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The IRS Adopts Largely Taxpayer-Favorable Changes To Schedule UTP

In January 2010, the IRS announced that it would require corporate taxpayers with assets of over \$10 million and audited financial statements to file a new Schedule UTP, disclosing information about their uncertain tax positions, with their 2010 tax returns. As originally proposed, Schedule UTP would have required a concise description of each uncertain tax position for which the taxpayer or a related entity had recorded a reserve in its financial statements, the reasons for determining that the position is an uncertain position, as well as the maximum amount of potential federal tax liability attributable to each uncertain tax position. The IRS also announced that it was studying potential penalties applicable to Schedule UTP.

Executive Summary

In finalizing Schedule UTP the IRS made the following major changes to the draft schedule: (1) implemented a five-year phase-in of the requirement to file Schedule UTP, beginning with corporations with assets greater than \$100 million; (2) eliminated the requirement to report a maximum tax adjustment; (3) eliminated the requirement to report the rationale and the nature of the uncertainty in the "concise description" of the uncertain tax position; and (4) eliminated the requirement to report uncertain tax positions for which no reserve is held because of IRS administrative practice. The IRS also announced an expansion of the policy of restraint and provided guidance to examiners and other personnel regarding the proper use of Schedule UTP.



Proposed Schedule UTP produced consternation among corporate taxpayers and their advisors. Comments to proposed Schedule UTP expressed concern that Schedule UTP would undermine both the attorney-client privilege and the work product doctrine by revealing the thought processes underlying a taxpayer's tax positions. Taxpayers also predicted that Revenue Agents would use Schedule UTP to set up an adjustment in the amount of the maximum tax exposure for each issue disclosed. Taxpayers urged that Schedule UTP be abandoned altogether, or at the very least "road-tested" with a pilot group of taxpayers, preferably from the Compliance Assurance Program (CAP), a voluntary, invitation-only IRS program that already requires extensive disclosures with respect to material tax positions. Taxpayers also urged the IRS to delay the implementation of any new penalties applicable to Schedule UTP.

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On September 24, 2010, IRS Commissioner Douglas Shulman announced the IRS response to taxpayer comments and the finalization of Schedule UTP. The IRS released a package of guidance, including: (1) a revised Schedule UTP; (2) revised Instructions; (3) Ann. 2010-75, giving notice regarding the contents of final regulations on Schedule UTP to be published by year-end; (4) Ann. 2010-76, announcing an expansion of the policy of restraint and a directive issued to all Large Business and International examiners and other personnel.

Phase-In of Schedule UTP Reporting

In response to taxpayer comments, Schedule UTP will now be phased in over five years. Corporate taxpayers with worldwide 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 beginning with their 2012 returns, and corporations with assets greater than \$10 million will be required to file Schedule UTP beginning with their 2014 returns. The IRS will review the utility of the Schedule UTPs filed with 2010 returns and will modify the schedule and instructions as appropriate.

Sutherland Observation: Corporations without audited financial statements are not required to file Schedule UTP regardless of their size. For purposes of Schedule UTP, an audited financial statement is defined as one on which an independent auditor expresses an opinion, specifically excluding compiled or reviewed statements. Private corporations that do not utilize or rely on audited financial statements will not be subject to the new UTP rules.

Clarification With Respect to Foreign and State Positions

The revised instructions to Schedule UTP clarify that the only uncertain tax positions required to be reported on Schedule UTP are United States federal income tax positions for which a reserve is established for financial statement purposes, or for which a reserve is not established because of an intent to litigate (if the position is not highly certain or immaterial). Uncertain United States tax positions for which a reserve was established must still be reported if they relate to foreign tax positions; for example, uncertain tax positions relating to United States foreign tax credits. Taxpayers are required to report only their own uncertain tax positions and not the positions of a related party.

The IRS confirmed that it will generally refrain from automatically releasing Schedule UTP information to foreign governments. States that require filing of a copy of a taxpayer's federal income tax return with its state return will receive a copy of Schedule UTP as part of the filing.

Sutherland Observation: Although Schedule UTP itself does not require reporting of uncertain state tax positions unless there is a federal income tax reserve, the question remains whether states will follow the IRS lead and require the filing of a similar state Schedule UTP.

Timing of Reporting on Schedule UTP

Taxpayers are required to report uncertain tax positions only in the year in which the later of two events occurs: a tax position is taken on a return or a reserve has been recorded. For corporate taxpayers included in multiple audited financial statements, the recording of a reserve in any audited financial statement in which the taxpayer is included triggers reporting of the reserve. Recording a reserve includes recording of reserves for United States federal income tax, interest, or penalties. Reserves for uncertain tax positions which were recorded prior to 2010 for positions taken on returns for years prior to 2010 need not be reported in 2010 or any later year, even if a reserve for such positions is still recorded in audited financial statements issued in 2010 or later.

The instructions clarify the reporting of recurring tax positions taken in multiple years. If a reserve is established in 2010 or later for positions taken on returns later than 2010, the reserve must be reported on Schedule UTP. If, however, a reserve is recorded with respect to a position taken prior to 2010 which may have implications in years other than 2010, but no reserve is recorded for the positions taken in the later years, the position need not be reported on Schedule UTP.

Replacement of the Maximum Tax Adjustment Requirement With a Rank Order

In response to taxpayer objections, the IRS eliminated the requirement to report a maximum tax adjustment on Schedule UTP. Instead, taxpayers must rank each uncertain tax position in order from the largest financial statement reserve to the smallest. Taxpayers must designate as “Major Tax Positions” those uncertain tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserve for all uncertain tax positions. Uncertain tax positions for which no reserve is held because a taxpayer intends to litigate the issue must also be reported, unless the position is highly certain or immaterial. For those uncertain tax positions where the taxpayer has an intent to litigate, the taxpayer need not determine a size, and such positions may be assigned any rank.

