Practical Considerations for Schedule UTP … an Addendum

By Michael J. Desmond and Ronald L. Buch, Jr.

Editor's Note: *In the July-August 2010 issue of The Tax Executive, Michael J. Desmond and Ronald L. Buch, Jr. offered practical guidance for complying with new Schedule UTP, relating to the disclosure of uncertain tax positions,[1] with the understanding that the Internal Revenue Service was likely to tweak the specifics of that requirement before final implementation. On September 24, 2010, the IRS announced its changes. This article discusses the changes.*

As expected, in issuing the final version of Schedule UTP on September 24, the Internal Revenue Service rejected calls to drop the schedule altogether; what Commissioner Shulman has characterized as a "game changer," while modified, is now final.[2] The changes made by the IRS are a move in the right direction. They reduce burden *(e.g.,* by eliminating a reporting trigger) and eliminate cumbersome and potentially misleading information, such as the amount of the maximum tax adjustment (MTA).

As notable, or perhaps more so, are the statements by the IRS regarding its "policy of restraint" in seeking tax accrual workpapers. With the final schedule, the IRS adopted an administrative policy of not asserting (at least by personnel in the Examination, or Compliance, part of the agency) that attorney-client privilege or work-product protection has been waived by a taxpayer on account of disclosures to its financial auditor for financial reporting purposes. Although it may be a hollow promise, the announcement is an indication that the IRS is sensitive to broader policy concerns regarding open communication between companies and their auditors.

Who Must File

In the final schedule, the IRS narrowed the scope of who must comply with the Schedule UTP filing requirement. The requirement to prepare and file a Schedule UTP will now be phased in over five years, with Schedule UTP being required by corporations reaching the following asset thresholds:

2010	$100 million
2012	$ 50 million
2014	$ 10 million

Although many commentators had recommended that taxpayers in the new Compliance Assurance Process program (CAP) be excluded from the Schedule UTP filing requirement, the IRS did not exclude any broad categories of taxpayers; the IRS did suggest, however, that the application of the Schedule UTP to CAP taxpayers would be addressed in forthcoming guidance making the CAP program permanent.[3] The final schedule was not expanded beyond corporations filing most series 1120 returns, although the IRS said it continues to consider requiring it for pass-through and tax-exempt entities.[4]

What Positions Must Be Reported

In its final form, the IRS narrowed the Schedule UTP reporting requirements in various ways, ranging from eliminating a reporting trigger to narrowing the concise description that is to be provided for each position.

The first, and perhaps most notable of these changes, was to eliminate the reporting trigger for "administrative practice" positions. The rationale for including this in the draft schedule was dubious, given that no reserve is established for such positions on the ground that it is the IRS's established administrative practice to allow (or at least not question) the position. Asking taxpayers to disclose these practices might have enabled the IRS to better understand its own actual or perceived practices, but it would have placed an enormous burden on taxpayers. A better approach might be through improved internal communications and guidance that would make administrative practice more uniform, something the IRS is continuing to work on.[5] Moreover, many items that would have been disclosed under the administrative-practice provision are items that are *de minimis* (which is often why the IRS administratively allows them in the first instance). The burden of calculating, tracking, and reporting those items would have been significant and in all events would be unlikely to lead to any significant adjustments. To its credit, the IRS recognized that the burden imposed by the administrative practice trigger would have outweighed the benefit of the information provided. Notably, however, the IRS has not given up on the issue, stating that it will continue to explore ways to assess the effect of administrative-practice positions on overall tax compliance.

Schedule UTP continues to require the reporting of positions for which no reserve was established based on an expectation to litigate to a favorable result. In the final schedule, however, the IRS narrowed the positions required to be disclosed in this category. Specifically, the IRS eliminated from the final Schedule UTP the reporting of positions that are "immaterial for audited financial statement purposes" and of positions that are "sufficiently certain so that no reserve was required."[7] To record no reserve because of the expectation to litigate to a favorable result requires that the position meet the more likely than not threshold, which (but for the expectation to litigate) would trigger some reserve requirement. At the other end of the spectrum, and the subject of broader debate, having a position that is sufficiently certain so that no reserve is required might be characterized as a "will" level position. Thus, while it is not entirely clear what remains of the expectation-to-litigate category of reportable positions, what remains is seemingly a requirement to disclose positions below a "will" (or perhaps a "strong should") level and at or above "more likely than not."[8]

