

**Strafford**

*presents*

# **U.S. v. Deloitte: Expansion of Work Product Doctrine in Tax Controversies**

## **Protecting Confidentiality of Internal Tax Documents From the IRS**

### **A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

#### **Today's panel features:**

Jonathan M. Prokup, Shareholder, **Chamberlain Hrdlicka**, West Conshohocken, Pa.

Edward Froelich, Of Counsel, **Morrison & Foerster**, Washington, D.C.

Kevin Spencer, Partner, **McDermott Will & Emery**, Washington, D.C.

### **Tuesday, September 28, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

You can access the audio portion of the conference on the telephone or by using your computer's speakers.

Please refer to the dial in/ log in instructions emailed to registrants.

## Part IV - Items of General Interest

### Reporting of Uncertain Tax Positions

#### Announcement 2010-75

In a series of Announcements the Internal Revenue Service announced that it was developing a schedule requiring certain business taxpayers to report uncertain tax positions on their tax returns and requested comments both on the proposal and on a draft schedule and instructions. Announcement 2010-9, 2010-7 I.R.B. 408; Announcement 2010-17, 2010-13 I.R.B. 515; Announcement 2010-30, I.R.B. 2010-19. The Service also stated in Announcement 2010-9 that it would issue a Notice of Proposed Rulemaking (NPRM) to provide that corporations would be required to file a schedule disclosing uncertain tax positions. The NPRM was published on September 9, 2010, and sets out a proposed rule explicitly authorizing the Service to require the filing of Schedule UTP. Requirement of a Statement Disclosing Uncertain Tax Positions, 75 Fed. Reg. 54802 (proposed Sept. 9, 2010). The Service expects a final rule will be promulgated by the end of the year.

The Service received a large number of comments on the overall proposal, including whether and how the Service should implement the requirement to file a schedule reporting uncertain tax positions, as well as the draft schedule and instructions released for comment on April 19, 2010. Many of the comments expressed concerns regarding how the Service would use the reported information, the interaction of the new reporting requirement with the existing policy of restraint, the additional burden the

reporting requirement would place on affected corporations, and the impact the reporting requirement would have on the relationship between the corporation and the Service or the corporation and its advisors or independent auditors. Some commentators questioned the Service's authority to require reporting of uncertain tax positions with the corporation's tax return.

All of these comments have been carefully considered in developing the final schedule and instructions, which require certain corporations with audited financial statements to file Schedule UTP, Uncertain Tax Position Statement, beginning with the 2010 tax year. A final schedule and instructions are being released contemporaneously with this Announcement. In addition, a Directive regarding implementation of Schedule UTP and related matters, and a separate announcement regarding modifications that will be made to the existing Policy of Restraint in conjunction with implementation of Schedule UTP, are being released contemporaneously with this Announcement.

#### Overview of major changes to the draft schedule and instructions

The final schedule and instructions make a number of significant changes to the April draft in order to address burden and other concerns expressed by commentators. Some of the major changes include:

- a five-year phase-in of the reporting requirement based on 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; and
- no reporting of administrative practice tax positions.

*Five-year phase-in period*

In Announcement 2010-9, the Service proposed that the reporting requirement apply to business taxpayers with total assets of at least \$10 million. The Service requested comments on whether transition rules should be used or criteria modified to either include or exclude certain business taxpayers, and the type of uncertain tax positions that should be reported by pass-through entities and tax-exempt entities.

In Announcement 2010-30, the Service announced that the types of corporations required to file the schedule initially would be limited to corporations that issue audited financial statements (or that have tax positions for which a related party records a reserve in an audited financial statement) and file Form 1120, U.S. Corporation Income Tax Return; Form 1120-F, U.S. Income Tax Return of a Foreign Corporation; Form 1120-L, U.S. Life Insurance Company Income Tax Return; or Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return.

A number of commentators recommended that the Service either increase the \$10 million total asset threshold permanently or during a transition period to allow many organizations additional time to implement the reporting requirement. Some commentators recommended that taxpayers in the Compliance Assurance Program (CAP) and taxpayers under continuous audit (CIC taxpayers) be excluded from the reporting requirement. Although a few comments recommended that the reporting requirement also apply to pass-through entities and tax-exempt entities, many suggested that the reporting requirements should be delayed or eliminated for these entities.

