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Schedule UTP: An Insider's Summary of the Background, Key Concepts, and Major Issues

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By J. Richard (Dick) Harvey, Jr.*

Abstract - A former IRS Commissioner has called Schedule UTP "the biggest change in tax administration in the last 50 years". Others have made less flattering comments, but most everyone working in the corporate tax community would admit it has been a big deal.

Based upon the author's perception as a senior IRS official, this article is intended to be a comprehensive discussion of three topics. First, it will summarize what led the IRS to require the filing of Schedule UTP. Second, it will discuss the key concepts, including why certain provisions were adopted (e.g., the much misunderstood "expect to litigate" provision). And finally, there will be a discussion of the major issues, including in some cases the author's views on such issues.

The article is written for several audiences, including: (i) corporate tax professionals who already have a working knowledge of Schedule UTP and should be most interested in the discussion of major issues and possibly the theory behind the "expect to litigate" provision; (ii) students and academics who should be interested in the entire article; and finally (iii) government officials who should be interested in techniques corporations may use to avoid disclosure, the definition of "reserve", whether Schedule M-3 should be modified, and several other sections.

* Copyright 2011 by J. Richard (Dick) Harvey, Jr.. Date of article is March 1, 2011. The article is scheduled for publication in the 2011 Spring edition of the DePaul University Business and Commerce Journal. Since August 2010 the author has been the Distinguished Professor of Practice at the Villanova University School of Law and Graduate Tax Program (rharvey@law.villanova.edu). Immediately prior to joining the Villanova faculty he was the Senior Advisor to IRS Commissioner Shulman and worked extensively on the development of Schedule UTP, offshore tax evasion, and other international projects. Professor Harvey joined the IRS upon retiring from PricewaterhouseCoopers (PwC) as Tax Partner and Leader of PwC's US Banking and Capital Markets Tax Practice. While at PwC, he specialized in FIN 48 with clients and consulted with the FASB during its development. Professor Harvey also served in the US Treasury Department's Office of Tax Policy during the drafting and implementation of the 1986 Tax Reform Act.

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1. Introduction, Purpose of Article, and Intended Audience

There has been much written about Schedule UTP since its announcement in January 2010. Many of the quotes have been eye-catching, including:

- "UTP regime rattles corporate tax community"[1]
- "There is scarcely a tax professional working today who is not familiar with the new schedule…"[2]
- A former IRS Commissioner called the schedule "the biggest change in tax administration in the last 50 years"[3]

There are many other quotes and comments[4], but most everyone working in the corporate tax community would have to admit it has been a big deal!

This article is intended to be a comprehensive discussion of three topics. First, it will summarize the author's perception of what led the IRS to require the filing of Schedule UTP. Second, it will discuss the key concepts of Schedule UTP including the author's perception of why certain provisions were adopted (e.g., the much misunderstood "expect to litigate" provision). And finally, there will be a discussion of the major issues surrounding Schedule UTP, including in some cases the author's views on such issues.

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1 Jeremiah Coder, *Year In Review: UTP Regime Rattles Corporate Tax Community*, 2011 TNT 1-7 (Jan. 3, 2011).

2 Mary Lou Fahey, *Transparency, Trust, and TEI*, The Tax Executive, Nov.-Dec. 2010 369.

3 Id. and direct discussion by the author with former Commissioner Lawrence Gibbs, now with Miller Chevalier.

4 Some of the comments are sufficiently profane that they cannot be published in this article.

The article is written for several audiences. For corporate tax professionals who already have a working knowledge of Schedule UTP, Section 5 (major issues) may be of most interest. However, the discussion of the reason for the "expect to litigate" provision in Section 4.3 may also be worthwhile. For students and academics the article provides a comprehensive discussion of the background, key concepts, and major issues surrounding Schedule UTP.

Finally, for my former colleagues in government Section 5 will be of most interest, but the following sections may be of particular interest: Section 5.3 (related to techniques corporations may use to avoid disclosure), Section 5.7 (definition of "reserve"), Section 5.10 related to pre-2010 NOL carryforwards, Section 5.11 (discussing whether Schedule M-3 should be modified), Section 5.13 (suggestion on how the IRS should audit Schedule UTP), and Section 5.14 (whether additional guidance will be the magic bullet).

2. Quick Summary of Schedule UTP[5]

Schedule UTP was first announced by IRS Commissioner Shulman during a speech in January 2010. After various requests for comment and a draft form, the IRS issued a final Schedule UTP on September 24, 2010. The basic concept behind Schedule UTP is that in a self-assessment tax system taxpayers should disclose uncertain tax positions at the time they file their tax return.

[5] This summary is intended as a very brief introduction for those that have had no prior exposure to Schedule UTP. See http://www.irs.gov/businesses/corporations/article/0,,id=221533,00.html for a general list of major IRS documents related to Schedule UTP.

Given disclosure on tax returns has been required for various issues (e.g., Form 8886 related to reportable transactions and Form 8275 related to positions that may cause a substantial understatement of tax), the basic concept behind Schedule UTP is not entirely new. Nevertheless, Schedule UTP has been very controversial because it creates a direct link between disclosure in the tax return and decisions made when preparing a corporation's audited financial statements.

Specifically, if a corporation (or a related party) records a "reserve" for a tax position in its audited financial statements, Schedule UTP requires the corporation to make a "concise description" of such tax position. In addition, disclosure on Schedule UTP is also required when a reserve is not recorded in the audited financial statements but in arriving at such conclusion there was an assumption that there is a greater than 50% probability the tax position will be litigated. This latter disclosure is referred to as the "expect to litigate" provision and it has been both misunderstood and controversial.

In addition to disclosing a "concise description" of a tax position, Schedule UTP also requires disclosure of other information (e.g., a ranking based upon the amount of tax reserve recorded for such tax position). Some corporations and their advisors are concerned that disclosure of a concise description will violate privilege (either attorney-client or accountant-client), or the work product doctrine.

3. Background that Led to Schedule UTP[6]

Although the IRS first announced Schedule UTP on January 26, 2010[7], the concept behind Schedule UTP had been discussed quietly in certain tax circles for years. As will be summarized below, in some cases it was discussed by taxpayers and their representatives as a compromise to address the IRS attempts to obtain taxpayer's tax accrual workpapers (TAWs)[8]. In other cases, it was discussed within the IRS as a way to improve the efficiency and effectiveness of corporate audits. In addition, there were other factors that contributed to the IRS's announcement in January 2010, and subsequent adoption of a Final Schedule UTP on September 24, 2010. Below is the author's view of the primary factors that led to Schedule UTP.

3.1. **Practical difficulties auditing large corporations** – Given the complex nature of the tax law in general, coupled with the complexity inherent in a modern corporation's business operations, it has become increasingly difficult for the IRS as a practical matter to efficiently audit a large corporation. This issue has been exacerbated by the efforts of tax lawyers, accountants, and investment bankers to (i) identify grey areas in the tax law

[6] This background is based upon first-hand experience of the author who participated extensively in the development of Schedule UTP while he was the Senior Advisor to IRS Commissoner Shulman. Others within government at the time may have different views.

[7] See *Announcement 2010-9*, 2010-7 I.R.B. 408, and Commissioner Shulman speech to New York State Bar Association on Jan. 26, 2010 at http://www.irs.gov/newsroom/article/0,,id=218705,00.html

[8] See IRS Internal Revenue Manual, section 4.10.20 at http://www.irs.gov/irm/part4/irm_04-010-020.html for current definition of TAWs.

that could be exploited, and (ii) once exploited make it an art form to minimize red flags in the corporate tax return that might arouse the IRS's interest.

At the time he announced Schedule UTP in January 2010, Commissioner Shulman estimated that 25%[9] of the IRS's audit time is devoted to identifying issues, rather than discussing an appropriate resolution of the issue. In addition, while in private practice, it was this author's experience that the IRS failed to identify many issues even after spending substantial time on issue identification.

Because these problems are not new, several different tax disclosure regimes were adopted over the years. Examples include:

- Form 8275 used to avoid the substantial understatement penalty[10]
- Form 8886 used to avoid the penalty surrounding reportable transactions[11]
- Schedule M-3 used to reconcile between worldwide financial accounting income and taxable income[12]

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9 Supra note 7.

10 IRC 6662(d)(2)(B)(ii) allows the 20% substantial understatement penalty to be avoided if "the relevant facts affecting the item's tax treatment are adequately disclosed…" and other conditions are met.

11 IRC 6707A imposes a penalty for failure to include information with respect to a reportable transaction as required in IRC 6011.

12 See Charles Boynton and William Wilson, *A Review of Schedule M-3: The Internal Revenue Service's New Book-Tax Reconciliation Tool*, Petroleum Accounting and Financial Management Journal 25, No.1 (Spring 2006). Also see http://www.irs.gov/businesses/corporations/article/0,,id=163246,00.html

Although the substantial understatement and reportable transaction regimes provided some benefits to the IRS, the benefit was primarily related to encouraging taxpayers to change their behavior.[13] For example, after implementation of the substantial understatement penalty, taxpayers generally would no longer take tax positions that in their view did not meet the required threshold (i.e., either substantial authority or more likely than not). Similarly, after adoption of the reportable transaction regime, taxpayers and their advisors tended to structure transactions so as to avoid reporting (e.g., confidentiality agreements and contingent fees were eliminated).

Given taxpayers and their advisors tended to structure around these reporting provisions, the IRS was not receiving specific disclosure on most uncertain tax positions being taken on returns. What information the IRS did receive from these disclosures was likely of little use.[14]

In 2004, the IRS announced, Schedule M-3, *Form 1120, Net Income Reconciliation for Corporations with Total Assets of $10 Million or More*.[15] Schedule M-3 replaced Schedule M-1 which attempted to accomplish a similar goal, but had significant

[13] Author's observation and also see Pamela Olson, *Announcement 2010-9: Can this Marriage Be Saved?*, BNA Tax Management Memorandum (Jul 5, 2010).

[14] For example, many of the disclosures may have been protective in nature (e.g., the taxpayer believed it met the required threshold of confidence, but wanted to disclose so as to be on the safe side). Nevertheless, both the substantial understatement and reportable transaction regimes may still be useful because of the favorable impact they had on taxpayer behavior (i.e., taking less aggressive positions).

[15] See IRS News Release IR-200491 (July 7, 2004).

deficiencies.[16] Although Schedule M-3 can provide valuable information to the IRS[17], the purpose of the schedule is to disclose a detailed reconciliation between financial accounting and taxable income that may assist the IRS in identifying tax issues. Schedule M-3 was not designed to directly disclose all material issues to the IRS. In many cases, Schedule M-3 will not provide any clue there is a tax issue. For example, assume a corporation records a $10 million expense in its financial statements, but there is a question as to whether the $10 million is deductible. If the corporation claims the $10 million deduction in its federal tax return, there will be no reconciling item on Schedule M-3 and it will be of no assistance to the IRS in identifying the issue.

In addition to specific disclosure regimes under the tax law, in 2006 the Financial Accounting Standards Board (FASB) adopted FIN 48[18] which requires substantial disclosure surrounding a business's "uncertain tax benefits" (UTBs).[19] One law firm has determined from 10-K filings that the 500 public companies with the largest UTBs have

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16 Supra note 12.

17 For example, the Schedule M-3, Part I reconciliation between worldwide financial accounting income and the financial accounting income of those entities filing a consolidated US tax return should be useful. In addition, disclosure of permanent vs. temporary differences in Parts II and III is very useful.

18 FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109* (June 2006). See http://www.fasb.org/pdf/aop_FIN48.pdf.

19 See FIN 48, paragraph 21. UTBs are effectively the amount of tax reserves recorded for potential issues upon audit.

in the aggregate over $200 billion of UTBs.[20] When the FASB was debating FIN 48 there was significant concern the disclosures required would provide a roadmap to the IRS.[21] In order to address this concern, the FASB only required disclosure of aggregate UTBs, rather than UTBs by tax jurisdiction.[22] Although FIN 48 disclosures are of some benefit to the IRS, as the FASB predicted, they have not provided a detailed roadmap to the IRS.[23]

In summary, one of the clear motivations behind Schedule UTP was to address the practical difficulties the IRS has had auditing large corporations. Although there were existing disclosure regimes (e.g., Forms 8275 and 8886, Schedule M-3, and FIN 48), they were not really designed to directly identify the majority of specific issues in corporate tax returns. As a result, the IRS still has had to spend substantial time identifying issues; any in many cases likely fails to identify all the issues.

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20 See Ferraro law firm analysis at http://www.tax-whistleblower.com/ferraro500/ and related article at http://www.tax-whistleblower.com/articles/IRS_Plan_to_Uncover.pdf.

21 See FIN 48, paragraph B64.

22 Id.

23 Id. and also see Answer #1 in *FIN 48 Implications: IRS LB&I Field Examiner's Guide* at http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html.

3.2. **Success of CAP Program** - In 2005, the IRS announced a pilot program titled "Compliance Assurance Process", CAP for short.[24] The purpose of the CAP program is to allow taxpayers working with the IRS to resolve issues prior to filing of their return. As part of the program, taxpayers commit to "communication of information about completed transactions in a manner that is timely and allows a meaningful analysis of material items affecting the tax return".[25] In addition, taxpayers enter into a memorandum of understanding which requires even more specific disclosure.

Over 100 corporations have agreed to participate in CAP[26]. In general, the IRS has found the CAP pilot program to be successful, and has decided to make the program permanent. One lesson the IRS learned from the CAP program is that enhanced disclosure can be valuable for improving both the efficiency and effectiveness of large corporate audits. Unfortunately, as a practical matter, many corporations did not want to participate in CAP because of the disclosure requirements.

