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# IRS RELEASES FINAL SCHEDULE FOR REPORTING “UNCERTAIN TAX POSITIONS”

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## INTRODUCTION

The Internal Revenue Service (IRS) has long sought a means through which to obtain insight into uncertain positions taken by taxpayers not otherwise readily apparent through the information provided with their returns so that it may focus its time and attention upon the proper taxpayers and issues.<sup>1</sup> The IRS’s answer: Schedule UTP.

In April 2010 the IRS issued Announcement 2010-30<sup>2</sup> releasing a draft of 2010 Schedule UTP, “Uncertain Tax Position Statement,” with instructions, and providing preliminary guidance to taxpayers. Following the release, commentators suggested numerous changes to the scope and content of information to be reported. Responding to these comments, on Sept. 24, 2010 the IRS issued Announcement 2010-75<sup>3</sup> together with final 2010 Schedule UTP and accompanying instructions (the “Instructions”).<sup>4</sup>

### *Final Schedule UTP*

Schedule UTP requires certain taxpayers to attach a schedule to their federal income tax return identifying certain “uncertain tax positions,” if a) the corporation has taken the position on its U.S. federal income tax return for the year or for a prior tax year and b) either the corporation or a related party recorded a reserve in its audited financial statements for the year with respect to the position, or the entities did not record a reserve because they expected to litigate the position.

Final Schedule UTP contains numerous changes vis-à-vis the previous draft aimed at remedying taxpayer concerns. The primary changes include the following:

- A five-year phase-in of the reporting requirement based upon a corporation’s asset size;
- No reporting of a “maximum tax adjustment”;
- No reporting of the rationale and nature of uncertainty in the concise description of the position;
- Interaction of Schedule UTP Disclosures and Economic Substance Disclosures; and
- Elimination of Disclosure of Administrative Practice Positions.

## FIVE-YEAR PHASE-IN

Pursuant to the Instructions, a corporation must file Schedule UTP with its income tax return if:

- The corporation files Form 1120, 1120-F, 1120-L or 1120-PC;
- The corporation has assets that equal or exceed \$100 million (subject to a phase-in, below);
- The corporation or a related party issued audited financial statements reporting all or a portion of the corporation’s operations for all or a portion of the corporation’s taxable year; and
- The corporation has one or more tax positions that must be reported on Schedule UTP.

The Instructions provide a phase-in for certain corporations determined by their asset size:

- Certain corporations with \$100 million or more in assets that have audited financial statements (or are included in the audited financial statements of a related party) will be required to file Schedule UTP beginning with 2010 tax years;
- Corporations with \$50 million in assets must file Schedule UTP beginning with 2012 tax years; and
- Corporations with \$10 million in assets must file Schedule UTP beginning with 2014 tax years.

The Instructions do not exclude taxpayers participating in the CAP or CIC programs from the Schedule UTP filing requirement.<sup>5</sup> Announcement 2010-75 provides that the IRS will address Schedule UTP compliance in upcoming CAP permanence guidance, which is expected to be released shortly. It also states further that the IRS will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers (e.g., partnerships and tax-exempt entities) for 2011 or later tax years. These entities are currently not required to file Schedule UTP.

Last, the Instructions provide a transition rule pursuant to which tax positions taken in tax years before 2010 generally need not be reported in 2010 or later. This is the case even if

a reserve is recorded in audited financial statements issued in 2010 or later. However, Example 9 in the Instructions appears to provide an exception to this general rule for NOL carryforwards and credit carryforwards. Under the example:

A corporation incurs a \$50 expenditure in 2010 and claims the entire amount as a deduction on its 2010 tax return. The deduction increases the corporation's NOL carryforward from \$100 to \$150. The corporation uses the entire \$150 NOL carryforward on its 2011 tax return. Claiming the \$50 deduction in 2010 is a tax position taken in the 2010 tax year because the position would result in an adjustment to a line item on the 2010 tax return if the position is not sustained. The deduction in 2011 of the NOL carried forward from 2010 is a tax position taken on the 2011 tax return, because the position would result in an adjustment to a line item on the 2011 tax return if the position is not sustained. The corporation did not record a reserve with respect to its 2010 tax position, but did record a reserve in its 2011 audited financial statements with respect to its 2011 tax position. Because the corporation did not record a reserve with respect to the tax position taken in 2010, the 2010 tax position is not required to be reported on Schedule UTP. However, because the corporation recorded a reserve for the 2011 tax position in its 2011 audited financial statements, the 2011 tax position must be reported in Part I of Schedule UTP filed with its tax return for the 2011 tax year.

