

Practice

By Kathryn Keneally and Charles P. Rettig

Final Uncertain Tax Positions Filing Requirements: IRS Addresses Key Concerns

At the beginning of this year, the IRS announced an intention to require certain business to report their uncertain tax positions.¹ The initial announcement was followed by a series of further announcements and public statements by IRS representatives. In April, the IRS issued a proposed new schedule, denoted Schedule UTP, in draft form. Both the initial announcement and the draft Schedule UTP and related instructions met with extensive comments from taxpayers and practitioners.

The IRS made clear that it expected Schedule UTP to be filed with tax returns filed for calendar year 2010 and for fiscal years that begin in 2010.² Thus the IRS needed to, and did, move quickly to address the comments that it received and to finalize the filing requirements.

On September 24, 2010, in a speech before the American Bar Association Section of Taxation, IRS Commissioner Douglas Shulman announced the release of the final Schedule UTP and instructions.³ Significantly, the release of the new Schedule UTP was accompanied by a directive to the field, and what the Commissioner described as “important modifications to the policy of restraint.” Taken together, these documents reflect careful consideration of many concerns raised by practitioners in connection with issues relating to the attorney-client privilege and work product doctrine, as well as concerns regarding how the information obtained through Schedule UTP may be used in IRS examinations.⁴



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A Phase-in for Taxpayers Required to File Schedule UTP

Corporations with total assets of at least \$10 million, and that issue audited financial statements or that have tax positions for which a related party records a

reserve in an audited financial statement, will eventually be required to complete Schedule UTP.⁵ The IRS solicited and received comments concerning whether there should be transition rules or other limitations to the class of taxpayers to be included in the filing requirements.

In Announcement 2010-75, the IRS set out a five-year phase-in of the Schedule UTP filing requirement. Corporations meeting the other filing criteria with assets equal to or exceeding \$100 million are subject to immediate filing requirements; the threshold will be reduced to \$50 million for tax year 2012 and to \$10 million for tax year 2014.

The IRS noted that many commentators suggested that taxpayers in the Compliance Assurance Program (CAP) and taxpayers under continuous audit (CIC taxpayers) be excluded from the reporting requirements.⁶ The final Schedule UTP instructions contain no such exclusion, but Announcement 2010-75 stated that further guidance concerning Schedule UTP compliance by CAP taxpayers will be forthcoming.

Significant Changes from the Draft to the Final UTP Schedule

The final instructions for the new Schedule UTP require the reporting of tax positions for which “[e]ither the corporation or a related party has recorded a reserve with respect to that tax position for U.S. federal income tax in audited financial statements, or the corporation or related party did not record a reserve for that position because the corporation expects to litigate the position.”

The IRS responded to comments that raised concerns regarding specific provisions of the draft UTP Schedule. First, the draft UTP Schedule had included a proposed requirement that taxpayers set out a “maximum tax adjustment” for each uncertain tax position listed on the schedule. This proposed requirement was criticized by many commentators for a number of reasons, including burdensomeness and the risk that the stated figures, while not necessarily reflecting the realistic amount in dispute, could distort the examination process. In response, the IRS eliminated the requirement. Instead, the final Schedule UTP requires taxpayers to rank all reported tax positions based on the amount of the U.S. federal income tax reserve recorded for that position, and to designate those tax positions for which the reserve exceeds 10 percent of the aggregate of reserves for all tax positions reported on Schedule UTP. Announce-

ment 2010-75 summarized that this requirement is intended to allow the IRS to evaluate the materiality of the items reported on Schedule UTP, stating: “This method relies on the reserve computations that corporations perform for audited financial statement purposes, but does not require disclosure of the actual amounts of the tax reserves.”⁷

In the draft Schedule UTP and instructions, the IRS would have required taxpayers to report tax positions for which no reserve was recorded because the corporation had determined that it was the IRS’s administrative practice not to raise the issue during examination. Many commentators objected to the inclusion of these positions, noting that corporations would be required to undertake an analysis far beyond financial reporting requirements. In Announcement 2010-75, the IRS noted that this proposed item had been removed from the final UTP schedule, based on a conclusion that “concerns about the administrability of this requirement outweighed the value of the information that may be included.”⁸ The IRS stated, however, that it “will continue to explore ways to assess the impact of these positions on overall tax compliance.”⁹

Similar to the administrative practice issue, many commentators had faulted the draft Schedule UTP for requiring disclosure of a position for which no reserve was recorded based on the corporation’s expectation to litigate the position. The final Schedule UTP retains this requirement. The instructions, however, clarify that the corporation may rely on the same documentation and analysis that it used in determining the treatment of that position in deciding not to record a reserve in its financial statements.¹⁰ This requirement, when taken together with other provisions of the draft Schedule UTP, raised a number of concerns regarding the attorney-client privilege and the work product doctrine. While retaining this requirement, the final Schedule UTP mitigated these concerns with other changes.