In addition, if substantially all large corporations participated in CAP, the IRS likely would have resource issues. Thus, the introduction of Schedule UTP could be viewed as

24 See Announcement 2005-87 published in the IRB 2005-50, Dec. 12, 2005 and http://www.irs.gov/irb/2005-50_IRB/ar14.html#d0e4363

25 Id.

26 Based upon author's knowledge

the IRS's effort to increase transparency for corporations with over $10 million in assets without the need for them to all join the CAP program.[27]

3.3. **Impact of FIN 48[28]** – Over the years the IRS informally received suggestions from tax professionals suggesting that corporations be required to make additional disclosures. In many cases, the suggestion was that the IRS should request a specific description of tax issues from corporations, but not request the reserve amount related to a specific issue. This suggestion is similar in concept to the approach taken in Schedule UTP.

Despite these suggestions, as a practical matter it was very difficult for the IRS to implement such an approach. The major stumbling block was that it was difficult for the IRS to determine how to define what issues should be disclosed. Some could argue the IRS attempted to define the type of tax issues it wanted disclosed when it issued regulations surrounding the reportable transaction regime[29], but as described in Section 3.1 the primary impact of the regime was to change taxpayer's behavior.[30] Taxpayers, especially large sophisticated corporations, continued to have many uncertain tax positions that were not being specifically disclosed on either Form 8886 or Form 8275.

[27] See Section 5.8 for additional discussion surrounding the CAP program and Schedule UTP.

[28] Supra, note 18.

[29] See reg. 1.6011-4.

[30] In addition, since listed transactions are included within the definition of reportable transactions, the regime also provided a mechanism to require taxpayers to disclose the existence of listed transactions once the IRS designated a transaction as listed.

At various times, informal suggestions were made to require corporate/business disclosures for tax issues with reserves in the audited financial statements (i.e., similar to Schedule UTP). However, prior to the adoption of FIN 48 there was significant diversity[31] surrounding the recording of tax reserves in US GAAP[32] audited financial statements. For example, although most businesses recorded reserves on an issue by issue basis, some recorded reserves on a year-by-year basis, or even an audit-cycle by audit-cycle basis. Furthermore, the standard for recording a reserve varied widely.[33]

Once the FASB adopted FIN 48 requiring that businesses analyze tax reserves by unit of account (i.e., defined by reference to specific tax issues), it became possible for the IRS to leverage the FIN 48 analysis done by corporations for their audited financial statements. Commissioner Shulman made reference to FIN 48 in his January 26, 2010 speech[34] announcing Schedule UTP. In summary, the adoption of FIN 48 also played a significant part in moving the IRS towards Schedule UTP.

Although clearly not pursued by the IRS, another approach might have been to impose a very substantial strict liability penalty[35] on any understatement attributable to a tax issue that was not disclosed. Such an approach would require Congressional action, and as a

[31] See paragraph B2 of FIN 48.

[32] GAAP = Generally Accepted Accounting Principles

[33] See paragraph B6 of FIN 48.

[34] Supra, note 3.

[35] For example, a 100% penalty would definitely have gotten business's attention.

practical matter, would have had almost no chance of being adopted. More importantly, even if it was adopted, corporations would inundate the IRS with disclosures and the utility of the disclosures would be greatly reduced. Thus, one benefit of linking Schedule UTP disclosure with the tax reserving process was to target the disclosures to those that should be of most interest to the IRS.

3.4. **Impact of Litigation surrounding tax accrual workpapers (TAWs[36]) –** In discussing TAWs, the U.S. Supreme Court has stated:

> "In short, tax accrual workpapers pinpoint the "soft spots" on a corporation's tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes."[37]

TAWs can be prepared by the taxpayer, or the taxpayer's external auditor, or both. Although the composition of TAWs varies from case to case, they generally include both (i) a description of the taxpayer's issue, and (ii) the reserve amount recorded in the audited financial statements. In some cases, the TAWs may also include tax opinions[38] surrounding the tax issues. In some cases tax opinions are prepared by the taxpayer or the external auditor, and in other cases they are prepared by external advisors.[39]

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36 See IRS Internal Revenue Manuel section 4.10.20.2 at http://www.irs.gov/irm/part4/irm_04-010-020.html for the IRS's current definition of TAWs.

37 *Arthur Young*, 465 U.S. 805 (1984)

38 This article uses the term "tax opinions" to refer to both formal tax opinions and other less formal tax advice.

39 There is some uncertainty whether the IRS definition of TAWs includes tax opinions prepared by, or for, the taxpayer. Specifically, TAWs are defined in IRM 4.10.20.2 to be part of "audit workpapers", and as

Needless to say, an IRS auditor would be very interested in obtaining access to (i) a description of a taxpayer's issues, (ii) the amount of reserve for each tax issue, and (iii) any tax opinions. As will be described in more detail below, there has been significant litigation surrounding the ability of the IRS to obtain TAWs. The IRS has won several cases (e.g., Arthur Young, El Paso, and Textron), but it also has lost a few (e.g., Regions Financial and Deloitte).

During the development of Schedule UTP, some within the IRS were interested in requiring large corporations to disclose both (i) a description of its tax issues, and (ii) the specific reserve related to such issues.[40] However, substantially all senior IRS officials were very concerned about either (i) the perception of fairness surrounding such a proposal, and/or (ii) whether the courts would uphold such a pursuit. In addition, there was concern such an aggressive approach might ultimately negate the ability of the IRS to obtain a complete set of TAWs in cases where it is more justified (e.g., in a criminal case).

As a result, some of these executives advocated reaching a compromise whereby large corporations would only disclose tax issues, but not the reserves or tax opinions related to

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such, must be "created by or for the independent auditor". If a taxpayer prepares a tax opinion in anticipation of litigation and then happens to also give the opinion to its auditor, has it created the opinion "for" the auditor? Also, what if the opinion was not given to its external auditor?

40 This possibility was alluded to in Commissioner Shulman's January 26, 2010 (Supra, note 7) speech when he stated: "We could have asked for more…a lot more…but chose not to."

those reserves. In addition, *Announcement 2010-76*[41] was issued simultaneously with the final Schedule UTP. *Announcement 2010-76* provides that if information was "otherwise privileged", the IRS would generally[42] not argue the taxpayer had waived privilege by virtue of disclosing the information to the taxpayer's external auditor. One suspects some within the IRS view the issuance of *Announcement 2010-76* and final Schedule UTP as a package deal designed to (i) hopefully reduce the tension surrounding TAWs, but (ii) still provide the IRS with information necessary to improve the efficiency of its audits.

Given the above summary, a brief history of the litigation surrounding TAWs might be helpful. In 1984, the IRS won the *Arthur Young* Case at the US Supreme Court[43]. In summary, this case allowed the IRS to obtain access to TAWs prepared by the taxpayer's independent external auditor (i.e., Arthur Young). While the case was being litigated, the IRS committed itself to a "policy of restraint" whereby it would only pursue TAWs if there were unusual circumstances. The existence of this policy of restraint was referred to in the Supreme Court's decision as follows:

> "Although the IRS guidelines were not applicable during the years at issue in this case, their promulgation further refutes respondents' fairness argument and reflects an administrative flexibility that reinforces our decision…"

Shortly after the Supreme Court's decision, the IRS reaffirmed its policy of restraint in

41 2010-41 I.R.B. 432 (Sept. 24, 2010)

42 See Section 5.5.4 for discussion surrounding some of the exceptions to the general rule.

43 *Arthur Young* , 465 U.S. 805 (1984).

Announcement 84-46.[44]

Prior to 2002, the IRS is rumored to have requested TAWs less than 10 times over a 20 year period. In 2002, the IRS issued *Announcement 2002-63* [45] which modified the IRS's policy of restraint. In addition to requesting TAWs when there were "unusual circumstances", the IRS announced it would also pursue TAWs when a taxpayer entered into a "listed transaction"[46]. Specifically, if a taxpayer entered into one listed transaction, the IRS would only pursue TAW information with respect to that one transaction. However, if the taxpayer entered into multiple listed transactions, the IRS would pursue the taxpayer's entire set of TAWs (i.e., impacting all potential issues).

Given many corporations (especially financial institutions) had invested in so-called SILO/LILO transactions and the IRS determined such transactions were "listed transactions"[47], the IRS began pursuing the TAWs from many taxpayers. From 2002 to 2009, the IRS is rumored to have requested TAWs from approximately 150 taxpayers. Although these taxpayers were likely not happy about the prospect of disclosing their TAWs to the IRS, substantially all did. However, two points are worth noting.

[44] 1984-18 I.R.B. 18 (1984)

[45] See *Announcement 2002-63*, 2002-27 I.R.B. 72 (July 8, 2002), and 2002-2 C.B. 72.

[46] Listed transactions are transactions the IRS has determined to be a "tax avoidance transaction" – see 1.6011-4(b)(2).

[47] See item #7 in *Notice 2000-15*, 2000-12 I.R.B. 826, for IRS notification that LILOs are listed transactions. See *Notice 2005-13*, 2005-1 C.B. 630 for notification of SILOs as listed transactions.

First, some of the taxpayers negotiated with the IRS and it is rumored that a few were able to avoid disclosing their entire set of TAWs. Rather, they may have only disclosed a description of the issue, and did not disclose either the reserve amount or any tax opinions. This result is similar to Schedule UTP, except that Schedule UTP requires disclosure of tax issues upon return filing, rather than upon audit.

Second, two taxpayers (i.e., Regions Financial and Textron) did not reach agreement with the IRS and refused to disclose TAWs. In Regions Financial (Regions), similar to the *Arthur Young* case, the IRS issued a summons to E&Y requesting their TAWs with respect to Regions. Regions interceded and directed E&Y to withhold 20 documents from the IRS. The IRS issued a summons, and Regions Financial filed motions to quash the summons. On May 8, 2008, the Northern District Court of Alabama ruled in favor of Regions concluding that disclosure of the 20 documents would violate the work product doctrine.[48]

The IRS appealed the case to the 11th Circuit. However, in December 2008, Regions Financial provided the IRS with all of the withheld documents. Thus, the 11th Circuit dismissed the government's appeal on December 30, 2008 prior to oral arguments.[49] Depending upon your point of view, the Regions case was a victory for the IRS or taxpayers[50].

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[48] *See Regions Fin. Corp. v. United States*, 2008 U.S. Dist. LEXIS 41940, No. 2:06-CV-00895-RDP (N.D. Ala. May 8, 2008).

[49] See discussion at http://taxprof.typepad.com/taxprof_blog/2009/01/ventry-regions.html.

[50] Although apparently not a victory for Regions (unless they obtained some concession from the IRS), the lower court decision was a victory for taxpayers in general.

Although the Regions case was somewhat unusual because of the surprise settlement, it pales in comparison to the twists and turns that took place in Textron's case. In Textron, the IRS sought Textron's TAWs directly from Textron and from their external auditors E&Y. Textron refused to comply with the IRS summons, and litigation commenced in the District Court of Rhode Island.

In August 2007, the District Court ruled in favor of Textron by concluding their TAWs were protected by the work product privilege.[51] The IRS appealed the case to the 1st Circuit. In a two-to-one decision in January 2009 the First Circuit held[52] that:

- The work product doctrine protects Textron's TAWs from discovery because they were prepared in anticipation of litigation, and
- Textron's disclosure of its TAWs to E&Y, did not in and of itself cause a waiver of work product protection because E&Y was *not* a potential adversary.

However, the First Circuit vacated the District Court's holding and remanded the case to that court to make two additional determinations:

- Whether E&Y's TAWs reveal the information contained in Textron's own TAWs, such that E&Y would be treated as a "conduit to a potential adversary," thereby causing Textron to have waived its work product protection, and
- Whether Textron had a right to obtain and therefore must produce E&Y's TAWs in response to the IRS summons issued to it.

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51 See *United States v. Textron*, Inc., 507 F.Supp.2d 138 (D.R.I. August 2007).

52 *U.S. v. Textron, Inc*., 553 F.3d 87 (1st Cir. 2009).

Given that the district court's decision was affirmed in part, vacated in part, and remanded in part, it is somewhat difficult to determine who won the case. Taxpayers chose to focus on the court's conclusion surrounding the work product doctrine that (i) the TAWs were not prepared in anticipation of litigation, and (ii) E&Y was not an adversary. The IRS chose to focus on the remanded part of the decision which left open the possibility that E&Y could be viewed as a conduit to a potential adversary. In addition to the general confusion surrounding the decision, the dissenting judge effectively urged the IRS to request the case be heard by the entire 1st Circuit (i.e., request an *en banc* review). The IRS made such a request and it was accepted.

The *en banc* decision was issued in August 2009 and concluded in a 3-2 decision that the IRS was entitled to obtain Textron's TAWs.[53] However, the rationale for the decision was the subject of much debate and the implications were potentially much broader than just tax concerns.[54] As a result, Textron requested the US Supreme Court to hear the case (i.e., requested *certiorari*). Many *amicus* briefs were filed challenging the rationale used by the 1st Circuit to decide in favor of the IRS. However, on May 24, 2010 the Supreme Court declined *certiorari*.[55]

53 *United States v. Textron, Inc.*, 560 F.3d 513 (1st Cir. August 2009).

54 For example, see Thomas Jaworski, *Textron Could Affect Future SEC Accounting Inquiries*, Panelists Say, 125 Tax Notes 296 (Oct. 19, 2009).

