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Should the States Piggyback on Federal Schedule UTP?

by J. Richard Harvey Jr.

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In this article, Harvey discusses several issues that state tax administrators may need to consider if they are seriously planning to pursue a Schedule UTP, on which taxpayers report uncertain tax positions, for state tax purposes. Issues discussed include: Will the IRS Schedule UTP benefit state tax administrators, or should states consider a state-specific Schedule UTP? If a state-specific schedule is adopted, should the states follow the IRS model for Schedule UTP? If not, when might they want to deviate? Will states be able to defend a state-specific schedule against privilege or work product challenges? Should states adopt a specific penalty for failing to adequately complete Schedule UTP?

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There has been much written about federal Schedule UTP since its announcement by IRS Commissioner Douglas Shulman in January 2010.¹ However, little has been written about issues other tax

administrators may need to consider if they plan to adopt some version of Schedule UTP for their own purposes. Other tax administrators are definitely thinking about Schedule UTP. For example, California has announced² that the federal Schedule UTP must be attached to the California state tax return, and the Alabama deputy commissioner has suggested that states may adopt their own versions of the schedule.³ Also, the Australian Taxation Office has published a draft form for 2012 that is largely based on the IRS Schedule UTP.⁴

The major benefit of adopting the IRS Schedule UTP might be in cases in which the state might pursue an adjustment on an issue that the IRS may decide not to pursue.

Although corporations are hoping that most other tax administrators will not adopt some version of Schedule UTP, I believe corporations will be disappointed. However, by the same token, I suspect that some state tax administrators believe it will be simple to adopt Schedule UTP for their purposes. They too could be disappointed. This article will discuss several issues surrounding Schedule UTP that state tax administrators may need to consider if they are seriously planning to pursue Schedule UTP.

Will the IRS Schedule UTP Benefit State Tax Administrators?

To the extent a federal tax problem carries over for state tax purposes, the IRS Schedule UTP may

¹See, e.g., the following articles by J. Richard Harvey Jr.: "Schedule UTP: Views of a Former Tax Adviser and Administrator," *Tax Notes*, Sept. 20, 2010, p. 1259; "Schedule UTP — Initial Observations," *Tax Notes*, Oct. 4, 2010, p. 115; "Schedule UTP Guidance — Two Major Issues," *Tax Notes*, Mar. 28, 2011, p. 1559; and "Schedule UTP: An Insider's Summary of the Background, Key Concepts, and Major Issues," 9 *DePaul Bus. & Com. L.J.* 349, available at <http://ssrn.com/abstract=1782951>.

²See http://www.ftb.ca.gov/professionals/taxnews/2010/December/Article_13.shtml.

³See http://www.alvarezandmarsal.com/en/global_services/tax/enewsletter/archives/DisplayEnewsletter.aspx?newsletter_id=375, question 11.

⁴See <http://www.ato.gov.au/content/downloads/bus00279408rtp2011.pdf>.

be of some benefit to state tax administrators. However, that benefit should be substantially diminished because states generally require that adjustments to federal taxable income be reported to the state tax authorities. Thus, the major benefit of adopting the federal Schedule UTP might be in cases in which the state might pursue an adjustment on an issue that the IRS may, for various reasons, decide not to pursue.

More importantly, the federal Schedule UTP will be of no help to state auditors because many state tax issues — for example, state nexus and apportionment — are unique to state taxation. As a result, if states want to get the maximum benefit from Schedule UTP, one would expect them to implement a state-specific form that requires disclosure of both state-only issues and issues affecting both federal and state tax calculations.⁵

Should States Adopt a State-Specific Schedule UTP?

There is no right answer to whether states should adopt a state-specific Schedule UTP. Some states may believe they have knowledge of most uncertain positions, and therefore Schedule UTP is not needed. Some other states may want to take a wait-and-see approach to see how the IRS Schedule UTP plays out. Yet other states may want to explore adopting a state-specific Schedule UTP, but may want to share the burden by being part of a group, for example, an effort led by the Multistate Tax Commission. And finally, some states may not want to wait around for a group of states to act, and may plow ahead on their own.

If States Want to Adopt Their Own Schedule UTP, What Major Issues Should States Evaluate?

In general, states will have to evaluate whether a state-specific Schedule UTP will provide enough useful information to justify the cost to both tax administrators and taxpayers of developing and completing the form. Below are some issues states should consider.

