. What does this indicate about other uncertain tax positions for which there is a reserve? Could the IRS argue that the taxpayer does not expect to litigate these positions and thus that documents created analyzing the risks regarding these positions are not work product because the corporation did not "anticipate litigation" with respect to these positions?

CONCISE DESCRIPTION SUBSTANTIALLY CHANGED

The proposed draft Schedule required a concise description that included a statement of "the rationale for the position and the reasons for determining the position is uncertain." In view of many negative comments claiming that the IRS was seeking information protected by privilege or work product through the concise description, the IRS substantially revised this requirement:

Provide a concise description of the tax position, including a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue.

Moreover, the instructions to the schedule specifically state that the description is not to include an assessment of litigation hazards or other risk analysis. To assist taxpayers, the IRS included an example of both a tax position and a sample description of that position.

Sample Tax Position

The corporation investigated and negotiated several potential business acquisitions during the tax year. One of the transactions was completed during the tax year, but all other negotiations failed and the other potential transactions were abandoned during the tax year. The corporation deducted costs of investigating and partially negotiating potential business acquisitions that were not completed, and capitalized costs allocable to one business acquisition that was completed. The corporation established a reserve for financial accounting purposes in recognition of the possibility that the amount of costs allocated to the uncompleted acquisition attempts was excessive.

Sample description

The corporation incurred costs of completing one business acquisition and also incurred costs investigating and partially negotiating potential business acquisitions that were not completed.

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The costs were allocated between the completed and uncompleted acquisitions. The issue is whether the allocation of costs between uncompleted acquisitions and the completed acquisition is appropriate.

The sample description provides nothing more than what a revenue agent could determine in the most general of information requests during an audit and does not indicate the nature of the uncertainty. That there is an uncertainty regarding the position is of course identified through the listing of the position on the UTP. Careful drafting of the description is important to ensure that nothing more than a general description of the relevant transaction or event giving rise to the tax benefit is provided.

HOW IS THE TAX POSITION MEASURED?

A tax position is based on the unit of account in the audited financial statements in which the reserve is recorded. The IRS is requiring consistency between GAAP reporting and UTP reporting in this regard. A tax position taken in a tax return means a tax position that would result in an adjustment to a line item on that tax return if the position is not sustained. A line item on a tax return may be affected by multiple units of account, in which case each unit of account must be reported separately on Schedule UTP. An example of this is the research credit under Code section 41, which appears on Form 6765 as a single credit amount. Multiple units of account can affect that amount. The instructions to the final UTP use the research credit to illustrate the unit of account approach to determining the position that is reported. In example 5, the instructions describe two corporations that each undertook two research projects giving rise to the research credit. The first corporation collects its creditable expenses at the project level, so its computation of the research credit is composed of two units of account, each of which must be reported on the UTP, assuming the corporation has determined that each position, as defined by the unit of account, is uncertain. The second corporation has adopted a functional expense unit to collect its creditable expenses and so must report each functional expense unit as positions, again only if the corporation has determined there is an uncertainty regarding each of those positions.

SPECIFIC GUIDANCE ON FOREIGN TAX POSITIONS

There was an uncertainty in the draft schedule regarding whether foreign tax positions had to be reported. For example, a company may have an uncertainty regarding a foreign tax credit computation where the uncertainty flowed from a determination of foreign tax law, not domestic tax law. Announcement 2010-75 clarified by stating that a corporation is required to report a U.S. federal income tax position taken in a return that arises out of uncertainty with regard to a foreign tax position (e.g., foreign tax credits) if a reserve for U.S. federal income tax was recorded to reflect that uncertainty.

This clarification raises an interesting question. Suppose that the uncertainty regarding the foreign tax credit stems from an uncertainty about foreign tax law and not the U.S. treatment of the foreign tax as a credit. If the issue is an item on a foreign tax return, it is not apparent how the IRS would have authority to audit such return and that would not seem to be the purpose of the schedule, which focuses on uncertain domestic tax positions based on domestic law.

PENALTIES

When the Commissioner first announced the proposal to require taxpayers to identify their uncertain tax positions he indicated the IRS may seek legislation for penalties for noncompliance. In later comments, officials stated that the IRS is no longer seeking special penalty legislation. Practitioners were left to speculate what might be the penalty for failure to complete the UTP schedule. In Announcement 2010-75, the IRS stated that it will wait to see how taxpayers comply and revisit the question of penalties where, with respect to specific noncompliant taxpayers, it might open an examination or

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make “another type of taxpayer contact.” The IRS did not elaborate on what type of other contact might be made. Certain non-audit contacts, such as a notice of inadequate records certainly do exist in the variety of enforcement tools of the IRS, but it is not clear what type of contact might be appropriate other than a notice of perceived lack of compliance with the schedule.

