

# Schedule UTP: Another Taxpayer Transparency Requirement

By Mary Monahan

Since 2002, the Internal Revenue Service (IRS) and financial statement initiatives have increased the number and detail of disclosures that must be made by large corporate taxpayers. The recently released final Schedule UTP requires large corporate taxpayers to disclose information about their uncertain tax positions. This adds yet another required disclosure, one which has implications for the IRS's historic "policy of restraint" regarding taxpayers' analysis and judgment concerning their tax positions as reflected in their tax accrual workpapers.



## Tax Accrual Workpapers and the Policy of Restraint

Historically, the IRS has applied a policy of restraint with respect to tax accrual workpapers, which are developed by a taxpayer and its auditor and support the tax reserve provision on a taxpayer's financial statements. In an early decision, the U.S. Court of Appeals for the Fifth Circuit upheld an IRS demand for a taxpayer's tax accrual workpapers, holding that the workpapers were not protected by the attorney-client privilege or the work product doctrine. See *United States v. El Paso Co.*, 682 F.2d 530, 534 n.3 (5th Cir. 1982).

Two years later, the U.S. Supreme Court held in *Arthur Young v. United States*, 465 U.S. 805 (1984), that the IRS had the right to demand the taxpayer's accountant's workpapers. Due to concerns regarding the impact of the *Arthur Young* decision on the integrity of the financial statement audit process, the IRS announced shortly thereafter that it would not request tax accrual workpapers except in certain limited circumstances. Because tax accrual workpapers provide a roadmap to the taxpayer's judgment on its tax positions, routine IRS requests for such workpapers created unease regarding the taxpayer's willingness to be forthright with its auditor about its tax position. Between 1984 and 2002, the IRS requested tax accrual workpapers in only a handful of cases.

In 2002, the IRS modified its policy of restraint. Taxpayers that had engaged in one or more "listed transactions" (that is, transactions that the IRS believed constituted abusive tax shelters) faced an almost certain IRS request for all or a portion of their tax accrual workpapers. The number of requests made by the IRS for tax accrual workpapers has increased dramatically since 2002.

## The Effect of FIN 48

Tax accrual workpapers grew in both size and complexity after the Financial Accounting Standards Board adopted Financial Accounting Standards Board Interpretation No. 48 (FIN 48) in 2006. FIN 48 increased the amount of information and

## Quick Look at Schedule UTP

Schedule UTP was first announced in January 2010. As finalized in September 2010, Schedule UTP would require, for the first time, a corporation with assets greater than \$100 million to do the following:

- File a form with its tax return providing a concise description of each uncertain tax position for which it or a related entity had recorded a reserve in its financial statements;
- Rank the uncertain tax positions in order from largest to smallest; and
- Identify as "Major Tax Positions" those uncertain tax positions representing more than 10 percent of the total reserve.

To address taxpayer worries about work product protection, the IRS eliminated the portions of the schedule that would have required a taxpayer to disclose its rationale for reserving for each uncertain tax position as well as the maximum tax adjustment that would have been attributable to each uncertain tax position. The IRS also announced a strengthening of its historic "policy of restraint" in conjunction with the final Schedule UTP.

complexity of the workpapers needed to be developed regarding uncertain tax positions and required increased financial statement disclosure with respect to tax reserves. In contrast to pre-FIN 48 tax accrual workpapers, which might have been fairly brief in describing an issue, FIN 48 workpapers had to set forth in detail the reasoning underlying the decision to hold a tax reserve for a particular issue and the amount of the reserve. In early 2007, the IRS announced that, in light of the information required to be developed under FIN 48, it would reexamine the policy of restraint.

## Adjustments to Proposed Schedule UTP

In early 2010, the IRS announced that it would obligate certain taxpayers to disclose details about their uncertain tax positions with their returns. Schedule UTP requires disclosure of tax positions that are associated with book reserves

### Work Product Protection of Tax Accrual Workpapers

Following the relaxation of the policy of restraint in 2002, taxpayers began to receive requests, and administrative summonses if they resisted, requesting tax accrual workpapers. Some taxpayers produced the workpapers, but others resisted production in part on the grounds that the workpapers were protected by the work product doctrine.