55 See Jeremiah Coder, *Supreme Court Denies Textron's Certiorari Petition*, 127 Tax Notes 951 (May 27, 2010).

Given the confusing case law described above, it is not surprising that even after the *en banc* decision by the 1st Circuit in Textron, there was still much dispute about the IRS's ability to obtain TAWs. Some, mostly in government, believed the IRS had a clear right to obtain TAWs in most, if not all cases. Most in the private sector were much less certain and believed the rationale in 1st Circuit decision was an aberration that might eventually be distinguished by other circuits or overturned by the U.S. Supreme Court.

Given this background, some in the private sector privately suggested a compromise whereby the IRS only should obtain a description of the issue, but not obtain the amount of the reserve by tax issue or tax opinions. For some in government, this was viewed as a reasonable compromise. Thus, when evaluating how Schedule UTP came about, one should consider the ongoing litigation surrounding TAWs, and the potential need to reach a compromise.

3.5. **Summary of Background that Led to Schedule UTP -** Given the above background, the IRS made a decision to pursue Schedule UTP. From my vantage point, the decision primarily resulted from the IRS's need to improve the efficiency and effectiveness of all large, corporate audits by obtaining enhanced transparency. The IRS was having favorable experiences with the CAP program, but expansion of that program to all large, corporations wass not practicable.

For some, the decision to pursue Schedule UTP coupled with *Announcement 2010-76* may also have been partially motivated by a desire to reduce the tension surrounding

TAWs.[56] Finally, rather than attempting to develop a new standard for disclosure, the issuance of FIN 48 allowed the IRS to leverage the work done by corporations when preparing their audited financial statements.

4. Schedule UTP – Key Concepts[57]

This section will address the major operating rules and decisions surrounding Schedule UTP as described in the instructions to Schedule UTP:

4.1. **Only applies to certain large corporations** – Large corporations are defined to be those with assets equal to or greater than (i) $100 million for 2010 and 2011; (ii) $50 million for 2012 and 2013; and (iii) $10 million for 2014 and later years. In addition, only corporations that file Forms 1120, 1120-F, 1120-L, and 1120-PC are required to file Schedule UTP. However, the IRS has left open the possibility that Schedule UTP could be expanded to other filers (e.g., flow-through or tax-exempt entities) in the future.[58] See Section 5.9 for additional discussion surrounding this possibility.

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56 The effort to reduce tension may have been partially successful. Per a quote attributed to Eli Dicker from TEI, "at least the temperature has been dialed down a bit". See Jerimiah coder, *UTP Guidance A High Priority, Wilkins Says*, 129 Tax Notes 165 (Nov. 11, 2010).

57 This discussion is based upon the author's personal experience and observations from reading both *Schedule UTP* (see http://www.irs.gov/pub/irs-pdf/f1120utp.pdf) and the *2010 Instructions for Schedule UTP* (see http://www.irs.gov/pub/newsroom/2010_instructions_for_sch_utp.pdf), hereinafter referred to as "instructions" or "instructions to Schedule UTP".

58 See *Announcement 2010-75*, 2010-41 I.R.B. 428 (Sept. 24, 2010).

4.2. **Effective Date/Transition Rule** – Schedule UTP is only required for tax positions taken in a tax year beginning in 2010. Thus, tax positions taken in pre-2010 tax returns are not disclosed on Schedule UTP.[59] In addition, Schedule UTP is not applicable to a short taxable year that begins and ends in 2010.

4.3. **Piggy-backs on financial statement analysis** – The general rule is that disclosure is required on Schedule UTP if a corporation (or a related party) has recorded a "reserve" for a tax position in its audited financial statements. Thus, a corporation needs to determine whether (i) it has a "tax position", and (ii) whether a "reserve" has been recorded for such tax position.

A tax position is very broadly defined as a "tax position that would result in an adjustment to a line item on that tax return (or would be included in a section 481 adjustment) if the position is not sustained". If there is any uncertainty surrounding a tax issue, it would seem to be a tax position. Thus, the key question is usually going to be whether there is a reserve[60] recorded in the audited financial statements with respect to such tax position.

Disclosure is also required if a corporation (or related party) has no reserve for a tax position, but the audited financial statements assumed there is a greater than 50%

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59 However, see Section 5.10 surrounding tax positions taken in a pre-2010 year that increase an NOL carryforward into a 2010 or later year. Some have questioned whether such tax positions are grandfathered under the transition rule.

60 See Section 5.7 for issues surrounding the definition of a "reserve".

probability a tax position will be litigated (the so-called "expect to litigate" provision).[61] The "expect to litigate" provision has not been well understood, especially by those that do not have a working understanding of FIN 48[62]. Before describing the types of scenarios the IRS was most concerned, a short description of FIN 48 may be helpful.

FIN 48 provides a two-step analysis for determining whether a tax benefit can be recorded in US GAAP financial statements for a tax position. First, the tax position must meet the recognition standard which generally requires that the business believes it has a greater than 50% probability of winning the issue in the "court of last resort"[63]. If the recognition standard is not met, the business records no tax benefit which is the functional equivalent of a 100% reserve.

Once the recognition standard is met, the business needs to determine the "largest amount of tax benefit that is greater than 50% likely of being realized upon settlement with a

[61] Technically the instructions to Schedule UTP provide that disclosure is required if there is less than a 50% probability of settlement. However, given that litigation and settlement are the only two outcomes, this standard equates with a greater than 50% probability of litigation.

[62] Supra, note 18.

[63] The "court of last resort" is the highest court that can hear a case, even if it has the discretion to not hear the case. Thus, the U.S. Supreme Court is the "court of last resort" for federal tax issues. - see Example 16-2 in PwC's 2009 Guide to Accounting for Income Taxes available at http://www.pwc.com/us/en/tax-accounting-services/publications/accounting-income-taxes-2009-guide.jhtml.

taxing authority that has full knowledge of all relevant information".[64] The FASB illustrated this concept through the following probability distribution table:[65]

Possible Tax Benefit	Individual Probability	Cumulative Probability
100%	5%	5%
80%	25%	30%
60%	25%	**55%**
50%	20%	75%
40%	10%	85%
20%	10%	95%
0%	5%	100%
	100%	

In the above example, the business would record a tax benefit of 60% (i.e., a 40% reserve) because it is the highest tax benefit that has a cumulative probability of more than 50% (i.e., 55% in the example).

The measurement step generally contemplates tax positions will be settled with the taxing authority (e.g., the IRS). However, in some cases, a business may expect to litigate a tax position. For example, assume a business estimates it has a 60% probability of winning the tax position in litigation and that litigation is expected. Although this fact pattern is not directly addressed by FIN 48, accounting firms have generally concluded that a 100% tax benefit can be recorded (i.e., no reserve recorded) if the business believes it has a greater than 50% probability of winning the tax position in litigation.[66]

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64 See FIN 48, paragraph 8.

65 See FIN 48, paragraphs A21-A25.

66 For example, see Section 16.4.1.5 of *PwC's 20009 Guide to Accounting for Income Taxes* available at http://www.pwc.com/us/en/tax-accounting-services/publications/accounting-income-taxes-2009-guide.jhtml.

In the example above, if the business were to prepare probability distribution tables, there would be a greater than 50% probability (i.e., 60%) of receiving a 100% tax benefit and thus no reserve would be recorded:

Possible Tax Benefit	Individual Probability	Cumulative Probability
100%	60%	**60%**
0%	40%	100%
	100%	

Given this possibility, the IRS had to determine whether Schedule UTP should require disclosure of this type of tax position (i.e., when no reserve is recorded, but the corporation assumed while preparing is audited financial statements that litigation is expected). Although no tax reserve would be recorded in its audited financial statements, this is a tax position the corporation has determined must be substantially uncertain if it cannot project reaching a reasonable settlement with the IRS.[67] The IRS decided it was reasonable to request disclosure of a tax position when the corporation "expects to litigate" such position. However, the IRS then had to develop an operational definition of "expects to litigate".

In the above example, it was assumed the corporation would litigate the tax position. However, in the real world, corporations try to avoid litigation if possible. Thus, if a corporation were to argue that it is "highly likely" to litigate a tax position, it might have

[67] It is theoretically possible the corporation may believe the issue is highly certain, but it does not expect the IRS to agree with this conclusion. In such case, this author still believes disclosure is appropriate. However, the instructions are not 100% clear on this point.

a difficult time convincing its external auditor that such an assumption is reasonable. A more reasonable argument might be there is some possibility of settlement and some possibility of litigation.

Again, FIN 48 does not directly address this sort of fact pattern. Nevertheless, while in private practice, the author became aware of two approaches for addressing this sort of fact pattern. Under the first approach, one would determine whether settlement or litigation was more likely. Probability distribution tables would then be constructed based upon whichever alternative was more likely. For example, if there was a greater probability of settlement than litigation, then probability distribution tables would be based upon settlement scenarios. If the reverse was true, the probability distribution tables would be based upon litigation.

The alternative approach is to splice together probability distribution tables[68]. This approach is more complicated and is best illustrated by an example. Assume it is 50/50 on whether there will be a settlement vs. litigation. In addition, further assume that if litigated, the business assumes it has a 70% probability of prevailing in litigation. Given these facts, one might splice together a probability distribution table as follows:

	Settlement (50%)			**Litigation (50%)**			
Tax Benefit	**Probability**	**x 50%**	**%**	**Probability**	**x 50%**	**%**	**Cumulative Probability**
100%	35%	x 50%	17.5%	70%	x 50%	35%	52.5%
75%	35%	x 50%	17.5%	0%	x50%	0%	17.5%
50%	30%	x 50%	15%	0%	x50%	0%	15%

68 For an example , see Rolfes, Sherwood, and Lovelace, *Schedule UTP: Ready or Not, Her It Comes*, BNA Tax Management Real Estate Journal 267 (Sept. 2010)

25%	0%	x 50%	0%	0%	x50%	0%	0%
0%	0%	x 50%	0%	30%	x50%	15%	15%
Total	100%		50%	100%		50%	100%

Given these facts, the "splicing approach" would result in the corporation recording 100% of the tax benefit (i.e., no reserve) because the probability of obtaining the 100% benefit is greater than 50% (i.e., 52.5%).

Because of the possibility a corporation may record no tax reserve for a tax position, but still may have assumed a material possibility of litigation while preparing its audited financial statements[69], the IRS had to decide what threshold of litigation probability should trigger disclosure on Schedule UTP. The IRS decided that if in preparing the audited financial statements it was assumed "the probability of settling with the IRS to be less than 50%", then disclosure is required. Said differently, if the probability of litigation is more than 50%, then disclosure is required. Thus, in the above example disclosure would still not be required on Schedule UTP because there is only a 50% probability of litigation.[70]

In summary, although no reserve is recorded for a tax position, the IRS determined that disclosure is appropriate when the corporation assumed for purposes of its audited

[69] Although the rule was crafted with FIN 48 in mind, it applies equally to non-US GAAP financial statements. Thus, if while preparing such a financial statement a corporation assumes there is a greater than 50% probability of litigating a tax position, then disclosure is required on Schedule UTP.

[70] However, if the probability of litigation in the example was 51% and all other facts were the same, disclosure would be required on Schedule UTP. Alternatively, the IRS should consider changing its definition of expect to litigate to a 50% or greater probability to require disclosure of the above example.

financial statement that there is a greater than 50% probability the tax position would be litigated. Such a fact pattern is indicative that the issue is (i) uncertain, (ii) the corporation expects the IRS to challenge the tax position, and (iii) the corporation does not believe it can reach a reasonable settlement with the IRS.

Some have argued that requiring disclosure of an "expect to litigate" tax position deviates from the general concept underlying Schedule UTP (i.e., that it piggy-backs on the conclusions reached by the corporation while preparing its audited financial statements).[71] These commentators suggested that if no reserve is recorded in the audited financial statements, then no disclosure should be required on Schedule UTP. Although the IRS could have reached this conclusion, it did not. There are two reasons why the IRS's position is justified.

First, the "expect to litigate" provision does piggy-back on the information that was developed while preparing the audited financial statements. However, instead of focusing solely on whether a reserve is recorded, it also focuses on the assumptions used to determine whether a reserve is necessary. Second, if the IRS had not adopted the "expect to litigate" provision, some corporations may have started arguing they were expecting litigation to avoid recording a reserve. Thus, to some extent, one can view the "expect to litigate" provision as an anti-abuse rule designed to minimize the temptation for corporations to make such an argument.

[71] See *Announcement 2010-75*, 2010-41 I.R.B. 428 (September 24, 2010).

In addition to the criticism discussed immediately above, other commentators have criticized the "expect to litigate" provision because they believe it might somehow violate the corporation's privilege or work product protection. Given expect to litigate provisions do not have to be singled out as such on Schedule UTP, the response to this criticism is that the disclosure pursuant to the "expect to litigate" provision is no different in concept than a disclosure of a tax position when a reserve is recorded in the audited financial statements. In both cases the corporation has determined there is some uncertainty in the tax law. In one case they recorded a reserve, while in the other case they did not because of the mechanics of FIN 48. If there is an issue with the "expect to litigate" provision, then there should also be an issue with the general requirement in Schedule UTP to disclose tax positions for which a reserve was recorded.[72]

4.4. Three parts to Schedule UTP - Schedule UTP is composed of three parts:

- **Part I** – Location to disclose tax positions related to the current taxable year. For example, if a corporation recorded a reserve in its 2010 audited financial statements for a tax position in its 2010 tax return, such tax position should be disclosed in Part I of Schedule UTP.
- **Part II** - Since it is not unusual for there to be a delay in recording a reserve related to a tax position, Part II is used to disclose tax positions related to prior taxable years that had a reserve recorded in an audited financial statement issued after the filing of the prior tax return. For example, if a corporation took a tax position in its 2010 tax return, but did not record a reserve until its 2011 audited financial statement, such

[72] See Section 5.5 for discussion of whether Schedule UTP will withstand legal challenge.

tax position would be disclosed in Part II of the 2011 Schedule UTP attached to its 2011 tax return. Part II includes a column to disclose the year a tax position relates (e.g., 2010 in the above example).