Subject to a new transition rule for 2010, the final Schedule UTP retains a requirement for disclosure in Part II of the schedule of uncertain positions taken on prior year returns that have yet to be reported

on a Schedule UTP. Part II may, however, be a source of some confusion and concern going forward. The basic requirements for disclosure of prior year positions can be summarized, as follows:

- **Uncertain Positions Taken Only on Pre-2010 Returns.** If an uncertain position was taken only on a return filed for a tax year before 2010, it will never have to be disclosed on Schedule UTP. Under the transition rule included with the final 2010 Schedule, no reporting is required even if the prior-year position becomes uncertain in 2010 or later.[9]
- **Multiple-Year Positions.** If an uncertain position was taken on a return filed for a year before 2010 and the same position is also taken on the 2010 or later return (an uncertain multi-year depreciation deduction, for example), it must be disclosed in Part I of the 2010 Schedule UTP.
- **Post-2009 Uncertain Positions.** If a position is taken on a 2010 or later return that is certain and thus there was no reserve when the return is filed, but a reserve is later established because the position becomes uncertain (owing, for example, to intervening legal or factual developments), it must be disclosed on Part II of the Schedule UTP. In this regard, Part II raises some concern about disclosure of privilege and work product, to the extent recently received legal or tax advice may be the reason the position has become uncertain.

What Must Be Disclosed

In addition to narrowing the positions that must be disclosed, the IRS limited what must be disclosed about those positions.

The final Schedule UTP no longer requires a disclosure of the maximum tax amount implicated by a position. Many had commented that this MTA number would be misleading and, in fact, would often be incalculable or only calculable at a cost that far outweighed whatever benefit might come from knowing this amount. Rather than identify the amount of the MTA, Schedule UTP now asks taxpayers to rank all uncertain positions based on the amount reserved, a concept initially reflected in the draft schedule for reporting valuation and transfer pricing positions. The amount itself is not to be disclosed. For this purpose, all positions reported on Parts I and II of the schedule are ranked together. In general, the ranking approach will reduce burden, because companies already compute the reserve amount on which the ranking is based.

For expectation-to-litigate positions where no reserve has been recorded, rather than compel taxpayers to calculate a theoretical amount at issue or a maximum tax adjustment solely for the purposes of this ranking process, these items may receive any ranking. This ranking of expectation-to-litigate positions could be somewhat misleading since taxpayers may list expectation-to-litigate positions last or close to last in their ranking in an effort to deflect a revenue agent's attention. Agents may then respond by issuing IDRs asking for identification of expectation-to-litigate positions, raising in turn questions over the extent to which agents will be permitted to drill down into the particulars of Schedule UTP reporting (as opposed to the substantive positions themselves).

Along with the new ranking requirement, column (e) of the final schedule requires that any uncertain positions whose reserve is greater than or equal to 10 percent of the total tax reserve be designated as a "Major Tax Position." By their very nature, expectation-to-litigate positions cannot be Major Tax Positions because there is no reserve to include in the numerator. Thus, no matter how large the amount potentially at issue, a position that is included solely because of an expectation to litigate will not be a Major Tax Position.

The Concise Description

Much of the concern regarding the draft Schedule UTP, and much of the focus of our prior article, was on the requirement to provide a "concise description." While the IRS claims to have narrowed what is required to be included in the description, concerns remain.

The IRS did remove two elements from the instructions for completing the concise description of uncertain tax positions. Specifically, the IRS eliminated from the instructions the requirement to include "the rationale for the position and the reasons for determining the position is uncertain." Under the new instructions, the description must include only "the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the Service of the identity of the tax position and the nature of the issue."[11] And as before, the IRS suggests that a few sentences should be sufficient.

The examples in the instructions shed more light on the nature of the concise description than the actual instructions. Two of the examples are particularly instructive because the same facts seem to underlie two examples that appear in both the draft and the final instructions.