Do States Want to Piggyback Totally on the Federal Schedule UTP?

During the development of Schedule UTP, the IRS made many policy decisions. Reasonable people could reach different conclusions on many of those. Thus, one threshold question for state tax administrators is whether they want to accept *all* the federal decisions, or reach their own state-specific conclusions.

⁵States may want to require taxpayers to designate those positions that only affect state taxation.

If a state wants to adopt its own conclusions, that will complicate both their own implementation and the compliance process for taxpayers. Nevertheless, as discussed later in this article, there could be good reasons for states to deviate from the federal model in selected cases.

As with most state tax concerns, it would be helpful from a taxpayer compliance perspective if the states developed a uniform state tax model for implementing Schedule UTP — even if the model differs slightly from the IRS model. The MTC could assist in that process, but practical questions include whether states would be able to reach agreement, and if so, how long that process would take. If experience is any guide, one would expect there to be variations among states.

Could States Defend a State-Specific Schedule UTP Against Privilege/Work Product Challenges?

As I have discussed in several articles,⁶ there could be litigation surrounding the IRS Schedule UTP. Specifically, some corporations may argue that disclosure of a tax position on IRS Schedule UTP violates various privilege and work product doctrines. Although that challenge would not be frivolous, the IRS should be able to successfully defend itself against such litigation.

In reaching this conclusion, I believe the IRS's policy of restraint⁷ is very important. Specifically, when a court is presented with the question whether disclosure of information on Schedule UTP violates privilege and work product doctrines, the court will have to balance competing arguments on the IRS's right to taxpayer information in a self-assessment system versus corporations' right to protect sensitive information. The IRS is likely to argue that requesting a description of the tax issue is reasonable in a self-assessment system. The IRS will also emphasize that by virtue of its policy of restraint, it is not requesting corporations to disclose their most sensitive information about a tax position (that is, the amount of reserve recorded or a tax opinion). If the policy of restraint did not exist, the IRS could theoretically review Schedule UTP to identify issues, and then request the taxpayer's reserves and tax opinions for those issues. If I were a judge, I would not look favorably on the IRS generally having that power. If judges share my concern, the IRS's policy of restraint could be important if corporations challenge Schedule UTP on the grounds that it violates the privilege and work product doctrines.

⁶*Supra* note 1.

⁷See IRS Internal Revenue Manual 4.10.20, available at http://www.irs.gov/irm/part4/irm_04-010-020.html, as modified by Announcement 2010-76, 2010-41 IRB 1, see *Doc 2010-20923* or *2010 TNT 186-27*.

Although I have not conducted any detailed research on whether states have a policy of restraint, my general impression from ad hoc discussions with state tax administrators is that few do. Also, some of the policies of restraint that may exist are informal, rather than written. In summary, if state tax administrators also are concerned about a potential legal challenge to a state-specific Schedule UTP, they should consider either adopting a policy of restraint or strengthening their existing policy.

How Will Tax Auditors Use the Information Provided on a State-Specific Schedule UTP?

How to use the information provided on the federal Schedule UTP has been a concern for the IRS. Corporations have expressed significant concern that IRS agents will automatically propose audit adjustments for all positions listed on Schedule UTP. Senior IRS officials have repeatedly stated that is not the IRS's intention.⁸

As a result, the IRS is planning significant Schedule UTP training for its agents. Also, until its agents are adequately trained, the IRS is planning to review all Schedules UTP in a centralized unit and give field agents only selected access to a corporation's Schedule UTP. Given the IRS's concern about that potential problem, the obvious question is whether states will be equally concerned and if so, whether they are prepared to make a special effort analogous to the IRS's.

Do States Want to Adopt a Specific Penalty for Failing to Complete Schedule UTP?

For federal purposes, there is no specific penalty regarding Schedule UTP. However, the IRS has said it may pursue a penalty in the future either through administrative actions or legislation. I have been critical of the IRS's failure to adopt a Schedule UTP penalty — especially an administrative penalty tied to the IRS's policy of restraint.

If states agree they need a penalty to enforce a state-specific Schedule UTP, they will have to decide whether to pursue an administrative or legislative penalty.