- **Part III** – Location for disclosure of the concise description(s).

4.5. **Concise description of tax position** – Schedule UTP requires a concise description of the tax position. A concise description is defined to include 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." The preliminary instructions to Schedule UTP also required "the rationale for the position and the reason for determining the position is uncertain".

Several commentators raised questions surrounding the additional requirement in the preliminary instructions.[73] Specifically, they questioned whether such disclosure is needed and could possibly violate a corporation's privilege and work product protection. In reaction to these comments, the IRS modified the concise description language to that it is very similar to the language in Form 8275 related to disclosure to avoid substantial understatement penalties.

[73] For example, see Tax Executives Institute comments at 2010 TNT 104-67 (May 28, 2010) and American Bar Association comments at 2010 TNT 104-66 (May 28, 2010).

See Examples 10-12 at the end of the Sch. UTP instructions for a description of the type of "concise description" the IRS is expecting. One suspects corporations will agonize over the 2-5 sentences that a typical concise description is likely to include.

4.6. **Reserve Ranking of Tax Positions** – Schedule UTP requires a ranking of tax positions based upon the amount of reserve recorded by category of tax position (i.e., "T" for transfer pricing and "G" for general). Thus, tax positions are labeled T1, T2, T3, etc… and G1, G2, G3, etc… The intention of this disclosure is to alert the IRS to those tax positions that should receive greater attention.

It should be noted that in the draft Schedule UTP, corporations were going to be required to disclose the "maximum tax adjustment" (i.e., MTA). See Section 5.4 for additional discussion surrounding whether the change from MTA disclosure to reserve ranking will give the IRS the information it needs to select taxpayers for audit

4.7. **Tax Position -** As mentioned previously, a tax position is very broadly defined. One concept that has been somewhat confusing to some is that tax positions are determined on a year-by-year basis. They are <u>not</u> determined on a transaction-by-transaction basis.

For example, assume a corporation enters into a transaction in 2009 that will result in uncertainties in the 2009, 2010, and 2011 tax returns. In this fact pattern, the corporation has a tax position for each of the 3 years. The 2009 tax position is grandfathered from disclosure by the transition rule, but the 2010 and 2011 tax positions may need to be disclosed separately if reserves are recorded for each tax position.

Another basic concept surrounding Schedule UTP is that a tax position should only be disclosed once. The best way to illustrate this is by example. Assume a corporation has a tax position in its 2010 tax return and records a 20% reserve in its 2010 audited financial statements. In such case, the corporation should disclose the tax position in Schedule UTP, Part I in the 2010 return. Assume that in 2011 the corporation increases its reserve for the 2010 tax position from 20% to 40%. Since the corporation has already disclosed the 2010 tax position, it should not disclose the 2010 tax position again in Schedule UTP, Part II in the 2011 return.

However, if the uncertainty that led to the 2010 tax position also exists for a 2011 tax position, the corporation has two tax positions. Assuming the corporation also recorded a reserve for the 2011 tax position prior to filing its 2011 return, such tax position would be disclosed on Part I of the 2011 Schedule UTP.

4.8. **Other Disclosures** - As summarized in Part I and II of Schedule UTP, disclosure of the following information is also required:

4.8.1. **Temporary vs. permanent tax positions** - Disclosure of the type of tax position consistent with the accounting standards used to prepare the audited financial statements. Temporary tax positions are ones were only the timing is uncertain (e.g., it is uncertain whether a deduction can be claimed in the current year or a future year). A permanent tax position is a tax position that is not temporary (e.g., exclusion of potentially tax-exempt interest income).

4.8.2. **Pass-through EIN#** - If the tax position taken by the corporation relates to a tax position of a pass-through entity (e.g., partnership, trust, etc…), the EIN# of the pass-through entity needs to be disclosed. The purpose of this disclosure is to allow the IRS to determine what entity's tax return should be potentially audited.

4.8.3. **Major tax position** - A box needs to be checked if the relative "size" of a tax position is equal to or greater than 10% of the aggregate size of all tax positions disclosed. "Size" is not defined, but most presume it is based upon the size of the reserve as determined for reserve ranking purposes.[74] For example, assume a corporation has disclosed tax positions on both Parts I and II of Schedule UTP for a particular year and that the aggregate reserves of the tax positions disclosed in both parts is $100. In this case, any tax position with a reserve greater than or equal to $10 will need to be labeled a major tax position.

4.8.4. **Applicable code section(s)** - Schedule UTP requires disclosure of up to 3 applicable code sections surrounding the tax position.

[74] This position is supported by language in *Announcement 2010-75*, 2010-41 I.R.B. 428 (Sept. 24, 2010).

4.9. **Disclosure on Schedule UTP can do double duty** - If a corporation discloses an issue on Schedule UTP, it is deemed to meet the separate filing requirements for (i) Form 8275 (related to disclosure surrounding substantial understatement penalties), and (ii) the new 40% penalty related to the codification of economic substance in IRC 7701(o)[75]. However, if a corporation has a reportable transaction, it must separately file Form 8886.

Prior to the advent of Schedule UTP, if a taxpayer filed Form 8275, it could be a strong indication they had <u>serious</u> concerns about the technical merits of the tax position (e.g., possibly less than 50% probability of success).[76] Now, if the tax position is disclosed on Schedule UTP, the IRS no longer knows whether the corporation has serious concerns about the technical merits of a tax position (e.g., may not meet the more likely than not or substantial authority standards). All the IRS will know is that the corporation recorded a reserve for the position, or expects to litigate the position.

One potentially outstanding question is whether the IRS will ultimately require corporations to check some box on Schedule UTP if they want to be deemed to have filed Form 8275? If such a box is required, the IRS will then have the information it had prior to Schedule UTP. If the IRS considers this approach, it should also consider allowing Schedule UTP disclosure to do double duty for Form 8886, related to reportable

[75] See *IRS Notice 2010-62*, 2010, 2010-40 I.R.B. 411 (Sept. 13, 2010) and *Announcement 2010-75*, 2010-41 I.R.B. 428 (Sept. 24, 2010) that state a complete and accurate disclosure on Scheudle UTP satisfies the disclosure requirements of IRC 6662(i) – except for reportable transactions.

[76] However, some taxpayers also filed protective Form 8275s.

transactions. However, in such case, the IRS should definitely require that a box of some type on Schedule UTP be checked to indicate disclosure is also being made to satisfy the requirements of Form 8886.

4.10. **Schedule UTP applies regardless of whether FIN 48 is used** - Although most corporations filing US corporate income tax returns prepare audited financial statements using US GAAP, Schedule UTP applies regardless of the overall method of accounting (e.g., IFRS) used to prepare the audited financial statements. Thus, if a reserve is recorded for a tax position in the audited financial statements[77], such tax position needs to be disclosed even if FIN 48 is not used in the audited financial statements. See Section 5.12 for a discussion of selected issues surrounding corporations using IFRS in their audited financial statements.

4.11. **Uncooperative related party –** Schedule UTP requires a corporation to determine whether either it, or a related party, recorded a reserve with respect to a tax position. Thus, when a corporation has not recorded a reserve for a tax position in its own audited financial statements, or does not have audited financial statements, the corporation should determine whether a related party has recorded a reserve with respect to the corporation's tax position. If the related party does not provide such information, Schedule UTP includes a box for corporations to check if a related party refuses to provide information.

[77] Or there is an assumption there is a greater than 50% probability of litigation.

This may sound somewhat confusing, but it is aimed primarily at a situation when there is a US subsidiary (or branch) of a foreign corporation.[78] For example, assume a US subsidiary (or branch) has a tax position, but as often is the case, reserves are recorded in the foreign parent's audited financial statements. If the foreign parent will not provide information to the US subsidiary (or branch) to determine whether a tax position should be disclosed, the US subsidiary should check the box on Schedule UTP.

5. Schedule UTP - Major Issues

There are many issues surrounding Schedule UTP. The ones listed below are among the more significant:

5.1. **Should the IRS be requesting corporations to complete Schedule UTP?** - Although to some extent, this is a relatively moot point since the IRS is moving forward with Schedule UTP, most of the comments submitted to the IRS severely criticized Schedule UTP.[79] The criticisms were varied, but it should be noted that Schedule UTP caught

[78] It can also be applicable in the domestic related party context. For example, assume domestic corporation P owns 75% of domestic corporation S, but they only prepare separate company financial statements. Further assume S has a tax position, but the reserve is recorded in P's audited financial statements. In such case, Schedule UTP requires S to disclose the uncertain tax position. However, if P will not provide S the necessary information, S should check-the-box for an uncooperative related party.

[79] For a summary of comments, see Jeremiah Coder, *Commentators Ask IRS To Abandon UTP Proposal, Change Schedule*, 127 Tax Notes 1064 (June 7, 2010), and Joseph DiSciullo, *Proposed Schedule UTP Continues To Draw Fire from Commentators*, 127 Tax Notes 1099 (June 7, 2010).

most corporate tax professionals by surprise. The major conceptual criticisms surrounding Schedule UTP included:

5.1.1. **Bad actors vs. all large corporations** - Corporate tax professionals were aware of the IRS's efforts to obtain Tax Accrual Workpapers (TAWs), but many viewed this as an IRS effort aimed at bad-actors (i.e., those that had participated in listed transactions or had unusual circumstances[80]). Schedule UTP requires disclosure from all large corporations, not just bad actors. Implicit in this criticism is that only bad actors should be required to disclose issues to the IRS. One response to this criticism is that in a self-assessment system like exists in the US, it is appropriate for all taxpayers to disclose issues to the IRS. This is especially the case for large, corporate taxpayers where it is often difficult for the IRS to quickly and effectively identify tax issues based upon the existing information provided in a return.

Another response is that as a practical matter, it is difficult for the IRS to identify "bad actors". Although participation in a listed transaction could be viewed as being a bad actor, my experience is that it is not a perfect indicator. For example, some taxpayers enter into aggressive tax positions and fully disclosed such transactions at the time the return was filed. Are these bad actors? Generally, I would say "no". Rather, the bad actors should be those taxpayers that entered into

80 The two criteria used by the IRS to determine whether to pursue TAWs – see IRS Internal Revenue Manual 4.10.20.3.

aggressive transactions and had no intention of disclosing the transactions and frankly hoped they would never be discovered by the IRS.

In summary, it is important to note many corporations and their advisors were surprised the IRS pursued disclosure of uncertain tax positions from all large corporations, rather than just those who had participated in listed transactions or had unusual circumstances. Nevertheless, the IRS has valid arguments for requiring disclosure from all large, corporations.

5.1.2. **Disclosure on return vs. audit** - Schedule UTP requires disclosure with the tax return, rather than upon audit. To the extent the IRS decided to pursue disclosure of tax issues, corporate tax professionals were expecting such disclosure to be upon audit, not at the time the return was filed. Thus, they were surprised again.

The primary reason tax professionals were focusing on disclosure upon audit is because the TAW litigation resulted from summons issued during the audit process. The IRS could have decided to only require disclosure upon audit, but a decision was made to require disclosure in the tax return, rather than allowing corporations to play the audit lottery and delay disclosure until they are selected for audit. In addition, the IRS wanted to use Schedule UTP to help identify taxpayers for audit.[81]

[81] However, see Section 5.4 for discussion of whether the IRS will be successful in identifying taxpayers for audit.

5.1.3. **Potential impact on financial accounting** - Finally, some view Schedule UTP as punishing corporations that take a conservative position in their audited financial statements by recording a tax reserve for an uncertain tax position. Said differently, there is concern Schedule UTP will encourage/reward corporations for not recording tax reserves in their audited financial statements. The IRS considered this concern during the drafting of Schedule UTP. As described in Section 4.3, part of the reason for the "expect to litigate" provision was to discourage corporations from being tempted to record no reserve by assuming the tax position was likely to be litigated.

In addition, during drafting of Schedule UTP, several other "anti-abuse" rules were considered. For example, the draft Schedule UTP would have also required disclosure of tax positions that avoided a reserve by virtue of the so-called "administrative practice" exception in FIN 48.[82] The IRS also considered requiring disclosure of tax positions with no reserve in various other scenarios.[83] If the IRS had adopted these disclosure requirements, it may have eliminated some of the incentive for corporations to avoid a reserve because such tax positions still would have been disclosed.

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82 However, because of various comments received, in the final Schedule UTP, the IRS dropped the requirement to disclose tax positions that avoided a reserve by virtue of the administrative practices provision – see *Announcement 2010-75*, 2010-41 I.R.B. 428 (Sept. 24, 2010). Also see discussion at Section 5.3.1.3.

83 For example, see Section 5.3.1.2 related to entries on a "net effects schedule" and Section 5.3.1.4 related to tax insurance.

Ultimately, except for the "expect to litigate" provision, the IRS decided to not require such disclosures. Rather, the IRS is effectively (i) anticipating that any efforts to avoid recording a reserve will be relatively immaterial, or (ii) relying on external auditors to impose some discipline on corporations. Time will tell whether this was a wise judgment. One suspects the IRS may ultimately have to require disclosure of tax positions when no reserve was recorded in the audited financial statements, but the external auditor posted an adjustment to a "net effects schedule".[84]

My personal view is that, in the aggregate, tax reserves in corporation's audited financial statements will not be materially reduced in order to avoid Schedule UTP. Nevertheless, over time corporations will likely eliminate tax reserves on specific tax positions wherever possible. In order to avoid being under-reserved, corporations may increase reserves on those issues where a reserve is unavoidable.[85] Thus, the overall integrity of the financial statements should not be materially impacted, but Schedule UTP has clearly created an incentive to not record a reserve for tax positions, especially when it is a close call on whether a reserve is needed.