Considering the transition rule above in light of Example 9, it appears that taxpayers would also be required to describe (in their concise description) positions taken in years prior to 2010 to the extent that the taxpayer establishes a reserve in later years with respect to an NOL carryforward (or credit carryforward) due to uncertainty specific to a pre-2010 tax position that is included in the computation of the carryforward. IRS officials have acknowledged this issue and have stated that the IRS intends to issue future guidance that addresses this issue.<sup>6</sup>

#### ELIMINATION OF MAXIMUM TAX ADJUSTMENT REPORTING

The instructions accompanying draft Schedule UTP required taxpayers to compute a "maximum tax adjustment," which the IRS defined as "the maximum United States federal income tax liability for the tax position if the position were not sustained upon examination by the Service." Responding

to concern expressed by numerous commentators regarding this calculation, the IRS eliminated this requirement from final Schedule UTP. Instead, final Schedule UTP generally requires the reporting taxpayer to rank its reportable tax positions, including transfer pricing and other valuation positions, from highest to lowest based on the size of the position's reserve amount computed for audited financial statement purposes. Taxpayers must also designate those tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all tax positions taken on the return. A box must be checked on the Schedule with respect to these "major tax positions."

Also addressed were concerns of commentators regarding the difficulty in computing the maximum tax adjustment for positions which a taxpayer expects to litigate, if challenged by the IRS. Announcement 2010-75 clarifies that "no size needs to be determined with respect to these tax positions and that these positions can be assigned any rank by the corporation." The Instructions clarify that taxpayers are only required to report reserves which are not recorded due to an expectation to litigate. They provide that a corporation must report a tax position for which no reserve was reported if:

the tax position is one which the corporation or a related party determines the probability of settling with the IRS to be less than 50% and, under applicable accounting standards, no reserve was recorded in the audited financial statements because the corporation intends to litigate the tax position and has determined that it is more likely than not to prevail on the merits in litigation.

Announcement 2010-75 clarifies that taxpayers are not required to report a tax position that a corporation would litigate, if challenged, but that is clear and unambiguous or is immaterial.

#### ELIMINATION OF CERTAIN REQUIREMENTS IN CONCISE DESCRIPTION

The IRS received a number of comments arguing that the requirement in the instructions to draft Schedule UTP that

Announcement 2010-75 clarifies that "no size needs to be determined with respect to these tax positions and that these positions can be assigned any rank by the corporation."

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taxpayers include the rationale and nature of the uncertainty as part of the concise description of the uncertain tax position exceeded disclosure requirements under FIN 48 and conflicted with the IRS's policy of restraint as well as its "stated objective not to require taxpayers to disclose their assessment of the strength or weakness of the position."<sup>7</sup>

The Instructions remove the requirement that taxpayers include within their concise description the rationale and nature of the uncertainty. According to the Instructions, the reporting taxpayer must 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 Instructions state that, in most cases, the description need not exceed a few sentences; however, "Available on Request" is not an adequate description.

#### INTERACTION OF SCHEDULE UTP DISCLOSURES AND ECONOMIC SUBSTANCE DISCLOSURES

In the Announcement the IRS states that in the case of a transaction that is not a reportable transaction, the IRS will treat a complete and accurate disclosure of a tax position on Schedule UTP as satisfying Internal Revenue Code section 6662(i) disclosure requirements.<sup>8</sup>

In addition, the IRS rejects commentators' requests that the IRS provide a so-called "angel list" that excludes certain tax positions from Schedule UTP filing requirements. For example, some commentators requested that the following tax positions not be subject to disclosure: 1) a tax position relating to whether a foreign entity's activities in the United States constitute a permanent establishment under a treaty; 2) tax positions regarding equity versus debt classification; and 3) whether or not a transaction constitutes a tax-free combination. The IRS states that it believes exclusion of these types of tax positions from Schedule UTP reporting would be inconsistent with the purpose and objectives underlying Schedule UTP.