The final schedule and instructions generally retain the previously announced filing requirements regarding types of corporations required to complete the schedule for 2010 tax years. Accordingly, public or privately held corporations that issue or are included in audited financial statements and that file a Form 1120, Form 1120-F, Form 1120-L, or Form 1120-PC must report their uncertain tax positions on Schedule UTP if they satisfy the total asset threshold. In response to comments, however, the Service has implemented a five-year phase-in of the Schedule UTP for corporations with total assets under \$100 million. Corporations that have total assets equal to or exceeding \$100 million must file Schedule UTP starting with 2010 tax years. The total asset threshold will be reduced to \$50 million starting with 2012 tax years and to \$10 million starting with 2014 tax years. The Service will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers for 2011 or later tax years, such as pass-through entities and tax-exempt entities.

The final instructions do not exclude CAP or CIC taxpayers from the reporting requirement. With respect to CAP, the Service will address Schedule UTP compliance in upcoming CAP permanence guidance that is expected to be released shortly.

*No reporting of maximum tax adjustment*

The draft schedule and instructions proposed that the corporation report a maximum tax adjustment for each tax position listed on the schedule, other than transfer pricing and other valuation positions. The maximum tax adjustment was defined in the draft instructions as the maximum United States federal income tax liability for the tax position if the position were not sustained upon examination by the Service. The draft instructions also provided the corporation a choice of ranking

transfer pricing and other valuation positions based on the federal income tax reserve or an estimate of the adjustment to federal income tax that would result if the position were not sustained.

Many of the comments recommended eliminating entirely or modifying the proposed requirement to report the maximum tax adjustment for each tax position. Many comments expressed concern that this amount would be unduly burdensome to compute, would provide the Service with misleading information about the riskiness of the position and its magnitude, and would not be a meaningful basis upon which to determine the issues or returns to examine. Some commentators recommended that no information be provided on the schedule regarding the materiality of the tax position. Some commentators expressed a preference for a measure that relied on information already available to the corporation to minimize the burden associated with completing the schedule. Many commentators suggested various alternative measures of magnitude including the following:

- ranges or baskets based on the maximum tax adjustment, a reasonable estimate of the federal income tax benefit, or the reserve for the tax positions;
- ranges or baskets based on a percentage of gross income, revenue, expenses, or reserves;
- ranking of all issues as proposed in the draft instructions for transfer pricing and other valuation issues;
- ranking of all issues based on magnitude, such as reserves for uncertain tax positions;

- disclosure of only those tax positions for which the tax reserve exceeds a percentage of the tabular roll-forward in the annual financial statement footnote disclosures;<sup>1</sup>
- disclosure of the maximum tax adjustment only if it exceeds \$500,000; and
- disclosure of the aggregate reserve for uncertain tax positions.

After considering the comments and the suggested alternatives, the Service has removed the proposed requirement to report the maximum tax adjustment. Instead, the final schedule and instructions require a corporation to rank all of the reported tax positions (including transfer pricing and other valuation positions) based on the United States federal income tax reserve (including interest and penalties) recorded for the position taken in the return, and to designate those tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all of the tax positions reported on the schedule. This ranking method is expected to allow the Service to more accurately evaluate the materiality of the issues reported on the schedule and to impose less burden on corporations than would have been the case under the maximum tax adjustment proposal. 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.

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<sup>1</sup> Public companies are required to disclose a tabular reconciliation of unrecognized tax benefits at the beginning and end of the reporting period in their annual financial statements. FASB ASC Topic 740-10 Income Taxes. Income Taxes, Accounting Standards Codification Subtopic 740-10-5015A (Fin. Accounting Standards Bd. 2010).

In addition, commentators noted the difficulty of computing the maximum tax adjustment for tax positions for which no reserve was created based on an expectation to litigate the position. The instructions address this concern by providing 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.

*Removal of requirement to include rationale and nature of uncertainty in concise description of the position*

A number of commentators expressed concern about the requirement that the rationale for an uncertain tax position, as well the nature of the uncertainty, be disclosed as part of the concise description. Commentators stated that these disclosures are not required by FIN 48 and asserted that they conflict with both the Service's policy of restraint and the Service's stated objective not to require that taxpayers disclose their assessment of the strength or weakness of their positions. Other commentators pointed out that the examples in the draft instructions did not provide this information. As an alternative, several commentators suggested that the requirements for a concise description be similar to the information required to be disclosed in conjunction with the filing of a Form 8275, Disclosure Statement.

In response to these comments, the proposed requirement to include the rationale and nature of the uncertainty in the concise description has been eliminated. The instructions now 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 Service of the identity of the tax position and the nature of the issue. This is based upon and consistent with the

information required to be reported on Form 8275. In addition, 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.