If states agree that they need a penalty to enforce a state-specific Schedule UTP, they will have to

⁸See Lee A. Sheppard, "Officials Try to Assuage Fears About Proposed UTP Reporting," 2010 TNT 78-1; and IRS Deputy Commissioner Steve Miller, "Directive for All Large Business and International Division Personnel: Reporting of Uncertain Tax Positions" (Sept. 24, 2010), available at http://www.irs.gov/pub/newsroom/internal_directive.pdf.

decide whether to pursue an administrative or legislative penalty. Given the uncertainties surrounding the legislative process, one would be unsurprised if states decided to pursue some sort of administrative penalty.

One possibility would be for states to agree that if a taxpayer discloses an issue adequately on the state-specific Schedule UTP, the state will not pursue the taxpayer's reserves or tax opinions on that issue.⁹ However, if a tax position is not adequately disclosed, the state will pursue all reserve and tax opinions. That carrot-and-stick approach could address two issues. First, it would effectively provide an administrative penalty for failing to adequately complete Schedule UTP, and second, it should improve the chances of a state rebuffing any privilege or work product challenges to a state-specific Schedule UTP.

Schedule UTP — Selected Federal Policy Decisions States May Want to Revisit

During the development of Schedule UTP, the IRS made many policy decisions. As discussed previously, states could decide to piggyback on the federal decisions. Alternatively, some states may want to reach their own conclusions. Below is a sampling of decisions the IRS made that states may want to reevaluate.

Disclosure Criteria

For federal purposes, disclosure of an uncertain tax position is required if either a reserve was recorded in an audited financial statement or a reserve was avoided but there is an expectation of litigation. One question is whether states also will want disclosure of tax positions when no reserve is recorded because the business believes there is an "administrative practice" that a taxing authority will not challenge a specific tax position.

Given that businesses have often avoided state tax reserves by invoking the "administrative practice exception" to Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes,"¹⁰ one could imagine some states deciding they want disclosure of those issues. The original IRS proposal would have required disclosure of those positions, but that provision was dropped from the final Schedule UTP. States may not want to be so generous.

Taxpayers Subject to Schedule UTP

The IRS Schedule UTP is applicable only to some large C corporations with audited financial statements. Tax-exempt organizations, partnerships, and

⁹One exception could be for criminal cases, in which case states could pursue tax opinions and reserve information.

¹⁰See FIN 48, paras. 7.b. and A14-A15, available at http://www.fasb.org/pdf/aop_FIN48.pdf.

other flow-through entities are not covered by the federal Schedule UTP. The IRS has said it will study whether tax-exempt organizations and flow-through entities should ultimately be covered. Also, corporations with unaudited financial statements are not covered. Finally, the IRS phased in the application of Schedule UTP. For 2010 and 2011, only corporations with \$100 million or more of assets must file a Schedule UTP. By 2014, corporations with \$10 million or more of assets will have to file.

It is possible that states could decide to apply a state-specific Schedule UTP to different taxpayers than those covered under the federal Schedule UTP.

It is possible that states could decide to apply a state-specific Schedule UTP to different taxpayers than those covered under the federal Schedule UTP. Initially, however, it may make sense for states to be consistent with the IRS approach.

Transition Relief

Another question might be whether states want to conceptually provide the same transition relief provided by the IRS. In general terms, the IRS provided that any tax issues related to tax years before 2010 should not be disclosed on Schedule UTP. This is the case even if the taxpayer records a reserve in 2010 or a later year, or uses a pre-2010 net operating loss carryover in a year when Schedule UTP is applicable (that is, 2010 or later years).

As a practical matter, the earliest a state could adopt a state-specific Schedule UTP is for 2011. Given that we are more than halfway through 2011, it seems unlikely a state will propose a state-specific Schedule UTP for this year. Nevertheless, if a state ultimately adopts a state-specific Schedule UTP, it will have to address transition issues.

One specific issue the IRS had to address involved the use of a pre-2010 NOL in 2010 or later years. Specifically, assuming there is an uncertain tax position embedded in the pre-2010 NOL, should that tax position be disclosed in 2010 or later return when the NOL is used? The IRS concluded the answer is no. Given the large NOLs from the financial crisis, one could imagine some states entertaining a different conclusion than that reached by the IRS.

Definition of Reserve and Timing of Disclosure

The IRS struggled with defining a reserve and provided guidance only in an FAQ posted to its

website on July 19.¹¹ The IRS broadly defined a reserve to include any reserve in the financial statement, including footnotes. Thus, for purposes of IRS Schedule UTP, a reserve includes the situation in which a corporation takes a tax position that does not immediately reduce its tax for a year, but will provide a benefit in a future year. Those reserves are usually recorded in deferred taxes.