Draft Instructions Example 14

The corporation investigated and negotiated several potential business acquisitions during the tax year. One of the transactions was completed during the tax year, but all other negotiations failed and the other potential transactions were abandoned during the tax year. The corporation deducted costs of investigating and partially negotiating potential business acquisitions that were not completed, and capitalized costs allocable to one business acquisition that was completed. The issue is the allocation of costs between failed acquisitions and the successful acquisition.[12]

Final Instructions Example 10

The corporation incurred costs of completing one business acquisition and also incurred costs investigating and partially negotiation potential business acquisitions that were not completed. The costs were allocated between the completed and uncompleted acquisitions. The issue is whether the allocation of costs between the uncompleted acquisitions and the completed acquisitions is appropriate.[13]

Although the example in the final instructions is less wordy, there is no material difference in the information disclosed in these two descriptions. Accordingly, either Example 14 in the draft instructions was deficient or the IRS did not meaningfully change the concise description requirement. The better view is that the example in the draft instructions was deficient.

In fact, the examples in the final instructions arguably are them-

selves deficient in places, or at least not as complete as the instructions seemingly require.

Draft Example 16

The corporation received a cash distribution from Venture LLC (Venture LLC is treated as a U.S. partnership for tax purposes). The corporation claims the distribution is not taxable because it did not exceed the corporation's basis in its interest in Venture LLC. The issue concerns (1) the computation of basis in the Venture LLC interest, and (2) the application of the disguised sale and partnership anti-abuse rules of Subchapter K and regulations thereunder to recharacterize the transaction as other than a distribution.[14]

Final Instructions Example 11

The corporation is a member of Venture LLC, which is treated as a U.S. partnership for tax purposes. The corporation received a cash distribution during the year from Venture LLC. The issue is the potential application of section 707(a)(2) to recharacterize the distribution as a sale of a portion of the corporation's Venture LLC interest.[15]

Draft Instructions Example 16 specifically identifies the corporation's reporting position (a nontaxable distribution). In contrast, although it can be surmised, Example 11 in the final instructions does not identify the position taken on the return, which the instructions seem to require.[16]

More problematic is what must be disclosed when the "nature of the issue" is the application of an affirmative defense the IRS may have to normative application of the tax law, such as the newly codified economic substance doctrine or the partnership anti-abuse rule of Treas. Reg. § 1.701-2. Arguably, the requirement to disclose the "nature of the issue" may be read to suggest that a taxpayer must also include in its concise description a reference to the IRS's affirmative defense if that is the reason for the uncertainty. Such detail would go beyond historical requirements for disclosure on a Form 8275, contrary to the IRS's suggestion that Schedule UTP disclosure should generally track Form 8275.[17]

The IRS's sample concise descriptions are somewhat formulaic, devoting one sentence each to the facts, the reported treatment, and the nature of the issue. Although the examples suggest that less may be sufficient, adhering to this formulaic description should be sufficient to fully comply with the Schedule UTP reporting requirements.

Duplicate Reporting

In recent years, the IRS has dramatically increased the amount of reporting on income tax returns of information unrelated to the computation or reporting of a tax liability. Much of that reporting is duplicative. While the IRS promises to study the issue of a more coordinated approach to reporting — mentioning in particular a new Schedule M-3 working group[18] — one immediate change made with respect to the final Schedule UTP relates to Forms 8275 (Disclosure Statement) and 8275-R (Regulation Disclosure Statement).

> A complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP will be treated as if the corporation filed a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, regarding the tax position.[19]

Thus, for purposes of accuracy-related penalties (including the new strict liability noneconomic substance transaction penalty), a "complete and accurate" Schedule UTP will constitute disclosure.[20] Although the IRS did not invoke in the Final 2010 Instructions any disclosure examples other than accuracy-related penalties, if Schedule UTP "will be treated" as a Form 8275, other disclosure requirements may also be satisfied. For example, the disguised sale rules cited in Example 11 of the final instructions require disclosure of certain transfers between partnerships and their partners.[21] That disclosure may be made on a Form 8275. If Schedule UTP is treated as a Form 8275, then the disguised sale disclosure requirement presumably may be satisfied by the Schedule UTP.[22] Other similar examples likely exist.[23]

Policy of Restraint

At the same time it announced the release of the final 2010 Schedule UTP, the IRS also announced a change to its so-called policy of restraint relating to tax accrual workpapers. While that policy is beyond the scope of this article, the interrelationship of that policy to Schedule UTP is worth noting.