*No reporting of administrative practice tax positions*

The proposal required that a corporation report on Schedule UTP tax positions for which no reserve was recorded because the corporation determined it was the Service's administrative practice not to raise the issue during an examination. Many commentators recommended elimination of this requirement because it would be unduly burdensome for corporations to identify, describe, and quantify these positions, and would provide the Service very little useful information.

After reviewing the comments, the Service determined that the concerns about the administrability of this requirement outweighed the value of the information that may be included. Therefore, the Service has eliminated the proposed requirement to report tax positions for which no reserve was created due to a widely-understood administrative practice, but will continue to explore ways to assess the impact of these tax positions on overall tax compliance.

*Consistency between Schedule UTP reporting and financial statement reserve decisions*

Some commentators opposed the proposal because of their understanding that it required a corporation to report tax positions for which no reserve was recorded in the corporation's financial statements (including expectation-to-litigate positions) either because the position was highly certain or was immaterial in the context of the audited financial statements. Other commentators recommended that the instructions clearly

state that highly certain and immaterial tax positions not be required to be reported on the schedule.

The final instructions address these comments by clarifying that the schedule seeks the reporting of tax positions consistent with the reserve decisions made by the corporation for audited financial statement purposes. The instructions clarify that corporations are not required to report tax positions that are either immaterial under applicable financial accounting standards or are sufficiently certain so that no reserve is required under those standards. A tax position that a corporation would litigate, if challenged, but that is clear and unambiguous or is immaterial is therefore not required to be reported on Schedule UTP. The instructions require reporting of tax positions taken in a return for which reserves were created under applicable financial accounting standards or for which no reserve was created because of an expectation to litigate.

A number of commentators requested that the instructions regarding unit of account be clarified to more closely align the term with its meaning in FIN 48. The final instructions add an example to emphasize that the definition of unit account should be applied consistently with the guidance in FIN 48. Some commentators stated that the draft instructions provided inadequate guidance regarding the treatment of a unit of account for reporting tax positions by corporations using IFRS. The final instructions continue to provide that a corporation that uses its entire tax year as a unit of account under IFRS or another method of accounting may not do so for Schedule UTP reporting, but must identify a unit of account based on FIN 48 principles or by using any other level of detail that is consistently applied if that identification is reasonably

expected to apprise the Service of the identity and nature of the issue underlying a tax position taken in the tax return.

*Additional areas of clarification*

Many of the commentators provided specific comments on the language in the draft instructions, either asking for clarification of the language or suggesting changes to the language. In response, the following changes were made to the instructions:

- The instructions clarify that Schedule UTP requires the reporting of U.S. federal income tax positions but not foreign or state tax positions. Under the general reporting instructions, however, a corporation is required to report a United States federal income tax position taken in a return that arises out of uncertainty with regard to a foreign tax position (e.g., foreign tax credits) if a reserve for United States federal income tax was recorded to reflect that uncertainty.
- The instructions clarify that a tax position is reported on Schedule UTP once (1) a reserve for a tax position is recorded and (2) a tax position is taken on a return regardless of the order in which those two events occur.
- The instructions clarify that corporations report their own tax positions on Schedule UTP and do not report the tax positions of a related party.
- The instructions clarify that tax positions taken in years before 2010 need not be reported in 2010 or a later year even if a reserve is recorded in audited financial statements issued in 2010 or later.
- The instructions clarify the reporting of recurring tax positions taken in multiple years.

- The instructions were revised to reflect the fact that Schedule UTP need not be filed for short tax years ending in 2010.
- The instructions clarify that worldwide assets are used to determine whether a corporation that files a Form 1120-F (including a protective return) must file Schedule UTP.
- The definition of audited financial statement was revised to clarify that an audited financial statement is one on which an independent auditor expresses an opinion and that compiled or reviewed financial statements are excluded from the definition of audited financial statement.
- The definition of record a reserve was revised to clarify that it includes the recording of a reserve for United States federal income tax, interest, or penalties and to reinforce that temporary differences must be reported on Schedule UTP.
- The instructions clarify for corporations included in multiple audited financial statements that the recording of a reserve in any audited financial statement in which the corporation is included triggers reporting of the tax position if the tax position is taken on a return filed by the reporting corporation.

*Privilege, work product doctrine, subject matter waiver, and policy of restraint comments*

A number of commentators asked that the proposal be withdrawn on the basis that the requirement to identify tax positions along with the taxpayer's views and assessments of those positions is inconsistent with the attorney-client privilege, the

work product doctrine, and the tax practitioner privilege, because it may require disclosure of information that is based upon the advice of counsel and tax return preparers and may require the sharing of the mental impressions of these advisers. Many of these commentators were also concerned that disclosure of tax positions on Schedule UTP could enable adversaries to raise questions about subject-matter waiver with respect to confidential communications related to the disclosed tax positions. Other commentators asked that the Service confirm that claims of privilege may continue to be asserted to the same extent permitted under current law.