The first post-2002 decision on the issue of the attorney-client or work product protection for tax accrual workpapers was *Textron Inc. et al. v. United States*, 577 F.3d 21 (1st Cir. 2009) (*en banc*), *cert. denied*, 135 S.Ct. 3320 (U.S. May 24, 2010). The district court held that Textron's tax accrual workpapers were protected by the work product doctrine because they were prepared in anticipation of litigation. A panel of the U.S. Court of Appeals for the First Circuit agreed and affirmed the district court's decision. The IRS's motion for reconsideration *en banc* was granted. The *en banc* decision vacated the panel decision and held that the workpapers were not protected by the work product doctrine because they were prepared for financial statement purposes rather than for use in litigation. A stinging dissent charged that the majority had "thrown the law of work-product protection into disarray." The U.S. Supreme Court declined to hear the case.

While *Textron* was making its way through the courts, another company was litigating the same issue with respect to its accountants' workpapers. The district court held that three outside legal opinions and one document evaluating the opinions, plus 16 documents that discussed, quoted and explained the opinions and the evaluation, were prepared in anticipation of litigation and thus were protected by the work product doctrine. The IRS appealed. However, before the case could be decided by the U.S. Court of Appeals for the Eleventh Circuit, the parties settled the substantive tax issue in the case, and the IRS withdrew its appeal. See *Regions Financial Corp. v. United States*, 2008 WL 2139008 (N.D. Ala. May 8, 2008).

Additionally, the District of Columbia Court of Appeals has addressed work product protection for an accountant's workpapers although in the context of a tax refund suit rather than a summons enforcement proceeding. The Department of Justice served a subpoena on the taxpayer's auditor requesting documents from its files. Citing work product protection, the auditor withheld three documents from its production—a memorandum prepared by the auditor summarizing notes from a meeting about the possibility of litigation over tax issues, a memorandum and flow chart prepared by the taxpayer's in-house attorney and accountant that analyzed several tax issues and a tax opinion prepared by the taxpayer's outside counsel. The district court held that the three documents were protected under the work product doctrine. The District of Columbia Court of Appeals affirmed the decision, holding that all the documents were prepared in anticipation of litigation. See *United States v. Deloitte LLP*, 2010 WL 2572965 (D.C. Cir. June 29, 2010).

Taxpayers are unlikely to be able to meet the restrictive standard adopted by the circuit courts in *Textron* and in *El Paso*. However, the decisions of the district court in *Regions* and of the circuit court in *Deloitte*, along with older decisions such as *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006), and *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), support a position that the analysis and judgments contained in tax accrual workpapers, if prepared in anticipation of litigation, would be protected by the work product doctrine.

developed under FIN 48 or a similar standard that identifies and quantifies uncertain tax positions for financial statements. Disclosure is also required for positions for which the taxpayer has not reserved because it plans to litigate. As originally proposed, the requirement to file Schedule UTP would have applied to corporations with more than \$10 million in assets. Because of taxpayer comments, the IRS decided to phase in the filing requirement over five years. With the finalized Schedule UTP, the IRS set forth:

- Corporate taxpayers with assets greater than \$100 million will be required to file Schedule UTP beginning with their 2010 returns.
- Corporations with assets greater than \$50 million will be required to file Schedule UTP with their 2012 returns.
- Corporations with assets greater than \$10 million will be required to file Schedule UTP with their 2014 returns.
- Regardless of size, corporations without audited financial statements are not required to file Schedule UTP.