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84 See Section 5.3.1.2 for additional discussion and description of a "net effects schedule" which is also referred to by other labels.

85 This may be possible because there usually is a range of reserves corporations can justify. Thus, if they currently record reserves in the low-to-mid end of the range, there may be room for them to increase the reserve.

5.2. **Will the IRS automatically propose audit adjustments?** – Once it was clear the IRS was not backing down from Schedule UTP, many corporate tax professionals became concerned IRS agents will automatically issue proposed audit adjustments for all tax positions listed on Schedule UTP. Senior IRS executives have on numerous occasions stated this was not the intent[86], plus at the time Schedule UTP was finalized, the IRS issued an internal directive from Steve Miller, Deputy Commissioner, to all LB&I personnel.[87] The directive includes various items intended to address taxpayer concerns. For example, it states:

> "This means that items disclosed on a Schedule UTP may or may not require an examination or an audit adjustment by the examiner."

The jury is still out on how IRS field agents will use Schedule UTP. The IRS is planning significant training, but there are likely to be some growing pains. One has to assume at some time in the future an IRS agent somewhere is going to take all of the tax positions disclosed on Schedule UTP and, with little thought, propose audit adjustments for all positions listed even though some are not warranted. If corporations believe an IRS agent is being unreasonable, they should discuss any issues with IRS management.

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86 For example, see article on Commissioner Shulman's comments at 71 DTR G-9 (April 15, 2010) and *Officials Try To Assuage Fears About Proposed UTP Reporting*, TNT 78-1 (April 23, 2010).

87 See http://www.irs.gov/pub/newsroom/internal_directive.pdf for Deputy Commissioner Steve Miller's directive to IRS agents.

5.3. **Will corporations attempt to avoid disclosure on Schedule UTP?** – Given many corporations are not anxious to be discussing uncertain tax positions with the IRS[88], the clear answer to this question is "yes".[89] Below are discussions of several approaches corporations may take to avoid disclosure on Schedule UTP.[90]

5.3.1. **By eliminating tax reserves –** There are many variations of this approach, but the end result of all will be the recording of no tax reserve in the audited financial statement. Specific approaches might include:

5.3.1.1. **Immaterial tax reserves** – Many corporations may attempt to eliminate immaterial tax reserves. Presumably external auditors will likely agree with this approach on the grounds the tax reserves eliminated are immaterial. However, it is not clear whether corporations might adopt this approach immediately, or over time. For example, assume a corporation has a recurring tax position starting in 2008 and that historically reserves were recorded for these positions. Would the corporation and its external auditor be comfortable eliminating reserves already recorded? If not, would the corporation and its

88 Either because they fear (i) an increase in their tax liability, or (ii) the time and effort required to respond to IRS inquiries.

89 However, as discussed in Section 5.1.3, it is my view that aggregate tax reserves should not be materially understated.

90 The description of these approaches should not be taken as an endorsement by the author. Rather, the descriptions are intended as an academic exercise. The hope is both the IRS and SEC will take steps to make it clear the use of these techniques will either not be looked upon favorably, or preferably, outright prevented by changes to the instructions.

external auditor be comfortable maintaining reserves for pre-2010 years, but not 2010 and later years. It will be interesting to see what develops, but one would suspect there will be a range of behavior with external auditors (and fear of the SEC) being the governor on how far corporations push the envelope.

5.3.1.2. **Relatively material tax reserves** – Some corporations may be willing to eliminate a relatively material tax reserve with the expectation their external auditor will only include the adjustment on a "net effects schedule"[91] and not propose an adjustment to the financial statements as a whole. External auditors accumulate various adjustments on such schedules and will only require a modification of a financial statement if the aggregate adjustment is material to the financial statements as a whole. It should be noted that for public companies external auditors are required to disclose such unagreed adjustments to the corporation's Board of Directors.[92] This disclosure may discourage some public corporations from executing this strategy.

5.3.1.3. **FIN 48 administrative practice provision** – FIN 48 allows a business to meet the recognition standard and effectively avoid recording a reserve if it is "widely understood that the past administrative practices and precedents of the

[91] Also referred to as a statement of unagreed differences (SUD), statement of adjustment proposals (SOAP), or by other labels and acronyms.

[92] See Public Company Accounting Oversight Board AU section 380.10, relating to auditor's communications with the audit committee.

taxing authority" are that they will accept a particular tax position[93]. The draft Schedule UTP originally required corporations to disclose this type of tax position under the theory that if a taxpayer believed there was a widely understood administrative practice, they should have no problem telling the IRS of such conclusion.

The final Schedule UTP does not require disclosure based upon comments that it would be "unduly burdensome or corporations to identify, describe, and quantify these positions, and would provide the Service very little useful information".[94] As a result, it is possible corporations may consider a more expansive use of the Administrative Practice provision. But if they do, they will likely need to get agreement from their external auditor.[95]

5.3.1.4. **Insurance or a tax indemnification** – Although tax insurance has been an idea floating around for years, it never really had many purchasers. It is possible, but not probable, that Schedule UTP could increase the demand for tax insurance. In order for this approach to be viable, a corporation will need to convince itself (and its external auditors) that the proper accounting for an insured or indemnified tax position is to record no tax reserve.

93 See FIN 48, paragraph 7.b.

94 See *Announcement 2005-75*, 2010-41 I.R.B. 428 (Sept. 24, 2010).

95 It is possible corporations may attempt to take this and other positions without telling their external auditor, but they do so at their peril. If the impact of such positions is material, they could be charged with criminal or civil fraud.

The proper accounting is likely to be the recording of a tax reserve offset by a receivable for any insurance or indemnification proceeds.[96] Said differently, netting the reserve with the receivable is not likely to be the appropriate accounting. Nevertheless, this strategy may be useful in convincing an external auditor that a tax reserve posted to a net-effects schedule is immaterial to the financial statements as a whole[97] and thus, no adjustment is needed to record a reserve.

5.3.2. **By checking-the-box for an uncooperative related party -** As described in Section 4.11, if a related party will not disclose whether it recorded a reserve[98] for a corporation's tax position, the corporation can check a box on Schedule UTP. It remains to be seen how many US subsidiaries/branches of foreign corporations take this approach to avoid disclosure; but some could. If the IRS wants to minimize this opportunity, it should think about getting out the word that if the box is checked, the corporations should expect a very thorough audit. In addition to US subsidiaries/branches of foreign corporations availing themselves of this technique, corporations with domestic related parties may also attempt this strategy.

96 For example, see Section 16.2.1.5 of *PwC's 2009 Guide to Accounting for Income Taxes* at http://www.pwc.com/us/en/tax-accounting-services/publications/accounting-income-taxes-2009-guide.jhtml.

97 It is more likely to be immaterial since there are offsetting receivables and payables. Thus, if the entry were made, the practical effect would be to only gross-up the balance sheet which generally has a higher materiality threshold than an entry that impacts either P&L or equity.

98 Or avoided a reserve though an "expect to litigate" assumption

5.3.3. **Can disclosure be avoided even though a reserve is recorded? -** The final instructions to Sch. UTP state the following:

> "If the corporation or a related party determined that, under applicable accounting standards, either no reserve was required for a tax position taken on a tax return because the amount was immaterial for audited financial statement purposes, or that a tax position was sufficiently certain so that no reserve was required, then the corporation need not report the tax position on Schedule UTP." [emphasis added]

Read in isolation, the above language could tempt some corporations to argue that even though a reserve was recorded, disclosure on Schedule UTP can be avoided. For example, assume a corporation recorded a reserve for a tax position even though no tax reserve was required because the reserve amount for such tax position would be immaterial to the financial statements.[99] In this fact pattern, can the corporation argue the reserve for the individual tax position was not "required" and therefore avoid disclosure?

Given my understanding of what the IRS intended, coupled with a holistic reading of the instructions and *Announcment 2010-75*[100], it is clear the IRS intended the "immaterial" and "sufficiently certain" language to only apply when no reserve

[99] Based upon the author's experience, the reserve for individual tax positions are rarely material to the financial statements as a whole. However, the total tax reserves for all issues are often material to the financial statements.

[100] 2010-41 I.R.B. 428 (Sept. 24, 2010).

was recorded in the audited financial statements. For example, *Announcement 2010-75* states:

> "Some commentators opposed the proposal because of their understanding that it required a corporation to report tax positions for which <u>no reserve</u> was recorded … either because the position was highly certain or was immaterial in the context of the audited financial statements." [<u>emphasis</u> added]

In addition, both *Notice 2010-75* and the Instructions for Schedule UTP state the general rule that disclosure is required if a reserve is recorded in the audited financial statements.

Even if one accepts that the quote discussed above only applies when there is no tax reserve recorded, there still is an issue as to how the "sufficiently certain" language interacts with the "expect to litigate" provision. For example, assume a corporation is sufficiently certain that it is not required to record a reserve for financial accounting purposes, but the corporation also anticipates there is a greater than 50% probability of litigation. In such case, which language controls (i.e., the "sufficiently certain" or the "expect to litigate" language)? One suspects the intention of the IRS is that the "expect to litigate" provision controls, and thus disclosure would be required in this example.

It will be interesting to see whether any corporations attempt to make either of the above arguments. Given the lack of an effective penalty for failing to properly complete Schedule UTP, one could imagine some corporations being tempted. Thus, the IRS should consider modifying the language in its instructions to make it clear that (i) the sufficiently certain and immaterial language is only intended to apply when there is no reserve[101], and (ii) the "expect to litigate" language trumps the "sufficiently certain" language.

5.4. Will reserve ranking give the IRS information it needs[102]? – One of the stated goals of Schedule UTP is to allow the IRS to prioritize issues for a taxpayer already selected for audit, while another goal is to help determine which corporations should be audited.[103] The draft Schedule UTP required disclosure of the maximum tax adjustment (MTA) which is the amount of tax at stake for a particular tax issue. For example, if a corporation deducted $100, but it was uncertain whether the tax position would be sustained, the MTA would equal $100 x 35% = $35.

The final Schedule UTP eliminated the MTA approach and substituted the reserve ranking approach discussed previously. The IRS believes the reserve ranking approach will adequately prioritize issues once a corporation has been selected for audit[104]. In a

[101] In addition, as discussed in Section 5.7, the IRS should consider imposing a penalty for failure to file, or adequately file, Schedule UTP.

[102] In the scope of issues surrounding Schedule UTP, this is not that important, but nevertheless it will be difficult for the IRS to meet one of its stated goals (i.e., assist in selecting taxpayers for audit).

[103] See *Announcement 2010-9*, 2010-1 C.B. 408 (January 26, 2010).

[104] However, since there is no reserve for "expect to litigate" tax positions, the IRS had to determine where they would be disclosed in the reserve ranking process. The IRS determined the corporation could choose

prior article, this author concluded the reserve ranking approach will do little to help the IRS select corporations for audit, especially when compared with the MTA approach.[105] The reason is that the reserve ranking approach eliminates all reference to the absolute size of an issue. The MTA approach would have allowed the IRS to aggregate the MTAs for a particular corporation and determine whether they were relatively large for a corporation of a particular size. If the IRS were to ever reconsider the MTA approach, it should only consider requiring disclosure of a tax position within certain MTA ranges.

If the IRS wants to select a corporation for audit using the reserve ranking approach, they will need to focus on the number of issues and the concise description. There will be no information on absolute size of the tax positions disclosed. It is possible that the change from MTA to reserve ranking is indicative that the IRS is planning to use the Schedule UTP mostly as an aid for auditing corporations it has selected for audit, rather than as a tool for selecting specific corporations for audit.

how to rank expect to litigate positions. It will be interesting to see what ranking strategies corporations employ.

105 See J. Richard Harvey, Jr., "Schedule UTP Guidance – Initial Observations", *Tax Notes*, Oct. 4, 2010, p. 115, and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1683607.

5.5 Will Schedule UTP withstand legal challenge? – After Commissioner Shulman's January 2010 announcement of Schedule UTP, several commentators[106] questioned whether the "concise description" proposal violated a corporation's privilege or work product protections. As discussed in Section 4.5, the IRS made changes in the final Schedule UTP that attempted to address these concerns. Nevertheless, some corporations and their advisors still believe Schedule UTP may violate privilege and/or the work product doctrine.[107] In the Treasury Decision adopting the final regulation authorizing Schedule UTP[108], the government referred to one such commentator as follows:

> "One commentator asked that the proposed regulation not be adopted because Schedule UTP would require the disclosure of privileged information. If the regulation is adopted, the commentator recommended it should state that taxpayer may assert any applicable privileges to providing information sought by Schedule UTP and that any disclosure of information on that schedule will not constitute a waiver of any applicable privilege."

The government responded to the comment by stating:

> "Provisions relating to the assertion of privilege are not included in this regulation, since it does not affect the existence of any applicable privileges

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106 For example, see American Bar Association comments at 210 TNT 104-66 and Pamela Olson, *Announcement 2010-9: Can this Marriage Be Saved?*, BNA Tax Management Memorandum (Jul 5, 2010)

107 For example, see Amy Elliott, *Practioners Consider Whether Schedule UTP Contains Protected Work Product*, 2010 TNT 194-2 (October 7, 2010).

108 2011-6 I.R.B. 453 (published in Federal Register on Dec. 15, 2010).

> taxpayers may have concerning information requested by a return or how they may assert those privileges."