The interplay between tax accruals and privilege has been the subject of much dispute, with no clear answer emerging from the litigation. The most recent case touching on this issue is *United States v. Deloitte*.[24] In short, the D.C. Circuit held that disclosure of work product to an outside accountant does not waive the protection. The *Deloitte* case did not meaningfully address either the attorney-client privilege or the federally authorized tax practitioner privilege of section 7525.

In Announcement 2010-76, the IRS announced its revised policy of restraint. If a document is otherwise privileged (including attorney-client privilege, work product, or section 7525), the IRS will not assert during an examination that disclosure to an independent auditor as part of the audit of the financial statements constitutes a waiver. Other exceptions to the policy of restraint remain in place (*e.g.*, undisclosed listed transactions).

This "restraint" is very clearly limited to IRS examinations. Nothing in the revised policy limits IRS Counsel or the Department of Justice from arguing waiver as a result of sharing documents with independent auditors. Moreover, this restraint is limited to sharing privileged information "as part of an audit of the taxpayer's financial statements."[25] The revised policy does not prevent the IRS from arguing waiver as a result of sharing privileged information as part of the return preparation process, such as when preparing Schedule UTP.

Penalties

In announcing the Schedule UTP last January, the IRS noted that it was:

> [E]valuating additional options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure of the required information regarding its uncertain tax positions.

One option being considered is to seek legislation imposing a penalty for failure to file the schedule or to make adequate disclosure.[26]

Many commentators on the draft schedule expressed concern that the revenue agents might be too aggressive in seeking to penalize taxpayers that did not file Schedule UTP or that filed schedules that, in the agents' view, were deficient. As referenced in the January announcement, there is no failure to file penalty targeted to the Schedule UTP. Thus, in order to impose penalties, the IRS would effectively have to take the position that the absence of the schedule, or a deficient schedule, should be deemed to be a complete failure to file, triggering a penalty under section 6651.[27] The instructions to the final schedule make no reference to penalties and the concurrent Announcement states only that "[t]he Service intends to review compliance regarding how the schedule is completed by corporations and take appropriate enforcement action . . . ."[28] In the short term, we expect penalties will not be an issue, though this could change if the IRS perceives a problem. In that case, given the hurdles that would have to be overcome in order to impose a failure to file penalty, it would likely be incumbent on the IRS to pursue targeted penalty legislation.

Conclusion

Routine access to more detailed information regarding corporate taxpayers' uncertain tax positions has been an interest of the IRS for many years. Developments in the world of financial reporting over the past decade have moved the ball on this discussion significantly, culminating in publication of the final 2010 Schedule UTP on September 24. There is no question that the schedule is, in Commissioner Shulman's words, "a game changer." The IRS should be commended, however, for its extraordinary outreach effort in connection with the draft schedule and for making a genuine effort to consider and incorporate numerous comments into the final 2010 schedule.

The hard work for taxpayers will now begin. Whether the Schedule UTP helps to accomplish the IRS's stated goals of increasing transparency and currency and, in turn, saving both taxpayer and IRS resources will depend in large part on how examinations of 2010 and later year returns with attached Schedules UTP proceed. The "game change" will no doubt impose a significant and unpredictable burden on taxpayers. Whether the game changes for the good and that burden is justified, or the Schedule UTP becomes a lightning rod for conflict, remains to be seen. Initial signals are, at least, pointing in the right direction.

Michael J. Desmond *is a partner with Bingham McCutchen LLP, dividing his time between the firm's Washington and Los Angeles offices. His practice concentrates on federal tax controversies, administrative dispute resolution, and tax policy counseling. Mr. Desmond received his B.A. degree from the University of California, Santa Barbara and his J.D. degree from the Columbus School of Law at the Catholic University of America. He has served as a trial attorney in the Attorney General's Honors Program at the Tax Division of the U.S. Department of Justice and a law clerk for U.S. District Court Judge Ronald S.W. Lew. From 2005 to 2008, he was Tax Legislative Counsel in the U.S. Department of Treasury. He is currently an adjunct professor of law at Georgetown University Law Center. He may be contacted at michael.desmond@bingham.com.*