As set out above, the instructions no longer require the rationale and nature of the uncertainty to be included in the schedule's concise description and further explain that the concise description should not include information related to the corporation's assessment of the hazards of a tax position or an analysis of the support for or against the tax position.

Many commentators raised issues about the effect of Schedule UTP's reporting requirements on the Service's policy of restraint. Some saw Schedule UTP as inconsistent with the policy of restraint, while others asked that the policy of restraint be expanded to cover documents used to prepare Schedule UTP. The Service is releasing, contemporaneously with the release of this announcement, Announcement 2010-76, which modifies the policy of restraint in response to these concerns.

*Other comments - exclude certain tax positions and expectation to litigate*

Various commentators suggested excluding certain types of tax positions from Schedule UTP reporting, including:

- all transfer pricing positions;

- temporary differences;
- correlative effects of foreign tax positions (e.g., effect of foreign tax positions on U.S. earnings and profits or foreign tax credits); and
- specified transactions or issues, such as permanent establishment, debt-equity, tax-free combinations, or issues the Service has conceded in an audit of the reporting corporation during the prior five years, which should be included in an “angel list.”

The final schedule and instructions do not incorporate any of the recommended exclusions. The Service believes that excluding these types of tax positions from Schedule UTP reporting would be inconsistent with the purpose and objectives underlying the new reporting requirement and that it is important to obtain reporting of all types of uncertain tax positions.

The proposal required a corporation to report a tax position taken in a return for which no reserve was recorded based on the corporation's expectation to litigate the position. A number of commentators suggested eliminating this requirement, either because it would be unduly burdensome to identify, describe, and quantify these positions, or because requiring reporting of these positions on Schedule UTP departs from the Service's stated objective of consistency with financial accounting standards. Many commentators recommended clarifying the scope of tax positions required to be reported as expectation-to-litigate positions. Some commentators expressed concern that this requirement would require corporations to reassess at the time of preparing Schedule UTP all tax positions taken in the current-year return for which no reserve was previously recorded and report on the schedule each tax position the corporation might

litigate if it had to do so in order to sustain the issue. A few commentators requested guidance on how the corporation documents an expectation-to-litigate position.

The final schedule and instructions retain the requirement to report tax positions taken in a return for which no reserve was recorded because of an expectation to litigate the position and incorporate revised instructions to clarify the meaning of expectation to litigate. The final instructions clarify that a corporation may rely on the reserve decisions it made for financial statement purposes to complete Schedule UTP and thus is not expected to reassess at the time the schedule is completed those reserve decisions previously made for financial statement purposes. The final instructions do not provide guidance on how a corporation documents an expectation to litigate position. The Service expects that a corporation would continue to document its decision in the same way as it substantiates any decision not to record a reserve in its financial statements.

#### Internal Directive and related changes

The Service is issuing contemporaneously with this Announcement a Directive concerning the use of Schedule UTP by the Service and its examination and research personnel. The Directive outlines the various uses for the information reported on the schedule and indicates that initial processing of Schedule UTP information will be centralized to ensure appropriate review to identify trends and areas requiring further guidance to address uncertainty in the law.

In addition, the Service will create a working group to study and revise the Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More, to reduce duplicate reporting. The Service believes that the

implementation of Schedule UTP is likely to reduce the need for some of the information currently reported on the Schedule M-3. The working group will begin its work in 2011 and will work with external stakeholders to develop appropriate revisions to the Schedule M-3.

The Service also will be expanding the Compliance Assurance Program (CAP) and making it permanent. The Service intends that the permanent CAP will consist of three phases: pre-CAP, which will allow a taxpayer to become current on the audit cycle while demonstrating the requisite transparency needed to be eligible for CAP; CAP, which will resemble the existing CAP pilot program; and CAP maintenance, which will call for the reduction of resources and taxpayer contact for those taxpayers in this phase as appropriate. Details will be contained in the upcoming CAP permanence guidance that is expected to be released shortly.

*Exchange of information with foreign governments*

Concerns have been raised that the Service will automatically disclose information reported on the Schedule UTP to foreign governments. The Service intends to generally refrain from providing Schedule UTP information to other governments except in those circumstances in which there is a reciprocal arrangement with the foreign government regarding uncertain-tax-position information, such as where the foreign government collects similar information for its own tax administration purposes and agrees to make this information available to the Service in a similar manner. In addition, even if reciprocity did exist, the Service would consider other factors in determining whether to disclose the information, including the relevance of the information to the foreign government, which in many cases would not be present.