#### ELIMINATION OF DISCLOSURE OF ADMINISTRATIVE PRACTICE POSITIONS

The IRS eliminated from final Schedule UTP the requirement to disclose positions for which a reserve was not established due to an administrative practice of the IRS. Taxpayers had

previously been required to check a box on draft Schedule UTP to indicate reliance upon IRS administrative practice.

#### COORDINATION WITH FORM 8275

The Instructions state that a taxpayer will be treated as if it filed a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, with respect to a tax position, provided that there is a complete and accurate disclosure of such tax position on the appropriate year's Schedule UTP.<sup>9</sup> In the event that there is such complete and accurate disclosure, a corporation does not need to file a Form 8275 or Form 8275-R regarding the tax position in order to prevent certain accuracy-related penalties with respect to the tax position.

#### IRS'S REVISED POLICY OF RESTRAINT

Announcement 2010-76 was issued concurrent with final 2010 Schedule UTP and Announcement 2010-75, making changes to the IRS's policy of restraint.

Three key changes to the policy of restraint, currently located in the Internal Revenue Manual (the "I.R.M.") part 4.10.20, which deals with "Requesting Audit, Tax Accrual, or Tax Reconciliation Workpapers" during examination, are made under the Announcement and are intended to largely reassure taxpayers that the IRS is not seeking their legal analysis or risk assessments. First, the Announcement clarifies that disclosure of issues on Schedule UTP does not otherwise affect the protections afforded under the policy of restraint. Second, it clarifies that a taxpayer may redact the following information from any copies of tax reconciliation workpapers relating to the preparation of Schedule UTP that it is asked to produce during an examination: 1) working drafts, revisions or comments concerning the concise description of tax positions reported on Schedule UTP; 2) the amount of any reserve related to a tax position reported on Schedule UTP; and 3) computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a so-called "major tax position."

Last, the Announcement adopts a policy pursuant to which the IRS will generally not seek documents that would otherwise be privileged (*e.g.*, privileged under the attorney-client privilege, the tax advice privilege in section 7525 of the Internal Revenue Code, or the work product doctrine), *even though* the taxpayer has disclosed the document to a financial auditor as part of an audit of the taxpayer's financial statements.

It is worth noting, however, that the IRS's policy of restraint with respect to privileged documents only applies "during an examination" process. Presumably, if the taxpayer seeks to litigate the issue in court, the IRS or Department of Justice would not be constrained by these policies. In addition, the IRS reserved the right to assert waiver of the noted privileges if the taxpayer has engaged in any activity or taken any action other than providing privileged documents to an independent auditor (*i.e.*, any activities which would waive the attorney-client privilege, the tax advice privilege in section 7525 of the Code, or the work product doctrine). The IRS also reserved the right to request tax accrual workpapers under IRM 4.10.20.3 when unusual circumstances exist or the taxpayer has claimed the benefits of one or more listed transactions.

## TREASURY ISSUES FINAL REGULATIONS REQUIRING DISCLOSURE OF UNCERTAIN TAX POSITIONS

Final regulations were adopted on December 13, 2010 under Treasury Regulation section 1.6102-2(a) providing the IRS authority to require disclosure on Schedule UTP. Under new section 1.6102-2(a)(4), "[a] corporation required to make a return under this section shall attach Schedule UTP, Uncertain Tax Position Statement, or any successor form, to such return, in accordance with forms, instructions, or other appropriate guidance provided by the IRS." The regulations are effective for returns filed for tax years beginning on or after January 1, 2010.<sup>10</sup>