In summary, the government does not believe Schedule UTP violates privilege or work product, but if challenged by corporations, it will ultimately be up to the courts. The challenge to Schedule UTP will likely be on the grounds that the "concise description" required by Sch. UTP contains (i) mental impressions of a corporation or its counsel that are sufficient to require work product protection[109], or alternatively (ii) advice that is protected under attorney-client or accountant-client privilege[110]. Given the importance of this question, there likely there will be a lot written on the subject. Thus, what follows is only a summary of some of the arguments that could be made.

5.5.1 IRS arguments:

- **Statutory and regulatory authority** - The IRS has very broad authority under IRCs 6001, 6011, and 6012 to request information on a tax return. For example, IRC 6011 states:

  > "Every person required to make a return or statement shall include therein the information required by such forms or regulations."

  In addition, the IRS and Treasury Department have issued specific regulations authorizing Schedule UTP.[111] In addition, since the recent U.S. Supreme Court

[109] See *Federal Rule of Civil Procedure 26(b)(3)* and *Hickman vs. Taylor*, 329 U.S. 495 (1947).

[110] See IRC 7525 for privilege related to federally authorized practioners (e.g., accountants).

[111] See 1.6012-2(a)(4) and (5) and *T.D. 9510* at 2011-6 I.R.B. 453. Also available at 2010 TNT 239-6 (Dec. 14, 2010).

case in *Mayo*[112] gives Chevron deference[113] to interpretative regulations that go through a notice and comment process[114], the IRS will likely argue that 1.6012- 2(a)(4) should be given such deference.

- **Judicial authority** - The IRS will likely cite the three cases that allowed the IRS access to a complete set of TAWs (i.e., not only a description of the issue, but also the amount of tax reserve for each issue) - see *Arthur Young*[115], *El Paso*[116],and *Textron*[117]. The following language in *Arthur Young* may be particularly helpful:

  "Our complex and comprehensive system of federal taxation, relying as it does upon self-assessment and reporting, demands that all taxpayers be forthright in the disclosure of relevant information to the taxing authorities. Without such disclosure, and the concomitant power of the Government to compel disclosure, our national tax burden would not be fairly and equitably distributed. In order to encourage effective tax investigations,

112 MAYO Foundation for Medical Education and Research vs. U.S., 131 S. Ct. 704 (Jan. 11, 2011).

113 Chevron deference means that if there is uncertainty in the statutory construction or legislative history, an administrative agency's regulation will be upheld as long as it results in a reasonable interpretation.

114 The Treasury regulation authorizing Schedule UTP (i.e., 1.6012-2(a)(4) and (5)) went through notice and comment.

115 465 U.S. 805 (1984)

116 682 F.2d 530 (5th Cir. 1982)

117 577 F.3d 21 (1st Cir. 2009)

> Congress has endowed the IRS with expansive information-gathering authority;"

- **Policy argument** – Building on the language in *Arthur Young*, the IRS would likely argue that in a self-assessment system, it is reasonable for the IRS to ask taxpayers to disclose an issue as long as the IRS is not asking for the taxpayer's detailed evaluation of the issue (i.e., a tax opinion or the reserve amount).

  The IRS would also then likely point to its policy of restraint in general, and specifically *Announcement 2010-76*[118] which generally makes it more difficult for the IRS to obtain otherwise privileged documents. They could go on to cite *Arthur Young* which states:

  > "Recognizing the intrusiveness of demands for the production of tax accrual workpapers, the IRS has demonstrated administrative sensitivity to the concerns expressed by the accounting profession by tightening its internal requirements for the issuance of such summonses."

5.5.2 Corporation arguments - Corporations will likely first argue that privilege/work product protections should trump the IRC and regulations. They will then argue that disclosure of only a concise explanation could violate privilege/work product protections because of the analysis that went into the determination that a reserve was required. Said differently, disclosure of the existence of a reserve is disclosing

118 2010-41 I.R.B. 432 (Sept. 24, 2010).

to the IRS that there was sufficient uncertainty surrounding a position that a reserve was needed.

If corporations are successful in planting some doubt in the judge's mind, they will then likely attempt to distinguish their facts from the above TAW cases likely to be cited by the IRS. For example, corporations could attempt to distinguish their facts from the *Arthur Young* case on the following grounds:

- IRS authority for Schedule UTP is IRCs 6001, 6011, and 6012 whereas the authority in *Arthur Young* is based on IRC 7602 (i.e., the IRS's summons authority).

    - When *Arthur Young* was decided by the U.S. Supreme Court in 1984, the IRS's policy of restraint only allowed the IRS access to TAWs in "unusual circumstances". Since Arthur Young, the IRS has changed its policy of restraint twice by expanding the fact patterns when TAWs will be requested. First, in *Announcement 2002-63*[119] that allowed the IRS to also obtain TAWs when a taxpayer has listed transactions[120]. And second, upon issuance of Schedule UTP which now allows the IRS to obtain a concise description of tax positions for all large, corporations.

- *Arthur Young* was a criminal case while Schedule UTP would apply to all large, corporations.

- *Arthur Young* was decided before Congress adopted the privilege in IRC 7525 for an authorized federal practioner.

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[119] *Announcement 2002-63*, 2002-2 C.B. 72 (July 2002)

[120] Listed transactions are defined in 1.6011-4(b)(2) and are transactions the IRS believes are very aggressive.

- In *Arthur Young* the TAWs were prepared by the external auditor, not the taxpayer.

In addition, corporations could cite the *Regions Financial*[121] case that was favorable to corporations. Other cases[122] that are favorable to corporations include Deloitte[123], Aldman[124], and Roxworthy[125].

5.5.3 Evaluation of arguments - In summary, there are arguments on both sides of the issue. If litigated, the key question a court will need to address is whether a concise description of a tax position is sufficient to violate privilege or work product protection. Clearly such disclosure is nowhere near as intrusive as requiring disclosure of the reserve amount or tax opinion related to the position. Nevertheless, some could argue the disclosure of the existence of a tax reserve for a particular tax position is either (i) disclosing the mental impressions of the corporation and their advisors (i.e., that there was enough uncertainty to record a reserve), or (ii) disclosing the results of discussions with outside counsel.

Given these conflicting arguments, the court will need to evaluate the arguments and weigh their respective pros and cons. In making such an evaluation, a court

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121 *Regions Fin. Corp. v. United States*, 2008 U.S. Dist. LEXIS 41940, No. 2:06-CV-00895-RDP (N.D. Ala. May 8, 2008)

122 However, these other cases deal with tax opinions, rather than just a description of the issue.

123 610 F.3d 129 (Fed. Cir. June 2010) decided after the IRS announced Schedule UTP

124 134 F. 3d 1194 (2nd Cir. 1998)

125 457 F.3d 590 (6th Cir. 2006)

will likely look at many factors, but ultimately this author believes they will need to determine whether it is reasonable for the IRS to require such disclosure in a self-assessment system. If the answer is "yes", then the IRS should win any future litigation. If the answer is "no", corporations should win. This author has stated in prior articles[126] that he believes the IRS holds the "high ground". Since the IRS is not asking for the corporation's reserve amount or tax opinions, Schedule UTP should be viewed as a reasonable exercise of the IRS's authority under IRCs 6001, 6011, and 6012.

5.5.4 Announcement 2010-76[127] and how the IRS could strengthen its litigating position - *Announcement 2010-76* was issued on September 24, 2010 concurrently with the final Schedule UTP. *Announcement 2010-76* states the following general rule:

> "If a document is otherwise privileged…and the document was provided to an independent auditor as part of an audit of the taxpayer's financial statements, the Service will not assert during an examination that privilege has been waived by such disclosure."

Initially the announcement seems very favorable. However, in addition to the general rule including some limitations (i.e., the document must be "otherwise

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126 See http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1683607 and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1679924

127 2010-41 I.R.B. 432 (Sept. 24, 2010)

privileged" and it is limited to an examination[128]), there also are two specific exceptions to this general rule.

- If the taxpayer has claimed the benefits of one or more listed transactions or because of unusual circumstances[129]
- The taxpayer has engaged in any activity or taken any action (other than disclosure to its independent auditor as part of the audit of the taxpayer's financial statements) that would waive privilege.

Thus, it would appear the IRS can still request documents in various circumstances.[130]

Section 3 of *Announcement 2010-76* also provides that if the IRS requests Tax Reconciliation Workpapers (TRWs)[131] during an examination, a taxpayer may redact among other things:

- The amount of any reserve related to a tax position reported on Schedule UTP.
- Other selected information surrounding the development of information provided on Schedule UTP.

[128] Thus, the benefits of *Announcement 2010-76* may not technically apply in Appeals or litigation. One hopes the IRS will exert pressure on both the IRS Appeals Division and the Department of Justice to also follow *Announcement 2010-76*.

[129] These are the same exceptions that apply to the IRS's policy of restraint for requesting TAWs - see IRM 4.10.20.3

[130] For example, if the IRS decided to list a transaction that was previously disclosed on Schedule UTP, or the IRS argued that a document was not otherwise privileged.

[131] Tax Reconciliation Workpapers are defined by the IRS in IRM 4.10.20.2

At first blush, this sounds very positive for corporations until one realizes that TRWs and TAWs are different.[132] The IRS routinely requests TRWs.[133] After careful reading, Section 3 of *Announcement 2010-76* seems to be making sure IRS agents do not circumvent the IRS's policy of restraint with respect to TAWs by obtaining sensitive information (e.g., tax reserves) through requests for TRWs that include information related to Schedule UTP. The bottom line is that an IRS agent can still attempt to obtain TAWs when (i) there are either listed transactions or there are unusual circumstances, or (ii) the IRS agent believes the document is not privileged.

After reading *Announcement 2010-76* many times, this commentator is left asking: What did it really accomplish? My conclusions are as follows:

- **Tax reserve information** - Prior to *Announcement 2010-76*, the IRS could obtain specific tax reserve information upon audit when there were either listed transactions or unusual circumstances. The announcement has not changed this conclusion. However, the announcement does prevent the IRS from obtaining such information through the back-door (i.e., by requesting TRWs).
- **Tax opinions** – This answer depends upon your starting point for the analysis. There are at least two variables.

[132] This author sheepishly admits it took him several readings before he focused on the TRW vs. TAW distinction.

[133] See IRM 4.10.20.3

- **Are most tax opinions protected under the work product doctrine?** **-** If one assumes that most tax opinions (i) are "prepared in anticipation of litigation", and (ii) the external auditor is not an "adverse party", then *Announcement 2010-76* does not seem to provide any relief. However, if one assumes tax opinions are not protected under the work product doctrine, then the relief provided in *Announcement 2010-76* is significant because it gives taxpayers an ability to avoid disclosing such tax opinions to the IRS. It is a safe assumption corporations and their tax advisors are likely in the first camp, while certain factions within the IRS are in the second camp.
- **Are tax opinions considered to be TAWs? -** If tax opinions are part of the TAWs[134], then prior to the announcement they could only be obtained if the taxpayer had listed transactions or unusual circumstances and this would not be changed by the announcement. If, however, tax opinions are <u>not</u> part of the TAWs (and they do not receive work product protection), then the announcement would significantly limit the IRS's ability to obtain them.

Where does this leave us? As indicated earlier, there seems to be no change with respect to the IRS's ability to obtain specific tax reserve information. As to tax opinions, it depends upon your starting point for the analysis. Most corporations and their advisors likely view *Announcement 2010-76* as moving the IRS

[134] Supra, note 39 for a discussion of the uncertainty surrounding whether TAWs are, or are not, part of TAWs.

substantially closer to where the case law may have been heading (e.g., *Deloitte*[135]) and are relieved they may not have to fight the IRS as frequently on access to tax opinions. On the other hand, some factions within the IRS may view *Announcement 2010-76* as a major concession by the IRS.

This commentator views *Announcement 2010-76* as a positive step forward by the IRS in recognizing that it is generally not appropriate for the IRS to pursue tax opinions and other sensitive information prepared by taxpayers. In some sense, one could view *Announcement 2010-76* as a partial acquiescence to *Deloitte*[136]. However, the IRS should have gone further.

Announcement 2010-76 should have provided that, except for criminal matters, the IRS can never get access[137] to tax opinions and tax reserve information for tax positions properly disclosed on Schedule UTP. There are several potential benefits from such an approach, including:

135 610 F.3d 129 (Fed. Cir. June 2010)

136 One of the three documents at issue in the *Deloitte* case was a tax opinion prepared by an outside advisor to Dow Chemical that was disclosed to Deloitte, Dow's external auditor, as part of a routine audit. The IRS conceded the tax opinion would have been privileged, but for its disclosure to Deloitte. The IRS then went on to argue work product protection should not apply because Deloitte was an "adversary" to Dow. *Announcement 2010-76* effectively prevents the IRS from making this argument.

137 This should include upon examination and appeals, and preferably litigation.

- It would be consistent with the IRS's statements that it only pursuing disclosure of tax issues, and not access to tax reserves or tax opinions;[138]
- The IRS would improve its litigating position surrounding Schedule UTP by effectively eliminating a corporation's ability to argue the IRS will get information on tax positions described on Schedule UTP and then declare the tax positions "listed transactions" in order to obtain tax opinion and/or tax reserve information;
- As drafted, the benefits of *Announcement 2010-76* can generally be obtained by any taxpayer. It is not conditioned on being a good citizen (e.g., complying with disclosure rules). Arguably this approach was too generous on the part of the IRS.[139]
- It would help address the lack of penalty surrounding Schedule UTP – see Section 5.6 below.

5.6 Penalties – Many have asked what penalties apply for failing to file, or adequately prepare, Schedule UTP? First, there is no specific penalty attached to the failure to file, or to adequately file, Schedule UTP. And second, theoretically a corporation could be subject to IRC 7203 penalties for willful failure to file a return or supply information, but as a practical matter, it is very difficult for the IRS to prove "willfulness".