### *Future guidance and changes*

While the instructions provide initial guidance concerning filing of Schedule UTP, the Service recognizes that they do not address every issue raised by commentators. For example, the instructions do not address issues related to the reporting of tax positions in the year in which a corporation is acquired or disposed of. As another example, a number of commentators recommended the instructions address the level or type of due diligence required to obtain reserve information from a related party or information from a pass-through entity relating to a corporation's uncertain tax position involving the pass-through entity. Other issues will arise as the Service and corporations gain experience with the schedule. The Service will continue to consider these issues and how best to provide further guidance.

In addition, the Service will review the completeness and utility of Schedule UTPs filed by corporations, beginning with 2010 tax years, and modify the schedule and instructions as appropriate. For example, the Service will review the reporting of transfer pricing positions on Schedule UTP and consider whether additional information, such as the specific country, character of income, or other facts are necessary to provide sufficient information regarding the identity and nature of those tax positions.

### *Penalties*

A number of commentators recommended that the Service expressly state that penalties will not be imposed, either permanently or during a transition period, for reporting failures regarding Schedule UTP. The final instructions do not provide specific instructions regarding penalties. The Service intends to review compliance regarding how the schedule is completed by corporations and to take appropriate enforcement

action, including the possibility of opening an examination or making another type of taxpayer contact, in those instances in which there appears to be a failure to complete the schedule or a failure to report whether the corporation is required to complete the schedule.

*Coordination with Forms 8275 and 8886*

Some commentators suggested the Service provide that in certain circumstances a corporation need not file Form 8886, Reportable Transaction Disclosure Statement, if a reportable transaction is disclosed on Schedule UTP. A number of commentators recommended that the Service expressly provide that disclosure of a tax position on Schedule UTP constitutes disclosure of the position to avoid penalties under sections 6662(b)(6) and 6662(i) involving an underpayment due to a claimed tax benefit because of a transaction lacking economic substance.

The final Schedule UTP instructions state that 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 or Form 8275-R regarding the tax position and that a separate Form 8275 or 8275-R need not be filed to avoid certain accuracy-related penalties with respect to that tax position. Consistent with Notice 2010-62, issued September 13, 2010, in the case of a transaction that is not a reportable transaction, the Service will treat a complete and accurate disclosure of a tax position on Schedule UTP as satisfying the disclosure requirements of section 6662(i). The Service is studying other ways to reduce duplicate reporting and is considering whether complete and accurate disclosure on Schedule UTP would also, in appropriate circumstances, provide the information necessary to satisfy the reportable transaction disclosure requirements.

The principal author of this announcement is Kathryn Zuba of the Office of the Associate Chief Counsel (Procedure and Administration). For further information regarding this Announcement contact Kathryn Zuba at (202) 622-3400 (not a toll-free call). For questions relating to Schedule UTP and instructions contact Deborah Palacheck at (202) 283-8710 (not a toll-free call).

## Part IV – Items of General Interest

### Requests for Documents Provided to Independent Auditors, Policy of Restraint and Uncertain Tax Positions

#### Announcement 2010-76

The Internal Revenue Service is expanding its policy of restraint in connection with its decision to require certain corporations to file Schedule UTP, Uncertain Tax Position Statement, and will forgo seeking particular documents that relate to uncertain tax positions and the workpapers that document the completion of Schedule UTP.

#### BACKGROUND

Schedule UTP requires a specified class of corporations to provide a concise description of each uncertain tax position for which the corporation or a related entity has recorded a reserve in its financial statements, or for which no reserve has been recorded because of an expectation of litigation. These uncertain tax positions are identified by corporations during the process of preparing financial statements under applicable accounting standards, such as FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48).<sup>1</sup> In reviewing and verifying financial statements for compliance with FIN 48, independent auditors may ask for copies of legal opinions and other documents in order to

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<sup>1</sup> Under the codification of accounting standards, the relevant portions of FIN 48 are now contained in Accounting Standards Codification subtopic 740-10, Income Taxes. FASB ASC 740-10.

understand transactions, to understand the legal bases for the treatment of transactions, and to determine the adequacy of reserves for contingent tax liabilities.

#### POLICY OF RESTRAINT

(1) If a document is otherwise privileged under the attorney-client privilege, the tax advice privilege in section 7525 of the Code, 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.