Ronald J. Buch, Jr. *is a partner with the law firm of Bingham McCutchen LLP, resident in the firm's Washington office. His practice focuses on tax controversy and litigation matters. Before joining the firm, he served as senior legal counsel with the IRS Office of Chief Counsel's Large and Mid-Size Business Division. Mr. Buch received his B.B.A. degree from Northwood University, his J.D. degree from Michigan State University College of Law, and his LL.M. degree from Capital University Law School. He currently serves as an adjunct professor at Georgetown University Law Center. He may be contacted at ronald.buch@bingham.com.*

1. Michael J. Desmond & Ronald L. Buch, Jr., Practical Considerations for the Impending Schedule UTP Filing Requirement, ___ Tax Executive ___ (July-August 2010), at 185.
2. Douglas H. Shulman, Commissioner of the Service, Prepared Remarks before the AICAP National Conference on Federal Taxation in Washington, DC (Oct. 26, 2009), *available at* www.irs.gov/irs/article/0,,id=215606,00.html.
3. Announcement 2010-75, 2010 WL 3720407 (Sept. 24, 2010).
4. *Id.*
5. For example, in a widely cited example of administrative practice, the preamble to proposed regulations under section 263(a) of the Internal Revenue Code states that the Treasury and IRS are considering a rule that would embrace the practice of allowing expensing of *de minimis* expenditures. Preamble to Prop. Reg. §§ 1.263(a)-1 through 1.263(a)-3, 73 Fed. Reg. 12838, 12840-41 (Mar. 10, 2008). William J. Wilkins, IRS Chief Counsel, has also noted in connection with the Schedule UTP that the IRS must provide taxpayers with more pre-filing certainty in the form of published guidance. Jeremiah Coder, *Wilkins Gives Update on UTP Regime, Economic Substance,* Tax Notes Today, 2010 TNT 142-1 (July 26, 2010).
6. Announcement 2010-75.
7. 2010 Instructions for Schedule UTP (Final 2010 Instructions), at 2; *see also* Announcement 2010-75.
8. This raises the broader question and ongoing debate about what qualifies under FIN 48 and other financial reporting standards as a position that, in the words of Announcement 2010-75, is "sufficiently certain so that no reserve is required." Illustrating a "tail wagging the dog" concern that Schedule UTP may drive, rather than follow, financial reporting, at one level the Schedule UTP gives taxpayers an incentive to cite a lower standard (a "should" standard, for example) as sufficiently certain to avoid establishing a reserve altogether and, in turn, avoid a Schedule UTP disclosure requirement.
9. This rule will presumably be carried forward onto the 2011 and later year Schedule UTP for positions taken only on pre-2010 returns.
10. Draft 2010 Instructions for Schedule UTP (April 19, 2010) (Draft 2010 Instructions), at 9.
11. Final 2010 Instructions, at 4.
12. Draft 2010 Instructions, at 9.
13. Final 2010 Instructions, at 5.
14. Draft 2010 Instructions, at 9.

15. Final 2010 Instructions, at 5.
16. Example 12 of the Final 2010 Instructions suffers from the same flaw.
17. *See* Announcement 2010-75.
18. *Id.*
19. Final 2010 Instructions, at 3.
20. *See, e.g.*, I.R.C. § 6662(d)(2)(B)(ii) (reasonable basis plus disclosure defense for substantial understatement penalty); *id.* § 6662(i)(1) (disclosure to reduce strict liability noneconomic substance transaction penalty from 40 percent to 20 percent); Treas. Reg. § 1.6662-3(c) (disclosure defense for disregard of rules or regulations penalty).
21. *See* Treas. Reg. § 1.707-3(c)(2).
22. *See* Treas. Reg. § 1.707-8(b).
23. *See* Treas. Reg. § 1.6694-2(d)(3)(i)(A) (disclosure on Form 8275 for purposes of return preparer penalty); Notice 2010-62, 2010-40 I.R.B. 411, 412 (disclosure to reduce the strict liability noneconomic substance penalty under section 7701(o)).
24. 610 F.3d 129 (D.C. Cir. 2010).
25. *Id.*
26. Announcement 2010-9, 2010-7 I.R.B. 408, 409 (Jan. 26, 2010).
27. Even if a section 6651 penalty were asserted, it would only apply if positive tax liability was otherwise required to be shown on the return.
28. Announcement 2010-75. Notably, the IRS did not adopt some commentators' suggestion that the Schedule UTP could be enforced through a further modification to the policy of restraint providing that any failure to file a complete schedule could lead to a broad request for all tax accrual workpapers.