

TAX LITIGATION ISSUES

Expert Analysis

Schedule UTP: Greater Transparency Or Undermining Privilege?

As corporate taxpayers use increasingly complicated transactions to minimize their tax liabilities, the Internal Revenue Service has a harder time identifying, understanding and investigating transactions that might warrant audit adjustments. Indeed, Commissioner Douglas Shulman recently reported that IRS examiners expend a quarter of the time spent on corporate audits trying to identify “uncertain tax positions” taken by the corporation.¹

In an effort to increase transparency, the IRS recently released Schedule UTP, through which certain business taxpayers will be required to report uncertain tax positions with their tax returns. While the introduction of Schedule UTP is likely to reduce the chance that dubious transactions will go unexamined, it remains to be seen how auditors will use the increased information available to them.

Background

Since Dec. 15, 2006, Financial Accounting Standards Board Interpretation No. 48 (FIN 48) has required corporations to identify and quantify uncertain tax positions for financial reporting purposes.² While the fact that a corporation reserves for a potential audit adjustment does not mean that its tax position is flawed or that the IRS would succeed in challenging the corporation's position, the potential for additional tax revenues through the disallowance of uncertain tax positions is substantial.³ Although the nation's top companies paid \$138 billion in corporate taxes in 2009, they reported more than \$200 billion in uncertain tax positions.⁴

Of course, “[t]he information developed in the course of complying with FIN 48...is highly relevant

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to understanding the taxpayer's tax positions and assessing how those positions affect the taxpayer's tax liability,” and access to that information can be useful to the IRS in focusing its examination resources and more quickly identifying issues.⁵ Because the information set forth in financial statements usually is not sufficiently detailed to assist the IRS in an audit, in January 2010, the IRS announced it was developing a schedule

Through Schedule UTP, certain business taxpayers will be required to report uncertain tax positions with their tax returns.

that would require the reporting of uncertain tax positions with the filing of tax returns “in order to improve tax compliance and administration.” On Sept. 24, 2010, after a period of public comment on a draft schedule, the IRS issued the final Schedule UTP and accompanying instructions and guidance.

Schedule UTP Requirements

Schedule UTP requires corporate taxpayers to disclose information about their uncertain tax positions, which include any positions for which reserves have been taken and documented pursuant to FIN 48 as well as those tax positions for which no reserves are reflected because the taxpayer expects to litigate the position and has determined that it is more likely than not to prevail on the merits. Taxpayers are required to rank all of

the reported tax positions based on their recorded reserves. In addition, taxpayers must specifically identify those tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all reported tax positions.⁶

While the draft Schedule UTP would have required taxpayers to provide the rationale or reasons for each uncertain tax position, final Schedule UTP replaces that provision with a requirement that taxpayers describe 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.”⁷ IRS Chief Counsel William Wilkins has indicated that removing the requirement that taxpayers explain the rationale for their tax positions is intended to make clear that Schedule UTP is not meant to enable the IRS to piggyback on the taxpayer's work.⁸

The Schedule UTP filing requirement will be phased in over five years, applying only to companies with assets of more than \$100 million in tax year 2010 and expanding to include those companies with assets of at least \$10 million by 2014. The IRS has not identified what penalty it will seek for the failure to comply with Schedule UTP. Rather, the IRS intends to “wait-and-see” how the schedule is completed by corporate taxpayers and to respond accordingly. Some commentators have suggested that the penalty rubric set forth in §6651 of the Internal Revenue Code should be applied to any failure to file Schedule UTP.⁹

Attorney-Client Privilege

A number of comments to the draft Schedule UTP reflected concerns that the required disclosures “would require taxpayers to identify information that inherently is based on the advice of counsel and tax preparers and to share the mental impressions of their legal and tax advisers.”¹⁰ This concern was genuine. As documented in this column,¹¹ the IRS previously has summoned the tax accrual work papers of corporate taxpayers. The privileged nature of

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those work papers has been the subject of much debate, highlighted by the en banc decision of the U.S. Court of Appeals for the First Circuit in *United States v. Textron Inc.*,¹² which rejected a claim that the corporation's tax accrual work papers were protected by the attorney work product doctrine, and a recent decision by the D.C. Circuit in *United States v. Deloitte*,¹³ which reached the opposite conclusion.

In response to concerns that Schedule UTP would lead to further attempts to compel the production of privileged information, the IRS released Announcement 2010-76 at the same time as final Schedule UTP. That Announcement declared an expansion of the IRS's existing "policy of restraint" in seeking the production of taxpayer work papers to encompass documents and information related to Schedule UTP.

Under the current "policy of restraint,"¹⁴ IRS auditors will not seek tax accrual work papers unless (a) the item under examination is a "listed transaction," i.e., one that the IRS has included in a published list of "tax avoidance transactions,"¹⁵ or (b) "unusual circumstances" apply. Unusual circumstances are deemed to exist only where the examiner has identified a specific issue for which there exists a need for additional facts, has sought from the taxpayer and additional third parties all the facts known to them relating to the issue, and has performed a supplementary analysis of the facts and a reconciliation of the taxpayer's return.¹⁶

Taxpayers from whom tax accrual work papers are sought frequently will object that the documents are privileged and not subject to production. It remains to be seen how Schedule UTP and the IRS's related pronouncements will affect litigation over privilege issues. Historically, the IRS has argued both that the documents are not privileged because they were not prepared in anticipation of litigation and that the taxpayer waived any privilege by providing the work papers to its independent outside auditor.¹⁷

Announcement 2010-76 appears to take the latter issue off the table, providing that where a document is otherwise protected under the attorney-client privilege, tax practitioner's privilege, or work product doctrine, the IRS will not assert that the privilege has been waived by virtue of disclosure to the independent auditor. The IRS's concession that providing documents to auditors does not constitute a waiver follows the D.C. Circuit's rejection of its argument in *Deloitte*, and thus is not as significant as appears at first blush.