(2) Paragraph (1) does not apply if

(a) the taxpayer has engaged in any activity or taken any action, other than those described in that paragraph, that would waive the attorney-client privilege, the tax advice privilege in section 7525 of the Code, or the work product doctrine; or

(b) a request for tax accrual workpapers is made under IRM 4.10.20.3 because unusual circumstances exist or the taxpayer has claimed the benefits of one or more listed transactions.

(3) Under current procedures, examiners request tax reconciliation workpapers as a matter of course. IRM 4.10.20.3. The taxpayer may redact the following information from any copies of tax reconciliation workpapers relating to the preparation of Schedule UTP it is asked to produce during an examination:

(a) working drafts, revisions, or comments concerning the concise description of tax positions reported on Schedule UTP;

(b) the amount of any reserve related to a tax position reported on Schedule UTP; and

(c) computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a Major Tax Position.

(4) Other than requiring the disclosure of the information on the schedule, the requirement to file Schedule UTP does not affect the policy of restraint.

(5) This Announcement describes the policy of the Service for seeking the documents described in paragraph 1 and 3 from taxpayers and third parties during an examination. It does not create or imply the application of the attorney-client privilege, the tax advice privilege under section 7525 of the Code, or the work product doctrine to any document of any taxpayer or third party.

(6) These modifications to the policy of restraint will be incorporated into IRM 4.10.20.

#### DRAFTING INFORMATION

The principal author of this announcement is Kathryn Zuba of the office of Associate Chief Counsel (Procedure and Administration). For further information regarding this announcement contact Kathryn Zuba at (202) 622-3400 (not a toll-free call).

# 2010

# Instructions for Schedule UTP



Department of the Treasury  
Internal Revenue Service

## Uncertain Tax Position Statement

Section references are to the Internal Revenue Code unless otherwise noted.

## General Instructions

### Purpose of Schedule

Schedule UTP asks for information about tax positions that affect the U. S. federal income tax liabilities of certain corporations that issue or are included in audited financial statements and have assets that equal or exceed \$100 million.

### Reporting Uncertain Tax Positions on Schedule UTP

#### Tax positions to be reported.

Schedule UTP requires the reporting of each U.S. federal income tax position taken by an applicable corporation on its U.S. federal income tax return for which two conditions are satisfied.

1. The corporation has taken a tax position on its U.S. federal income tax return for the current tax year or for a prior tax year.
2. Either 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 tax position because the corporation expects to litigate the position.

A tax position for which a reserve was recorded (or for which no reserve was recorded because of an expectation to litigate) must be reported regardless of whether the audited financial statements are prepared based on U. S. generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS), or other country-specific accounting standards, including a modified version of any of the above (for example, modified GAAP).

A tax position is based on the unit of account used to prepare the audited financial statements in which the reserve is recorded (or in which no

reserve was recorded because of an expectation to litigate). A tax position taken on a tax return is a tax position that would result in an adjustment to a line item on that tax return if the position is not sustained. If multiple tax positions affect a single line item on a tax return, report each tax position separately on Schedule UTP. See *Tax position taken on a tax return* on page 2.

#### Reporting current year and prior year tax positions.

Tax positions taken by the corporation on the current year's tax return are reported in Part I. Tax positions taken by the corporation on a prior year's tax return are reported on Part II. A corporation is not required to report a tax position it has taken in a prior tax year if the corporation reported that tax position on a Schedule UTP filed with a prior year tax return. If a transaction results in tax positions taken on more than one tax return, the tax positions must be reported in Part I of the Schedule UTP attached to each tax return in which a tax position is taken regardless of whether the transaction or a tax position resulting from the transaction was disclosed in a Schedule UTP filed with a prior year's tax return. See Example 6 and Example 7. Do not report a tax position on Schedule UTP before the tax year in which the tax position is taken on a tax return by the corporation.

**Note.** Part II will not be completed for Schedule UTP for the 2010 tax year, because tax positions taken before the 2010 tax year are not reported. See *Transition rule* below.

#### Concise description of tax position.

A corporation that reports a tax position in Part I (or Part II after the 2010 tax year) is required to provide a concise description of each tax position in Part III. See Examples 10 through 12.

#### Consistency with financial statement reporting.

The analysis of whether a reserve has been recorded for the purpose of completing Schedule UTP is determined by reference to those reserve decisions made by the corporation or a related party for audited financial statement purposes. 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.

**Transition rule.** A corporation is not required to report on Schedule UTP a tax position taken in a tax year beginning before January 1, 2010, even if a reserve is recorded with respect to that tax position in audited financial statements issued in 2010 or later. See Example 8.