Sutherland Observation: The elimination of the requirement to report a maximum tax adjustment addresses objections that the maximum tax adjustment would be burdensome to calculate and would lead Revenue Agents to automatically set up an adjustment in that amount. The substitution of a requirement to rank uncertain tax positions in order of the amount of the reserve and to identify each uncertain tax position that represents 10 percent or more of the total reserve may, however, give the IRS more insight into a taxpayer’s risk assessment with respect to each position than it would have had under the maximum tax adjustment requirement. Taxpayers can assign any rank to tax positions for which they hold no reserve because they intend to litigate the issue.

Simplification of the “Concise Description”

The required “concise description” of uncertain tax positions reported on Schedule UTP has also been curtailed. The draft Schedule UTP had required disclosure of the rationale and the nature of the uncertainty of the uncertain tax position. This requirement has been eliminated. Schedule UTP now requires 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. No assessment of the hazards of the tax position or analysis of the support for or against the tax position is required.

Sutherland Observation: The elimination of the requirement to include the rationale and the nature of the uncertainty in the proposed "concise description" also was apparently in response to taxpayer concerns that: (1) the disclosure of the rationale and the nature of the uncertainty might cause a waiver of applicable privileges and (2) crafting this portion of the concise description would have imposed an undue burden on taxpayers.

Penalties

No new penalties relate to the requirement to file Schedule UTP. The IRS has not issued specific penalty guidance, but will review compliance with Schedule UTP. In addition, complete and accurate disclosure of an uncertain tax position on the appropriate year's Schedule UTP will be treated as if the taxpayer had filed a Form 8275 or a Form 8275-R regarding the uncertain tax position. A separate Form 8275 or 8275-R filing is not required to avoid certain accuracy-related penalties with respect to that position.

Expansion of the Policy of Restraint

Concurrently with the release of final Schedule UTP, the IRS released Ann. 2010-76, which sets forth new guidance regarding application of the IRS "policy of restraint" with respect to requests for documents relating to uncertain tax positions. The IRS will forgo seeking documents related to uncertain tax positions and the workpapers and drafts relating to the completion of Schedule UTP.

Most significantly, the IRS will not assert waiver of privilege with respect to any document protected by the attorney client privilege, the tax practitioner privilege, or the work product doctrine which is provided to an independent auditor as part of the audit of the taxpayer's financial statements. The IRS may still assert waiver with respect to any other activity, or with respect to tax accrual workpapers for which the general IRS policy of restraint does not apply, either because of unusual circumstances or because the taxpayer has engaged in one or more "listed transactions." The expansion of the policy of restraint does not create or imply the application of any privilege to any document.

With respect to tax reconciliation workpapers (which are not subject to any policy of restraint), taxpayers may redact working drafts, revisions, or comments concerning the "concise description" required by Schedule UTP, the amount of any reserve related to a position reported on Schedule UTP, and computations determining the ranking of uncertain tax positions to be reported on Schedule UTP, or the designation of a position as a Major Tax Position.

Sutherland Observation: The expansion of the policy of restraint primarily benefits documents protected by the attorney-client privilege that are disclosed to auditors as part of the financial statement audit process. It is clear under case law that such disclosure waives the attorney-client privilege. The IRS's policy of restraint with respect to the attorney-client privilege is of benefit to taxpayers.

For documents protected by the work product doctrine in addition to or in lieu of the attorney-client privilege, there is a substantial body of case law holding that disclosure to an auditor does not waive work product protection. The IRS's policy of restraint with respect to work product protection is therefore of less benefit.

Taxpayers sharing copies of legal opinions and other privileged documents with independent auditors in the process of reviewing and verifying financial statements can now protect those documents from disclosure to IRS examiners (unless "unusual circumstances" exist or the taxpayer has engaged in listed transactions).

The agreement not to assert waiver is not an admission that any document is protected by a privilege. This determination will continue to be made using existing standards, including *Textron*, to the extent it applies to a particular taxpayer or document.

Guidance to LB&I Personnel

In an attempt to allay taxpayer concerns that examiners would simply set up adjustments for every issue reported on Schedule UTP, a directive was issued to personnel of the Large Business and International Division (LB&I) providing rules for examinations involving Schedule UTP. (The IRS announced in IR 2010-88 that the Large and Mid-Size Business (LMSB) division had been realigned to devote more centralized attention to international tax compliance. The name of the division will officially change on October 1, 2010.) The directive provides for a centralized process to select issues and returns for audit, and to determine compliance with the requirements of Schedule UTP, as well as to publish guidance to eliminate uncertainty and identify trends. LB&I examiners are required to approach an examination of uncertain tax positions "with impartiality" and to apply the law as it currently exists. The directive clarifies that Schedule UTP should not be used as a substitute for other examination tools, and that LB&I examiners should engage corporate taxpayers early with respect to uncertain tax positions, using tools such as the Quality Examination Planning process, and, in any event, prior to issuance of IDRs. LB&I examiners will receive specific training on Schedule UTP over the next year.

Sutherland Observation: Although Exam will not be receiving or reviewing a significant number of Schedule UTP filings until late 2011, this guidance was presumably issued contemporaneously with the final Schedule UTP to attempt to allay taxpayers' concerns that Schedule UTP would become a de-facto audit plan.

Expansion and Permanence of the CAP Program

The adoption of Schedule UTP may (or may not) increase demand for the CAP program, which involves small numbers of taxpayers and may have been unattractive to certain prospective invitees because of the disclosure requirement. CAP may become more attractive now that all large corporate taxpayers are required to make similar disclosures. The IRS announced that it will expand CAP and make it permanent. Details will be provided in forthcoming CAP guidance.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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