## CONCLUSION

The IRS's recent guidance on Schedule UTP evidences that the IRS listened to and appreciated comments from the various commentators, as the IRS addressed many of the issues raised. That said, as with all new guidance areas, unanswered questions remain. For example, additional guidance surrounding the initial year reporting of multiple year positions (*e.g.*, amortization) as well as guidance surrounding the reporting of tax positions in the year in which a corporation is acquired or disposed of would be beneficial. Whether the IRS will ultimately expand Schedule UTP reporting to partnerships and tax-exempt entities also remains to be seen. ◀

### END NOTES

- <sup>1</sup> See, *e.g.*, U.S. v. Arthur Young, 465 U.S. 805 (1984); U.S. v. Deloitte & Touche USA, 623 F.Supp.2d 39 (D.D.C. 2009), *aff'd in part, rev'd in part* 610 F.3d 129 (2009); Textron Inc. v. Comm'r, 336 F.3d 26 (1st Cir. 2003).
- <sup>2</sup> 2010-19 I.R.B. 668.
- <sup>3</sup> 2010-41 I.R.B. 428.
- <sup>4</sup> The IRS concurrently issued Announcement 2010-76, 2010-41 I.R.B. 432 (discussed in more detail below), as well as an industry directive.
- <sup>5</sup> The Compliance Assurance Process, or "CAP," is an IRS program pursuant to which taxpayers engage in full disclosure of information concerning their completed business transactions and their proposed return treatment of all material issues. Participating taxpayers that resolve all material issues will be assured, prior to the filing of the tax return, that the IRS will accept their tax return, if filed consistent with the resolutions, such that no post-filing examination will be required. Coordinated Industry Case, or "CIC," taxpayers are typically subject to examination on a continuing basis (as opposed to CAP participants, which is essentially "real time"). CIC applies to the largest taxpayers within the Large Business and International, or "LB&I," division of the IRS, some of whom also participate in the CAP program.
- <sup>6</sup> See *UTP Aims to be Consistent with Financial Reporting Standards*, IRS Officials Says, 2010 TNT 211-1 (Nov. 2, 2010) ("Addressing several technical issues related to the UTP regime, [Edward Froelich of Morrison & Foerster LLP] said it was unclear how transition relief would be applied in situations in which issues in nonreportable years might give rise to positions taken on returns after the reporting effective date -- for example, net operating loss carryforwards. [Kathryn A. Zuba, special counsel with the IRS Office of Associate Chief Counsel (Procedure and Administration)] said the UTP reporting principle applies regardless of the pre-2010/post-2009 tax year reporting distinction. If a reserve was recorded and the position reported on a U.S. return, that position is subject to UTP disclosure, she said. However, the IRS is considering the extent to which further guidance may address issues like NOLs, she said."). See also *IRS Official Outlines Potential Areas for Guidance on Schedule UTP*, 2010 TNT 214-1 (Nov. 5, 2010) (additional guidance will likely take the form of frequently asked questions).
- <sup>7</sup> Ann. 2010-75.
- <sup>8</sup> Section 6662(i) provides for a 40 percent penalty for non-disclosure of economic substance transactions (a 20 percent penalty will otherwise apply under section 6662(b)(6)). See Notice 2010-62, 2010-40 I.R.B. 411. Under the Notice, economic substance transactions must be on either Form 8275 or 8275-R with the taxpayer's return to avoid the 40 percent penalty in section 6662(i). Form 8275 is used by taxpayers and tax return preparers to disclose items or positions, except those taken contrary to a regulation, that are not otherwise adequately disclosed on a tax return to avoid certain penalties. Form 8275-R, on the other hand, is used by taxpayers and tax return preparers to disclose positions taken on a tax return that are contrary to Treasury regulations. Taxpayers may avoid certain penalties otherwise applicable under section 6662 through disclosure on these forms, assuming their positions are reasonable. Additional disclosure requirements are provided in Notice 2010-62 for economic substance transactions which are also reportable transactions.
- <sup>9</sup> See Fn. 8 for a discussion on Forms 8275 and 8275-R.
- <sup>10</sup> Treas. Reg. § 1.6102-2(a)(5).

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