**Periods covered.** File a 2010 Schedule UTP with the 2010 income tax return for the calendar year 2010 and for a fiscal year that begins in 2010 and ends in 2011. A corporation is not required to file a Schedule UTP for a short tax year that ends in 2010.

### Who Must File

A corporation must file Schedule UTP with its income tax return if:

1. The corporation files Form 1120, U.S. Corporation Income Tax Return; Form 1120-F, U.S. Income Tax Return of a Foreign Corporation; Form 1120-L, U.S. Life Insurance Company Income Tax Return; or Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return;
2. The corporation has assets that equal or exceed \$100 million;
3. 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 tax year; and
4. The corporation has one or more tax positions that must be reported on Schedule UTP.

Attach Schedule UTP to the corporation's income tax return. Do not file it separately. A taxpayer that files a protective Form 1120, 1120-F, 1120-L, or 1120-PC must also file Schedule UTP if it satisfies the four requirements set forth above.

A corporation required to file Schedule UTP also must check "Yes" to

Form 1120, Schedule K, Question 14; Form 1120-F, Additional Information, Question AA; Form 1120-L, Schedule M, Question 15; or Form 1120-PC, Schedule I, Question 13.

### **Computation of assets that equal or exceed \$100 million.**

**Forms 1120, 1120-L, and 1120-PC.** A corporation's assets equal or exceed \$100 million if the amount reported on page 1, item D of Form 1120, or the higher of the beginning or end of year total assets reported on Schedule L of Form 1120-L or Form 1120-PC, is at least \$100 million.

**Form 1120-F.** The assets of a corporation filing a Form 1120-F equal or exceed \$100 million if the higher of the beginning or end of year total worldwide assets of the corporation reported on Form 1120-F, Schedule L, Line 17, would be at least \$100 million if the corporation were to prepare a Schedule L on a worldwide basis.

**Affiliated groups.** An affiliated group of corporations filing a consolidated return will file a Schedule UTP for the affiliated group. The affiliated group need not identify the member of the group to which the tax position relates or which member recorded the reserve for the tax position. Any affiliate that files its U.S. federal income tax return separately and satisfies the requirements set forth above must file a Schedule UTP with its return setting forth its own tax positions.

## **Definitions and Special Rules**

**Note.** All examples in these instructions assume the calendar year is the reporting year both for U.S. federal income tax and financial statement purposes and the independent auditor's opinion on the audited financial statements is issued before the filing of the tax return.

**Audited financial statements.** Audited financial statements mean financial statements on which an independent auditor has expressed an opinion, whether qualified, unqualified, disclaimed, or adverse, under GAAP, IFRS, or another country-specific accounting standard, including a modified version of any of the above (for example, modified GAAP). Compiled or reviewed financial statements are not audited financial statements.

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

The initial recording of a reserve will trigger reporting of a tax position taken on a return. However, subsequent reserve increases or decreases with respect to the tax position will not.

If a corporation is included in multiple audited financial statements, the corporation must report a tax position on Schedule UTP if a reserve for that position was recorded in any of those audited financial statements.

**Example 1. General rule regarding recording a reserve.** A corporation records a reserve in its 2010 audited financial statements relating to a tax position taken on its tax return for the 2010 tax year. The corporation files its 2010 tax return on September 15, 2011. The corporation must report the 2010 tax position on Part I of Schedule UTP and file Schedule UTP with its 2010 tax return. If the corporation increases its reserve with respect to the tax position taken on its 2010 tax return in its 2012 audited financial statements, the corporation is not required to report the 2010 tax position again on its 2012 tax return as a result of the reserve increase in 2012.

**Related party.** A related party is any entity that has a relationship to the corporation that is described in sections 267(b), 318(a), or 707(b), or any entity that is included in consolidated audited financial statements in which the corporation is also included.

**Example 2. Related party general rule.** Corporation A is a corporation filing Form 1120 that has \$160 million of assets. Corporation B is a foreign corporation not doing business in the United States and is a related party to Corporation A. Corporations A and B issue their own audited financial statements. Corporation A takes a tax position on its tax return. If Corporation B records a reserve with respect to that tax position in its own audited financial statements, even though Corporation A does not, then that tax position must be reported by Corporation A on its Schedule UTP.

**Example 3. Reserve recorded in consolidated financial statements.** Corporation C files a tax return and has assets of \$160 million. Corporations C and D issue consolidated audited financial statements, but they do not file a consolidated tax return. Corporation C takes a tax position for which a reserve was recorded in the consolidated financial statements of Corporations C and D. The tax position taken by Corporation C on its tax return must be reported on its Schedule UTP because a reserve was recorded for its tax position in consolidated financial statements in which Corporation C was included.