ANNOUNCEMENT 2010-76, MODIFICATION OF THE POLICY OF RESTRAINT

Announcement 2010-76 states that the IRS will not assert a waiver of attorney-client privilege, section 7525 tax advisor privilege or work product during an examination with respect to documents that are disclosed to an outside auditor in the course of a financial audit. (It is necessarily implied that the IRS would also not assert that such production is a subject matter waiver regarding the subject covered by the documents provided to the auditor.) It is important to note that this applies only to documents that are otherwise protected or privileged and for which such protection has not already been waived through some other disclosure. This policy of restraint is limited and does not apply to taxpayers who have engaged in listed transactions as in *United States v. Textron* or to the IRS’s existing policy of seeking tax accrual workpapers in “unusual circumstances.”

Although this policy of restraint is most welcome, it raises some important considerations such as:

- Will counsel for the IRS in litigation follow this policy of restraint or will they assert a waiver (and subject matter waiver) should the controversy proceed beyond the examination level?
- Does completing the UTP schedule itself constitute a waiver? Apparently, although it is not expressly stated, the IRS is of the view that it is not requiring the production of any privileged or work product information in the revised schedule, hence filing such schedule is not a waiver. We would have welcomed a more explicit statement to that effect.
- Taxpayers should also consider the consequence of waiver with respect to other federal and state agencies, such as state tax authorities, which are not bound by Announcement 2010-76.

We also note that there is a continuing dispute within the circuit courts as to what documents are protected by work product even where they are provided to an outside auditor. The Government recently declined to appeal the recent decision of *United States v. Deloitte* in which the D.C. circuit court rejected the IRS’s arguments that work product did not apply to information provided to the taxpayer’s outside auditor in the course of a financial audit.

TRANSPARENCY, THE BYWORD OF OUR TAX ADMINISTRATION

The idea and eventual implementation of Schedule UTP follows a trend within the IRS to rely on increased taxpayer disclosure.² This schedule is perhaps the fullest expression of mandatory disclosure proposed by the IRS to date (with the prior proposed Schedule an even more expansive, and many argued, intrusive, request) for it asks affected taxpayers to list each uncertain tax position and provide a factual description of the same. Here are the Commissioner’s thoughts on the subject and how this new schedule fits into tax administration.

I have been clear since my first day on the job that I thought transparency and increased information flow were the key to the future of sound, fair and efficient tax administration. If we receive information with tax returns and from third parties, we can identify potential non-compliance more efficiently and target our resources more effectively. I also believe the concept

² The IRS has also increasingly relied upon enhanced (and even strict liability) penalties to force compliance.

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of more transparency is consistent with our nation's historic framework of a voluntary compliance system. Our tax system is set up in such a way that taxpayers fill out their own returns. This self-assessment system reflects the fact that it is the taxpayer, and not the IRS, who possesses all of the information relevant to tax liability. We then use information reported by the taxpayer to make judgments about issues to pursue, and returns to audit.

The sentiment expressed by the Commissioner to achieve more efficient and fair audits is honorable and optimistic. However, it is not entirely realistic. While the taxpayer possesses all the facts, the IRS possesses the quite overwhelming advantage of discretion in its audit function, especially in regard to what it may or may not treat as an abusive shelter. This client alert is not the forum to consider the authority and discretion of the IRS in this respect. Suffice it to say that such discretion can run contrary to another deeply held sentiment of the American public, namely, to pay the least amount of taxes due in accordance with the rule of law.

The mildly tragic aspect of the release of the final schedule is the almost tangible relief expressed by tax practitioners and taxpayers upon learning of the less intrusive approach in the final UTP. Certainly the IRS acted well in listening to the deluge of comments, but is there no, lingering, opposition to the now finalized request for each uncertain tax position to be described to the IRS? Isn't that the equivalent of asking the taxpayer to tell the IRS which positions are those that the IRS has a reasonable chance of winning in court? Why should the IRS be entitled to that information where analysis of tax positions often turns on important concepts that are undefined, where the Code and published guidance leave vast gray areas of interpretation and every transaction must apparently meet the *Coltec* standard of step-by-step tax-independent meaning?

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