138 See at Supra, note 7, Commissioner Shulman's January 26, 2010 speech stating "The proposal does not require the taxpayer to disclose the taxpayer's risk assessment or tax reserve amounts."

139 However, if one's frame of reference is that the IRS was inappropriately pursuing tax opinons, then the announcement is not too generous. Rather, the IRS would be considered to be adopting a more reasonable approach.

Ultimately the IRS is going to need an appropriate penalty for failure to either file, or adequately prepare, Schedule UTP. Although the IRS could pursue a specific monetary penalty with Congress, another option was described at the end of the immediately preceding section (i.e., Section 5.5.4). Specifically, the IRS should provide that, except for criminal matters, the IRS can never get access[140] to tax opinions and tax reserve information for tax positions properly disclosed on Schedule UTP. Thus, if a corporation adequately disclosed a tax position on Schedule UTP, it would be protected from the IRS obtaining either the tax reserve or tax opinions with respect to such tax position. This carrot and stick approach could be very effective in inducing corporations to adequately complete Schedule UTP.[141] In addition, it may also discourage corporations from eliminating tax reserves for tax positions so as to avoid disclosure on Schedule UTP.[142]

[140] This should include upon Examination, Appeals, and preferably litigation.

[141] If the proposal were adopted, I would expect substantially all corporations would decide to disclose tax positions in order to assure protection of the related tax reserves and tax positions.

[142] If corporations did not record a reserve for a tax position and therefore did not disclose the tax position on Schedule UTP, their tax opinions for such tax position would be at risk. Thus, they may want to disclose an issue on Schedule UTP to protect their tax opinion. Some might go on to argue this proposal would be an incentive for corporations to record a reserve for every little issue and therefore inundate the IRS with disclosures on Schedule UTP. Although this is possible, one doubts many corporations would take this approach because of the administrative burden of responding to IRS information document requests.

5.7 Definition of "reserve"[143] – The definition in the Schedule UTP instructions is somewhat circular. Specifically, it states:

> "A corporation or a related party records a reserve for a U.S. federal income tax position when a reserve for income tax, interest, or penalties with respect to that position is recorded in the audited financial statements of the corporation or a related party." [emphasis added]

Although the above definition does clarify that a reserve includes a reserve for tax, interest, or penalties, it does not define what is meant by a "reserve". Most accountants and some lawyers know generally what is meant by "recording a reserve", but like most everything in accounting, there are grey areas. For example, are the following reserves?

- Reduction of a deferred tax asset or increase in a deferred tax liability to reflect an uncertain tax position
- Reclassifying a deferred tax liability to a current liability
- Reducing a tax receivable claimed on a return to account for an uncertain tax position
- Recording of a liability (or reduction of an asset) in purchase accounting[144]
- Various footnote disclosures:

[143] For a more expansive definition of this topic, see J. Richard (Dick) Harvey, Jr., *Schedule UTP – Two Major Issues*, Tax Notes, March 28, 2011 and: http://ssrn.com/abstract=1782936

[144] When a business acquires another business, the acquirer needs to do "purchase accounting" (see FAS 141R) to accurately reflect the purchase on its balance sheet. Part of this process is evaluating whether the target's tax reserves are appropriate. If an entry is made to adjust the target's tax reserves, the offsetting adjustment is usually to goodwill, rather than expense.

- Inclusion in the footnote disclosure surrounding unrecognized tax benefits (e.g., FIN 48, paragraph 21)
- Reduction of an NOL or FTC carryforward in a corporation's footnote disclosure

If a corporation is attempting to avoid disclosure of a tax position on Schedule UTP, it may use the lack of definition to argue in certain cases that a reserve has not been recorded. For example, the text book accounting surrounding a FIN 48 tax reserve would generally include (i) the recording of an expense, (ii) the recording of a current liability, and (iii) inclusion in the footnote disclosure of UTBs. However, in practice, short-cuts are often taken or relatively unique situations arise.

For example, when a temporary difference is involved, a business may only accrue interest expense and decide not to make a reclassification from deferred tax liability to current tax liability. In addition, in purchase accounting, a business will record a reserve, but the offsetting entry is usually to goodwill, not expense. Without clarification, it is possible some corporations may argue that all of the text-book requirements for a reserve are required, as opposed to just one.

In addition, because of the uncertainty surrounding the definition of a reserve, in some cases corporations may feel compelled to disclose tax positions even though the IRS may not want disclosure at such time. For example, should disclosure be required for certain tax reserves included in deferred tax balances?[145] Specifically, does the IRS want disclosure only when the corporation has an uncertainty that could result in the payment of cash (or reduction of a refund) for a return already filed (or about to be filed). Or, does it want to get disclosure sooner (e.g., when an NOL carryforward is increased by an uncertain tax position, or more generally when a position is taken in a return that will not produce cash tax benefits until a later year)? In addition, does the IRS want to get disclosure more than once with respect to certain tax issues?[146]

Although the IRS has not defined reserve, some clue of what they may have been thinking can be found in Example 9 of the *Instructions for Schedule UTP*. This example assumes a corporation takes a position in its 2010 tax return that increases its NOL carryforward from $100 to $150. The $150 NOL carryforward is fully utilized in 2011. Given these facts, Example 9 assumes the corporation has a tax position for both 2010 and 2011, but that it only records a reserve with respect to its 2011 tax position. Thus, the example concludes the tax position needs to be disclosed in the 2011 Schedule UTP.

There are two interesting observations from Example 9. First, there are two tax positions (i.e., 2010 and 2011). The IRS could have conceivably viewed the 2011 tax position to

145 The type of tax reserves being discussed here relate to FIN 48 reserves, and not FAS 109 valuation allowance reserves.

146 For example, assume a corporation takes a questionable tax position in 2010 year that produces a deferred tax benefit for financial accounting purposes, but will not produce a cash tax benefit until 2015. Does the IRS want disclosure in 2010 only, 2015 only, or both 2010 and 2015?

be a continuation of the 2010 tax position, but they did not.[147] Second, the facts assume a reserve was only recorded in 2011, but not 2010. The unanswered question is: Why didn't the corporation in Example 9 record a reserve with respect to its 2010 NOL carryforward? Specifically, can one infer from the example that the IRS may have been thinking of reserves as amounts that only result in the payment of cash (or reduction of a refund) <u>for a return already filed</u>? The short answer is that it is not clear.

The reason is that if a corporation had a 2010 NOL carryforward of $150, it could have potentially recorded a deferred tax asset in its 2010 audited financial statements. If there was uncertainty surrounding the NOL carryforward, it may have recorded less of a deferred tax asset to reflect such uncertainty. Accountants would usually refer to this as a " tax reserve". Thus, should one interpret Example 9 to mean the IRS does <u>not</u> consider the reduction of a deferred tax asset to be a "reserve" for purposes of Schedule UTP? Since there are other possible explanations for why the corporation did not record a reserve in 2010[148], unfortunately one cannot draw a definitive conclusion.

Nevertheless, one thing is clear. The IRS needs to clarify the definition of "reserve" to address this issue. In order to simplify the disclosure, the IRS could consider defining

147 One could speculate as to the reason, but it could have been a concern that the definition of reserve was not clear and the IRS was concerned that if concluded there was only a tax position in 2010 and a corporation viewed itself as recording a reserve in 2011, the IRS may be stuck with no disclosure.

148 For example, the corporation may not have thought the tax position was uncertain, or alternatively, the corporation may not have been able to project sufficient future taxable income to justify a deferred tax asset.

reserves by reference to liabilities (or reductions in assets) that relate to the payment of cash (or reduction of a refund) with respect to the tax, interest, or penalties for returns that are already filed (or about to be filed). This "cash" approach would effectively delay disclosure on Schedule UTP until such time as a tax return is filed, and there is some cash at stake. It would not require disclosure when a reserve is recorded in deferred tax balances or there is no cash at stake for a return that has already been filed.[149]

In addition to better defining "reserve", the IRS could consider narrowing the definition of a "tax position" so that it is defined by reference to a potential change in the tax liability for a year, rather than a potential change in a line item. The one problem with both of the above "cash" approaches is that the IRS may want disclosure of uncertain tax positions sooner in order to provide guidance to both taxpayers and its agents. If so, the IRS could keep the broad definition of tax positions and define reserves broadly to include reserves embedded in deferred tax balances.

5.8 Compliance assurance process (CAP) – Many commentators requested the IRS not require Schedule UTP for those taxpayers in CAP since such taxpayers are already required to make significant disclosures to the IRS. At first blush, this request seems reasonable. However, the IRS has not yet agreed. Instead, the IRS has indicated it would

149 For example, an NOL carryforward with imbedded uncertain tax positions. However, if a corporation did not do text book accounting and attempted to hide a current reserve in a deferred tax balance, this definition should require disclosure because there would be a liability related to a previously filed return where cash is at stake.

be making the CAP program permanent and that it will be expanded to three phases.[150] Although to the best of this commentator's knowledge, the IRS has not articulated its specific reasons, they could be the following:

- A careful reading of the typical CAP disclosure requirement could result in a slightly different disclosure under CAP vs. Schedule UTP. For example, the standard memorandum of understanding (MOU) generally requires that during the course of the audit, taxpayers need to disclose facts surrounding transactions with tax reserves. However, there is no need for the taxpayer to specifically state it has recorded a reserve for a particular tax position. Thus, disclosures made during a CAP audit may be somewhat less informative that those on Schedule UTP.
- If the disclosure requirements in the CAP MOU and Schedule UTP are really identical, then corporations should not be objecting to completing Schedule UTP since presumably all issues should have been disclosed to the IRS under CAP.[151]

Another issue surrounding CAP is whether the IRS has the capacity to handle all the corporations that may now decide they want to participate in CAP.[152] There at least two reasons why corporations may want to join CAP. First, they may want the general benefit of settling years more quickly. These benefits include less financial statement

[150] See *Announcement 2010-75*, 2010-41 I.R.B. 428 (September 24, 2010). The three phases are pre-CAP, CAP, and CAP maintenance.

[151] It is possible corporations are just trying to avoid duplicate disclosure, but it is also possible that some corporations disclose less information in CAP than would be required by Schedule UTP.

[152] See Jeremiah Coder, *The Future of the CAP Program*, 2010 TNT 55-3 (March 23, 2010).

reserves and less difficulty managing the location of information from prior tax returns[153].

Second, large, complicated corporations often do not become aware of tax positions until years after the position was taken on a return.[154] Additionally, corporations may initially be very confident of a tax position, but as time passes and either the IRS issues guidance or court cases are decided, the confidence level may decrease.[155] Regardless of the reason, corporations often need to record tax reserves for these newly found tax positions in their audited financial statements. If a corporation is not in CAP, they clearly will need to disclose such a tax position in Part II of Schedule UTP. If a corporation is in CAP, there is a possibility the year could be settled with the IRS before the corporation discovers the issue.[156]

153 Through the passage of time, or acquisitions and mergers, it is often very difficult for taxpayers to obtain information requested by the IRS during audit. If audits could be completed quicker, this problem would be greatly reduced.

154 Most corporations make adjustments to pre-tax income to determine taxable income. If a corporate tax department does not have a thorough understanding of how pre-tax income was calculated when it files its tax return, it is likely to have uncertain tax positions that will be discovered over time as it better understands the components of pre-tax income.

155 A prime example of this was corporation's confidence level when they first entered into LILO/SILO transactions. Based upon "will" opinions from reputable outside counsel, substantially all LILO/SILO investors recorded no reserves. However, as the IRS started to question the transactions and corporations started losing in court, reserves were then recorded.

156 Because of this second possibility, assuming the IRS does not already do so, the IRS should consider requiring CAP taxpayers to disclose uncertain tax positions they become aware of subsequent to the

In summary, the IRS is in the process of expanding and making the CAP program permanent. In this process, the IRS should revisit the CAP disclosure requirements and evaluate whether there are some disclosure loopholes corporations may be exploiting when compared to the disclosure required in Schedule UTP. If the IRS is ultimately satisfied with the CAP disclosure requirements, it may be possible to eliminate the Schedule UTP filing requirement for CAP taxpayers.

5.9 Extension of Schedule UTP to more taxpayers - When Commissioner Shulman first announced the corporate transparency proposal in January 2010, it was not clear what taxpayers would be covered. As the project progressed there was a decision made to initially limit the proposal to certain types of large corporations.[157] Thus, pass-through entities and tax-exempt organizations are not currently required to file Schedule UTP. One could speculate as to the reasons, but two that come to mind are:

- **FIN 48 generally requires a reserve to be recorded in the entity with the potential tax liability** - Since flow-through entities and tax-exempt entities do not usually pay tax, tax reserves would generally not be recorded for such entities.[158] In

settlement of an audit. However, there may be a practical issue in defining such tax positions because the taxpayer may not record reserves in its audited financial statements for such positions (i.e., they may be considered "effectively settled" under FIN 48).

157 See Section 4.1 for the entities initially subject to Schedule UTP.

158 It should be noted that tax-exempt entities can have unrelated business income, and as a result, have tax reserves. In addition, there can be qualification and other tax issues for both tax-exempt entities and flow-through entities.

the case of a "true" flow-through entity (e.g., partnership and certain trusts), the owners of such entity would record most reserves. If the IRS wanted a true flow-through entity to disclose UTPs that ultimately impacted the owner's tax liability, it would have had to further deviate from FIN 48 by requiring some sort of hypothetical reserve calculation.[159]

- **IRS wanted to see how Sch. UTP worked for corporations before extending it to flow-through entities –** In addition, getting the IRS systems reprogrammed to handle Schedule UTP was a big job for corporations without also adding flow-through entities and tax-exempt corporations.