Finally, unlike audit or tax accrual work papers, the IRS routinely seeks tax reconciliation work papers "used in assembling and compiling financial data preparatory to placement on a tax return"¹⁸ at the beginning of an examination. Pursuant to

the new policy set forth in Announcement 2010-76, taxpayers are now entitled to redact certain information, including drafts of the concise description of uncertain tax positions, the amount of reserves related to such positions, and computations regarding the ranking of positions, from tax reconciliation work papers used in conjunction with the preparation of Schedule UTP.¹⁹

IRS Directive

As the Supreme Court held 75 years ago, a taxpayer has a right to arrange its affairs to pay the least amount in taxes.²⁰ The mere fact that a tax position is uncertain does not mean that the taxpayer does not have a factual or legal basis for the position, and in response to "anxiety about how IRS agents would use the [reported] information...during examinations," the IRS issued a directive with the final Schedule UTP outlining the agency's policy on use of information set forth in the Schedule UTP.²¹ The directive urges an "equitable and balanced examination program" and requires that examiners impartially approach each examination, engaging taxpayers early in the process to "eliminate uncertainty."

Conclusion

Together with Announcement 2010-76 and its directive, the IRS has sought to reassure taxpayers and their professional tax advisors that Schedule UTP will not be used to undermine legitimate privilege positions or simply to disallow all positions identified as uncertain. While greater transparency will limit corporate taxpayers' ability to avoid examination of dubious tax positions, it remains to be seen whether revenue agents conducting complex corporate audits will abide by the directive that not every position identified on Schedule UTP will warrant an adjustment and that Schedule UTP is not a shortcut for the detailed factual and legal analysis required in auditing complicated transactions.



1. Associated Press, "IRS Scales Back Rule on Disclosing Lffy Tax Breaks," New York Times (Sept. 24, 2010).

2. See IRS Announcement 2010-9 at p. 2.

3. The tax gap, defined as the difference between the amount of taxes that should be paid and the amount paid voluntarily and on time, was estimated at approximately \$345 billion for tax year 2001, the most recent estimate. Department of Treasury, "Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance" (July 8, 2009) at p. 2.

4. David Kocieniewski, "IRS Plan to Uncover Companies' Tax Strategies," New York Times (Aug. 24, 2010).

5. IRS Announcement 2010-9 at p. 3.

6. IRS Announcement 2010-75 at pp. 6-7. The taxpayer can assign any rank to those uncertain tax positions for which no

reserve has been set aside.

7. Id. at p. 7.

8. "IRS Will Not Seek Privileged Documents Disclosed to Auditors, Chief Counsel Says," 79 USLW 1484 (BNA Oct. 19, 2010).

9. Letter from Carl Levin, Chairman, Permanent Subcommittee on Investigations to Douglas Shulman, Re: Announcements 2010-9, 2010-17, and 2010-30 Related to Reporting Uncertain Tax Positions (May 21, 2010) at pp. 3-4.

10. Letter from Thomas M. Susman, Director of the American Bar Association Governmental Affairs Office, to the Internal Revenue Service, Re: IRS Proposals Requiring Disclosure of Uncertain Tax Positions (May 28, 2010) at p. 2.

11. John J. Tighe, Jr. and Jeremy H. Temkin, "The IRS Still Wants Your Company's Workpapers," New York Law Journal (March 12, 2009); Jeremy H. Temkin, "The Next Chapter in 'Textron' Over Protection for Work Papers," NYLJ (Sept. 17, 2009).

12. 577 F.3d 21 (1st Cir.), cert. denied, 130 S. Ct. 3320 (2010).

13. 610 F.3d 129 (D.C. Cir. 2010) (holding that corporate documents prepared during an annual audit can warrant work product protection and that the corporation did not waive this protection by producing the documents to an outside auditor). See also *United States v. Adlman*, 134 F.3d 1194, 98-99 (2d Cir. 1998) (memorandum prepared by company's attorneys estimating likelihood of success in litigation for purposes of justifying reserves was entitled to work product protection even if prepared primarily to assist in making a business decision).

14. Although the Internal Revenue Manual (IRM) sets forth IRS policies, it generally is not binding on the IRS. Michael I. Saltzman, IRS Practice and Procedure ¶3.01 (updated through 2010).

15. 26 CFR §1.6011-4(b)(2). A current compilation of listed transactions is available at <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>. With respect to tax accrual work papers created in connection with a listed transaction, the IRS employs a modified "policy of restraint," seeking work papers pertaining only to the transaction in question or for the entire year under examination depending upon whether the taxpayer properly disclosed the listed transaction on its return. See IRM 4.10.20.3.2.3 (Jan. 15, 2005).

16. IRM 4.10.20.3.1 (July 12, 2004).

17. See *Deloitte*, 610 F.3d at 136, 140; *United States v. Textron Inc.*, 577 F.3d at 27; *United States v. Textron*, 507 F.Supp.2d 138, 153 (D.R.I. 2007).

18. IRM 4.10.20.2 (July 12, 2004).

19. Announcement 2010-76 at pp. 2-3.

20. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

21. Prepared Remarks of IRS Commissioner Shulman to the ABA (Sept. 24, 2010).