For those concerned about the protections of the attorney-client privilege and work product doctrine, possibly the most significant change from the draft to the final Schedule UTP is the elimination of the requirement to include the rationale and nature of the uncertainty. As revised, the instructions require a concise description of the tax position, including 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. Significantly, as Announcement 2010-75 sum-

marized, “the final instructions expressly state that a corporation is not required to include an assessment of the hazards of a tax position or an analysis of the support for or against the tax position.”¹¹

Policy of Restraint Strengthened

The draft Schedule UTP and related announcements by the IRS gave rise to many concerns regarding potential waivers of the protections of the attorney-client privilege, the work product immunity and the statutory tax practitioner privilege.¹² Many were concerned that the Schedule would require the disclosure of privileged information, or more subtly, that disclosure of certain information might be deemed a subject matter waiver of underlying legal analysis and advice.

The revisions to Schedule UTP reflect that these concerns were heard by the IRS, most significantly in the elimination of the requirement that the rationale and nature of the uncertainty be set out. In addition, simultaneous with the release of the final Schedule UTP, the IRS released a revised statement of its policy of restraint, directed at addressing these concerns.¹³

The IRS’s long-standing policy of restraint states that the IRS will seek tax accrual work papers only in “unusual circumstances.”¹⁴ In setting out this “policy of restraint,” the INTERNAL REVENUE MANUAL defines “tax accrual work papers” as “those audit work papers, whether prepared by the taxpayer, the taxpayer’s accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities ... and to footnotes disclosing those tax reserves on audited financial statements.”¹⁵ The INTERNAL REVENUE MANUAL defines “unusual circumstances” as follows:

- A specific issue has been identified by the examiner for which there exists a need for additional facts.
- The examiner has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue.
- The examiner has sought a supplementary analysis (not necessarily contained in the work papers) of facts relating to the identified issue and the examiner has performed a reconciliation of the taxpayer’s Schedule M-1 or M-3 as it pertains to the identified issue.¹⁶

Examiners are instructed to seek tax accrual work papers only when “factual data cannot be obtained from the taxpayer’s records or from available third

parties, and then only as a collateral source for factual data.” They are further instructed to limit such requests “to the portion of the work papers that is material and relevant to the examination.”¹⁷

In Announcement 2010-76, the IRS stated that it “will forego seeking particular documents that relate to uncertain tax positions and the workpapers that document the completion of Schedule UTP.” In connection with the new Schedule UTP filing requirements, the policy of restraint will now provide: “If a document is otherwise privileged under the attorney-client privilege, the tax advice privilege in Code Sec. 7525, or the work product doctrine 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.”¹⁸

The new additions to the policy of restraint contains exceptions for (1) other acts by a taxpayer that waives the applicable privilege, and (2) a request for tax accrual workpapers is made based on unusual circumstances or a claim for tax benefits for a listed transaction. Upon a request in an examination for tax reconciliation workpapers, the policy of restraint will permit a taxpayer to redact drafts and comments relating to the concise description of tax positions reported on Schedule UTP, the amount of any reserve related to a tax position reported on Schedule UTP, and the computations relating to the ranking of tax positions or the designation of a major tax position on the Schedule.¹⁹

Guidance to the Field

Schedule UTP is ushering in a new era. It is clearly intended and will be used as a tool in future examinations. Simultaneous with its release, the IRS issued filed guidance, which provided this valuable caution to examining agents in the Large Business and International Division:

[E]ssential to LB&I’s success with UTPs is ensuring that examiners conduct examinations consistent with the understanding that UTPs are uncertain for a number of reasons, including ambiguity in the law and a lack of published guidance on issues. This means that items disclosed on a Schedule UTP may or may not require an examination or an audit adjustment by the examiner. Although the Schedule UTP is intended to expedite

the return selection and issue identification processes, it does not serve as a substitute for other examination tools or for the independent judgment of the examiner, and it should not be used to shortcut other parts of the audit process or the careful and considered examination of issues and an objective application of the law to the facts.²⁰

The final Schedule UTP and the revised policy of restraint demonstrate that the IRS listened to and considered many of the concerns of taxpayers and practitioners in drafting the form and instructions. The field directive similarly reflects this careful consideration. Now taxpayers, practitioners and the IRS will turn to the real-world implementation of this new regime.

ENDNOTES

¹ Announcement 2010-9, IRB 2010-7, 408.

² *Id.*

³ IRS News Release, IR-2010-98, *Prepared Remarks of IRS Commissioner Doug Shulman to the American Bar Association*, Toronto, Canada, Sept. 24, 2010.

⁴ See K. Keneally and C. Rettig, *The IRS Takes A Controversial Position On Uncertain Tax Positions*, J. TAX PRACTICE & PROCEDURE, Apr.–May 2010.

⁵ Announcement 2010-30, IRB 2010-19, 668; Announcement 2010-75, IRB 2010-41.

⁶ Announcement 2010-75, *id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² Code Sec. 7525.

¹³ Announcement 2010-76, IRB 2010-41.

¹⁴ IRM §4.10.20.3(2).

¹⁵ IRM §4.10.20.2(1).

¹⁶ IRM §4.10.20.3.1(2).

¹⁷ IRM §4.10.20.3.1(1).

¹⁸ Announcement 2010-76, *supra* note 13. The new provisions will be included at IRM §4.10.20.

¹⁹ *Id.*

²⁰ IRS LB&I Directive (Unnumbered) on Reporting of Uncertain Tax Positions.

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