On Schedule UTP, taxpayers must provide a concise description of each issue with sufficient detail to determine the nature of the issue. As originally proposed, the concise description was to include a taxpayer's rationale and the nature of the uncertainty involved in the uncertain tax position as well as the maximum tax adjustment attributable to the

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position. Taxpayers raised concerns that the proposed concise description implicated virtually all the types of information that would be contained in a taxpayer's tax accrual workpapers except for the taxpayer's actual reserve and its assessment of its percentage chance of success on each issue.

In response to taxpayers' concerns, the IRS eliminated the requirements to disclose the rationale, the nature of the uncertainty and the maximum tax adjustment. Instead, taxpayers must rank their uncertain tax positions in order from largest to smallest and must identify each tax position that represents more than 10 percent of the total reserve. Ranking uncertain tax positions in order of the amount of the reserve, while addressing work product concerns in connection with the original proposal, may give the IRS insight into the taxpayer's risk assessment relating to each position.

### Expansion of the Policy of Restraint

With respect to the tax accrual workpapers themselves and assessment of the percentage chance of success, the IRS announced an expansion of the policy of restraint. The IRS will forgo seeking documents related to uncertain tax positions and the workpapers and drafts related to Schedule UTP only if the taxpayer is otherwise eligible for the application of the policy of restraint (that is, if no "unusual circumstances" exist and the taxpayer has not engaged in listed transactions).

The IRS also announced that it will not assert a waiver argument with respect to any document protected by the attorney-client privilege, the tax practitioner privilege or



the work product doctrine that is provided to an independent auditor as part of the audit of the taxpayer's financial statements but that a failure to assert a waiver argument is not an admission that any document is protected by a privilege. The IRS may still assert waiver in connection with any other activity that may constitute a waiver or with respect to documents or taxpayers to which the policy of restraint does not apply. This determination will continue to be made using existing standards.

### Possibilities and Considerations

Schedule UTP has significantly increased the transparency required for large corporate taxpayers. Because corporate taxpayers with assets greater than \$100 million must file Schedule UTP with their 2010 tax returns, the adoption of Schedule UTP may increase demand for the Compliance Assurance Program (CAP). This program, which involves a small number of taxpayers, may have been unattractive to certain prospective invitees because of the disclosure requirement. However, CAP may become more attractive now that all large corporate taxpayers are required to make similar disclosures.

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### Schedule UTP Examinations

In an attempt to allay taxpayers' concerns that Schedule UTP would lead examiners to simply set up adjustments for each uncertain tax position disclosed on the schedule, a directive was issued to all personnel of the Large Business and International Division (LB&I) (the successor to the Large and Mid-Size Business Division) providing rules for examinations involving Schedule UTP. The directive provides for a centralized audit and issue selection process as well as a centralized process to determine compliance with Schedule UTP. LB&I examiners will receive training specific to the handling of Schedule UTP and were instructed to approach an examination of uncertain tax positions "with impartiality."

Many large corporate taxpayers have been cognizant of the risk of potential disclosure to the IRS when preparing descriptions of uncertain tax positions in their FIN 48 workpapers. Taxpayers that wish to maximize the possibility of work product protection for tax accrual workpapers might consider documenting anticipated litigation with respect to their uncertain tax positions. Taxpayers may

also wish to take steps to protect the confidentiality of the workpapers and other materials disclosed to their auditors. However, taxpayers asserting that tax accrual workpapers were prepared in anticipation of litigation should be aware of the possibility of a spoliation claim if their document retention policies allow for the disposal of materials relating to an uncertain tax position for which work product protection is claimed.

*Mary Monahan, a member in Sutherland's Tax Practice Group, has experience representing taxpayers in complex federal tax audit and litigation matters. She has participated in the litigation of a number of federal tax cases in the Tax Court, the Court of Federal Claims, U.S. District Courts, the U.S. Courts of Appeals and the U.S. Supreme Court. She also has experience representing taxpayers with respect to eligibility for the research tax credit and in constitutional challenges to state tax statutes. Mary has worked with multinational corporations on tax planning for corporate acquisitions and restructurings, focusing particularly on tax accounting and income recognition issues.*