Given comments in *Announcement 2010-75* that the IRS may extend Schedule UTP to flow-through and tax-exempt entities in 2011, or later years, it is clear this issue is far from resolved. If the IRS does eventually extend Schedule UTP to such entities, it should continue to piggy-back on financial accounting. This will be easier to do for tax-exempt entities, especially those with unrelated business tax income. In the case of flow-through entities, one needs to distinguish between true flow-throughs (e.g., partnerships and certain trusts) and synthetic flow-through entities (e.g., RICs and REITS).

For synthetic flow-throughs, it should be easier to piggy-back on FIN 48 because the ultimate tax liability should be at the flow-through level and therefore if there are uncertain tax positions, reserves should be recorded on the entity's audited financial statements. However, for true flow-throughs, reserves should generally not be recorded

[159] The IRS would have needed to require the flow-through entity to perform a FIN 48 analysis for tax purposes even though it is not required for financial accounting purposes.

because the owner of the entity will report the activity of the flow-through on its own tax return.[160] If FIN 48 is revised in the future so that real flow-through entities need to disclose potential tax exposures that ultimately will be borne by the owners, then extending Schedule UTP to such entities would be more practicable.

5.10 Pre 2010 carryforward utilized in 2010 or later year[161] – One of the major effective date questions being asked is whether the Schedule UTP transition rule applies to a pre 2010 tax position that increased a pre 2010 NOL carryforward that is ultimately utilized in 2010 or a later year? This is a major issue for corporations (e.g., financial institutions) that had large NOLs during the recession that will be carried forward into 2010 and later years. The technical issue ultimately depends on (i) the definition of a "tax position", (ii) whether a "reserve is recorded with respect to such tax position, and (iii) how the transition rule is interpreted. Below is my analysis of these issues.

The corporation has a tax position in 2009, but such tax position is clearly grandfathered and therefore no disclosure is necessary. The corporation also has a tax position in 2010[162] unless the transition rule provides relief. Given there are two distinct tax positions (i.e., 2009 and 2010) and given there is nothing in the transition rule that deems the 2010

160 There could be situations where a real flow-through would record a reserve (e.g., qualification issues).

161 For additional discussion of this topic, see J. Richard Harvey, Jr., *Schedule UTP – Two Major Issues*, Tax Notes, March 28, 2011 and http://ssrn.com/abstract=1782936

162 If the utilization of the 2009 NOL carryforward is disallowed in 2010 it will result in multiple line items on the 2010 tax return changing (e.g., taxable income and tax liability). In addition, the logic of Example 9 makes clear there should be a 2010 tax position.

tax position to be a continuation of the 2009 tax position, it seems clear to this commentator that the transition rule as currently drafted only provides relief for the 2009 tax position, and not the 2010 tax position.

The analysis then turns to whether a "reserve" is recorded with respect to the 2010 tax position. Given currently there is no clear definition of "reserve", there is some uncertainty in reaching a conclusion. Nevertheless, given there is cash tax exposure in the 2010 tax return, it would seem a reserve would eventually be recorded with respect to the 2010 tax position. The only argument to the contrary would be if a corporation could somehow argue that <u>any</u> reserve recorded is with respect to the 2009 tax position, and not the 2010 tax position.[163] This would seem to be a significant stretch because there would a cash tax exposure directly related to the 2010 tax position, but it further supports the need for clarification surrounding the definition of "reserve".

From a policy perspective, the IRS could decide the 2010 tax position is just a continuation of the 2009 tax position and therefore should be grandfathered.
It will be interesting to see where the IRS lands on this policy issue.

5.11 Should Schedule M-3 be modified or eliminated? - As described in Section 3.1, Schedule M-3 was adopted with much fanfare in 2004. It requires reconciliation between worldwide pre-tax income for financial accounting purposes with taxable income as reported on the US tax return. In *Announcement 2010-75*, the IRS announced it would be

[163] Possibly the IRS's reason for leaving Example 9 in the instructions somewhat ambiguous

creating a working group to study and revise Schedule M-3 to reduce duplicate reporting. The IRS also stated "the implementation of Schedule UTP is likely to reduce the need for some of the information currently reported on Schedule M-3". Some commentators have suggested to the IRS that, given the issuance of Schedule UTP, Schedule M-3 should be eliminated.[164]

This commentator believes Schedule M-3 should be modified, but not eliminated. The only scenario that would support total elimination is if for some reason the IRS decided to rely exclusively on Schedule UTP for auditing corporations with $10 million or more of assets. Given several of the techniques described in Section 5.3 for avoiding disclosure on Schedule UTP, relying exclusively on Schedule UTP would be a serious mistake. Thus, it seems clear the IRS needs Schedule M-3 as a tool to help satisfy itself it has identified all material tax issues. As summarized in Footnote 13, the two most important components of Schedule M-3 are (i) the reconciliation between worldwide financial accounting income and taxable income, and (ii) the identification of permanent and timing differences. These components of Schedule M-3 should be retained. What could be modified is that Part II and Part III of Schedule M-3 combined have approximately 70 line items to categorize various income and deduction amounts. Are all of these line items really necessary? One suspects not. In addition, when filing a consolidated return, is it really necessary for supporting schedules to be filed for all includable corporations?[165]

[164] See Tax Executives Institute comments on Schedule UTP at 2010 TNT 104-67 (June 1, 2010)

[165] See http://www.irs.gov/instructions/i1120lm3/ch02.html#d0e550 for the specific instructions to Part II and III of Schedule M-3 that state that for consolidated returns, supporting schedules should be filed for all includable corporations.

5.12 International Financial Reporting Standards (IFRS) – Most of the world uses IFRS to prepare its audited financial statements. As of the date of this article[166], there has been significant discussion about the US potentially switching or converging to IFRS in the future. Whether this will ultimately occur is far from certain.

Currently US GAAP (i.e., FIN 48) has relatively detailed rules[167] surrounding the recording of income tax reserves, whereas IFRS does not. In many ways, the accounting for tax reserves under IFRS is at a similar place as US GAAP was before the issuance of FIN 48. Thus, businesses using IFRS have significant flexibility in their ability to choose a unit of account for analyzing tax positions. For example, some businesses record tax reserves by individual technical issue, whereas others might record reserves based upon an entire taxable year, or even an audit cycle.

The IRS was aware of this "unit of account" issue when it issued Schedule UTP. As a result, the current instructions to Schedule UTP provide special rules when the audited financial statements are prepared on a unit of account based upon the entire taxable year[168]. The special rules provide that a corporation must instead identify a unit of

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[166] March 1, 2011.

[167] The FASB would prefer to call them "principles" or implementation guidance, rather than "rules".

[168] The IRS should consider changing the wording of its instructions to provide that if the unit of account is not based on a specific tax issue, the special rules are applicable. As currently drafted, a non-US GAAP corporation could have a unit of account by audit cycle and the special rule could be read to be inapplicable.

account "based upon on principles that result in apprising the IRS of the identity and nature of the issue".

It is my hope that eventually IFRS will require businesses to analyze tax positions on an issue by issue basis. However, until that time corporations using IFRS in their audited financial statements will need to wrestle with the language in the Schedule UTP instructions. Those instructions are the one area where Schedule UTP does not directly piggy-back onto the audited financial statements.

Finally, as currently designed, Schedule UTP requires corporations to analyze tax positions in their audited financial statements on a tax position by tax position basis. This design is crucial to the success of Schedule UTP. If the US ultimately adopts or converges to IFRS, and there continues to be flexibility within IFRS to use a unit of account that is not based upon an individual tax issue, the IRS will need to seriously rethink Schedule UTP.

5.13 How will the IRS audit Schedule UTP? - Although there has been lots of discussion and concern surrounding how the IRS will use Schedule UTP[169], there has been very little discussion on how the IRS will make sure the Schedule UTPs it receives are accurate. As discussed in Section 5.11, continued use of Schedule M-3 may be part of the solution However, my suspicion is that unless the IRS becomes aware of a taxpayer blatantly

[169] See Section 5.2 of this article.

failing to include tax positions on Schedule UTP[170], corporations will more or less be on the honor system for some period of time.

Eventually the IRS will need to figure out how to determine whether all appropriate uncertain tax positions are disclosed on Schedule UTP. Given that Schedule UTP ties into the audited financial statements, one obvious possibility is to have the external auditor attest to the accuracy of Schedule UTP. To say such a proposal would be unpopular with both corporations and the external auditing profession would be an understatement. Nevertheless, unless someone can develop an alternative idea, the IRS should consider pursuing it in the future.

5.14 Will additional guidance be the magic bullet? - Since the announcement of Schedule UTP, it has been have suggested the IRS should issue substantially more guidance so as to minimize the number of uncertain tax positions that need to be disclosed on Schedule UTP. In response to these suggestions, the Chief Counsel's Office has stated publicly they are aware of the increased need for guidance, but have stated that in order to issue more timely guidance; practioners will need to be more open to "pretty good guidance" (i.e., leaving some questions unanswered).[171]

[170] For example, through the whistleblower program authorized by IRC 7623(b)

[171] Crystal Tandon, *Wilkins Says Chief Counsel Focusing on UTP, Economic Substance*, 130 Tax Notes 510 (Jan. 31, 2011) and 2011 TNT 17-9.

Although the issuance of more timely guidance from the IRS Chief Counsel's Office would be a very welcome development, this commentator has serious reservations that sufficient guidance can be issued to greatly reduce the number of uncertain tax positions. Even if the amount of issued guidance was doubled (which is extremely doubtful), the cold, hard truth is there a substantial industry of professionals (tax lawyers and accountants, and investment bankers) whose primary job is to identify uncertainties in the tax law and exploit them. This is further complicated by the complex nature of today's large corporation, many of which operate in countries around the world.

Thus, unless (i) tax professionals stop attempting to exploit uncertainties in the tax law or (ii) Congress and the Administration somehow greatly simplify our corporate income tax law (e.g., eliminate it), the IRS will need Schedule UTP or some substitute to efficiently and effectively audit large corporations.

6 Summary – This article has attempted to summarize, from a former government official's perspective, the background that led to Schedule UTP, its key concepts, and the major issues. Although much has been written about Schedule UTP, and there is likely much more to be written, one thing is certain: It already has been a big deal. Corporate tax executives, their advisors, government officials, and even some academics, have devoted significant energy developing, understanding, and criticizing Schedule UTP.

Now that the first chapter of the story is relatively complete[172], the 2nd chapter needs to be written. Specifically, large corporations and their advisors will turn their attention to completing the 2010 Schedule UTP. Although Schedule UTP is based upon decisions a corporation makes while preparing its 2010 audited financial statements, there will undoubtedly be significant time spent preparing the 2010 Schedule UTP - especially in drafting the concise description.[173]

Once large corporations start filing Schedule UTP, or possibly earlier for CAP taxpayers, the IRS will start writing the 3rd chapter with the main topics including: (i) how best to use the information provided on Schedule UTP, and (ii) how to make sure field agents use the information properly. The IRS will surely have growing pains as it wrestles with the practical realities of sifting through thousands of Schedule UTPs and attempting to control thousands of agents.

A 4th chapter could be written if Schedule UTP is challenged on the grounds it violates privilege (attorney-client or accountant-client), the work product doctrine, or both. If this chapter is to be written, it likely will start with some corporations filing 2010 Schedule UTPs with a statement that information is being withheld because disclosure could violate privilege and/or work product protections. Such a chapter could take a long-time to

172 One outstanding item is that as of March 1, 2011 (the date of this article), the corporate tax community is still awaiting potential IRS FAQs surrounding Schedule UTP. Among the issues that could be addressed include (i) the definition of a reserve (Section 5.7) and (ii) pre-2010 NOL carryforward being utilized in 2010 or later years (Section 5.10).

173 On a per word basis, the few sentences providing a concise description may be the most expense in the history of many corporate tax departments.

complete, but as summarized in Section 5.5, the IRS should ultimately prevail – if challenged.

In conclusion, Schedule UTP has the potential to substantially increase transparency on large, corporate income tax returns, and increase the IRS's efficiency and effectiveness while performing audits. However, if corporations don't perceive there to be a meaningful incentive[174] to accurately complete Schedule UTP, the IRS could face huge problems in obtaining the information it really needs to make Schedule UTP a success. Thus, I urge the IRS to seriously consider implementing a carrot and stick approach as described in Sections 5.5.4 and 5.6 of this article.

In addition, the IRS needs to clarify many of the uncertainties discussed in this article, and minimize opportunities for corporations to avoid disclosure. The most significant would seem to be: (i) the definition of a "reserve" (Section 5.7), (ii) whether an uncertain tax position imbedded in a pre-2010 NOL carryforward will ultimately need to be disclosed in Schedule UTP (Section 5.10)[175], (iii) methods corporations may use to avoid disclosure (Section 5.3) and (iv) whether the IRS should require external auditors to attest to the information a corporation files on schedule UTP (Section 5.13).

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174 Or penalty for failing to accurately complete the schedule

175 As Schedule UTP is currently drafted, it seems pretty clear corporations will need to disclose the utilization of an uncertain pre-2010 NOL carryforward in 2010 and later years (see Section 5.10). Thus the real issue is whether the IRS should make a policy decision to reach a different conclusion, and regardless, inform the public of its conclusion.

Finally, although the IRS needs to spend significant effort providing more guidance in general, they should not believe it is the magic bullet for making a meaningful reduction in the number of uncertain tax positions (Section 5.14). Given the complexity of the typical modern corporation, a meaningful reduction in uncertain corporate income tax positions is likely to only result from a total elimination of the corporate income tax.