Given the IRS's broad definition of a reserve, the IRS also had to decide whether taxpayers should effectively disclose an uncertain tax position twice — once when a corporation records a reserve in deferred taxes, and again when they record a current reserve for that position. The IRS appears to have determined a tax position only needs to be disclosed once in this situation.¹²

For example, assume a corporation takes an aggressive tax position on its 2010 tax return that increased the 2010 NOL carryforward and recorded a reserve in deferred taxes for the uncertainty. Further assume the NOL is not used until 2015. In this case, the IRS had to decide whether to require disclosure of the tax position in 2010, 2015, or both years. The IRS decided to obtain disclosure only for 2010. It will be interesting to see whether the IRS can keep track of a UTP disclosed in 2010 that will not produce a deficiency until 2015. One can imagine that some states may decide to get disclosure in 2015 only, or alternatively get disclosure in both years (that is, 2010 and 2015).¹³

Concise Description

Given concerns about privilege and work product, the IRS agonized over what sort of description taxpayers should provide on Schedule UTP. The IRS opted for a minimalistic approach whereby taxpayers only describe the tax issue in approximately two to five sentences. Some states might want a more expansive disclosure, but if they go down that path, they will have to develop a definition and evaluate its effect on any privilege and work product challenges.

I recommend states to mimic the IRS's approach until any privilege and work product challenges are settled and it is determined whether the IRS approach to concise description is sufficient for state purposes. After that period of time, states could revisit the issue.

¹¹See <http://www.irs.gov/businesses/article/0,,id=237538,00.html>, FAQ 6.

¹²*Id.*, FAQ 10. It is not clear whether the IRS intends this result when only NOL carryforwards are involved, or whether it is also intended whenever a reserve is recorded in deferred taxes.

¹³If a state wants disclosure only in 2015, it should consider defining a reserve more narrowly than the IRS does. A reserve could be defined as excluding reserves in deferred taxes.

Conclusion

A former IRS commissioner has called Schedule UTP “the biggest change in tax administration in the last 50 years.”¹⁴ Others have made less flattering comments, but most everyone working in the corporate tax community would admit it is a big deal and will have a material effect on how the IRS and large corporations approach audits in the future. Thus, the obvious question is whether other tax administrators will consider adopting the federal Schedule UTP, or some variation, for their own purposes. Clearly, the Australian tax authorities are, and many state tax administrators in the United States may as well.

This article discusses some of the major issues that state tax administrators should consider. In summary, state tax administrators are unlikely to obtain much value from the IRS Schedule UTP and will likely want to develop their own Schedule UTP so that state-specific issues can also be disclosed. Nevertheless, state tax administrators may want to piggyback on many of the policy decisions the IRS made while developing Schedule UTP. One example where they may want to deviate is when taxpayers have avoided disclosing a reserve because of the administrative practices exception in FIN 48. In that case, disclosure is not required on IRS Schedule UTP, but given the frequent use of that exception in the state tax arena, one can imagine states reaching a different conclusion.

¹⁴Mary Lou Fahey, “Transparency, Trust, and TEI,” *61 Tax Executive* 369, 370 (2010); and also discussion by the author with former IRS Commissioner Lawrence Gibbs, now with Miller & Chevalier.

States also should consider whether they are concerned about a state-specific Schedule UTP being successfully challenged on the grounds that it violates a taxpayer’s privilege or work product doctrine rights. Although the IRS Schedule UTP is likely to be challenged, the IRS should be able to defend itself because it has a policy of restraint when requesting a taxpayer’s tax accrual workpapers. States should be considering whether they want to adopt a policy of restraint or strengthen an existing one.

It would be ideal if the states could generally adopt the IRS model and keep deviations to a minimum.

States also should consider adopting any special procedures for processing a state-specific Schedule UTP. The IRS is expending considerable effort in this area. States should also evaluate whether they need a specific penalty for taxpayers that fail to adequately complete Schedule UTP. One possibility would be for states to agree that if a taxpayer discloses a UTP adequately on the state-specific schedule, the state will not pursue the taxpayer’s reserves or tax opinions for that issue. However, if a UTP is not adequately disclosed, the state will pursue all reserve and tax opinions.

Finally, it would be ideal if the states could generally adopt the IRS model and keep deviations to a minimum. Whether that goal is attainable remains to be seen. The MTC may be able to play some role in that process. Stay tuned. ☆