**Reserve not recorded based on expectation to litigate.** A corporation must report on Schedule UTP a tax position taken on its return for which no reserve for income tax was recorded 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 the litigation.

**Tax position taken on a tax return.** A tax position taken on a tax return means 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(a) adjustment) if the position is not sustained. If multiple tax positions affect a single line item on a tax return, each tax position is a separate tax position taken on a tax return.

A single decision about how to report an item of income, gain, loss, deduction, or credit may affect line items in multiple years' returns. If so, that decision can result in a tax position taken on each affected year's return. For example, a decision to amortize an expense rather than currently deduct that expense, or a decision to currently deduct rather than amortize an expense, affects line items on each year's return in which the tax position is taken during the period of amortization. Whether these tax positions taken on a return are reported on Schedule UTP for a particular tax year, and when they are reported, depends on whether and when a reserve is recorded. See Example 6 and Example 7.

**Example 4. Use of expiring net operating loss carryforward.** A corporation has a \$100 net operating loss carryforward that will expire unless it is used in the 2010 tax year. The corporation reports \$100 of income in 2010 but is uncertain whether the income should be reported in 2010 or 2011. The corporation has taken a tax position on each of its 2010 and 2011 tax returns because on each return there would be an adjustment to a line item on that return if the position taken in that year is not sustained.

**Unit of account.** A unit of account is the level of detail used in analyzing a tax position, taking into account both the level at which the taxpayer prepares and supports the tax return and the level at which the taxpayer anticipates addressing the issue with the IRS. The unit of account used by a GAAP or modified GAAP taxpayer for reporting a tax position on Schedule

UTP must be the same unit of account used by the taxpayer for GAAP or modified GAAP.

In the case of audited financial statements prepared under accounting standards other than GAAP or modified GAAP, a corporation that issues audited financial statements with a unit of account that is based upon the entire tax year may not use that unit of account for Schedule UTP. The corporation must instead identify a unit of account based on similar principles applicable to GAAP or modified GAAP taxpayers, or use any other level of detail that is consistently applied if that identification is reasonably expected to apprise the IRS of the identity and nature of the issue underlying the tax position taken on the tax return.

**Example 5. Unit of account.**

Corporation A and Corporation B each have two individual research projects and each anticipates claiming a research and development credit arising out of their projects. Corporation A chooses each individual research project as the unit of account for GAAP financial reporting purposes, since the corporation accumulates information for the tax return about the projects at the project level and expects the IRS to address the issues during an examination of each project separately. Corporation B determines that the appropriate unit of account for GAAP financial reporting purposes is the functional expenditures, based on the amount of its expenditures, the anticipated credits to be claimed, its previous experience, and the advice of its tax advisors. Based on the unit of account used for financial reporting purposes, Corporation A must use each project as its unit of account for Schedule UTP reporting, and Corporation B must use functional expenditures as its unit of account for Schedule UTP reporting, regarding the research and development credit.

### Ranking Tax Positions by Size

The corporation must rank by size each tax position listed in Part I. The size of a tax position, however, need not be reported anywhere on Schedule UTP. See the instructions for Part I, column (f), regarding coding to be used to rank the corporation's tax positions.

**Size.** The size of each tax position is determined on an annual basis and is the amount of U.S. federal income tax reserve recorded for that position. If a reserve is recorded for multiple tax positions, then a reasonable allocation of that reserve among the tax positions to which it relates must be made in determining the size of each tax position.

**Expectation to litigate.** Do not determine a size for positions listed because of an expectation to litigate. See the instructions for Parts I and II, column (f), regarding ranking of these positions.

**Affiliated groups.** The determination of the size of a tax position taken in a tax return by an affiliated group filing a consolidated return is to be determined at the affiliated group level for all members of the affiliated group.

### Coordination with Other Reporting Requirements

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. A separate Form 8275 or Form 8275-R need not be filed to avoid certain accuracy-related penalties with respect to that tax position.

### Comprehensive Examples

**Example 6. Multiple year positions.** A corporation incurs an expenditure in 2010 and claims the entire amount as a deduction on its 2010 return. During the course of reviewing its tax positions for purposes of establishing reserves for U.S. federal income taxes for its 2010 audited financial statements, the corporation determines it is uncertain whether the expenditure should instead be amortized over 5 years and records a reserve with respect to the position taken in 2010. The corporation did not record a reserve for any of the positions taken in tax years 2011 through 2014. The corporation has taken a tax position in each of the 5 tax years because, on each year's tax return, there would be an adjustment to a line item on that return if the position taken in that year's return is not sustained. The tax position taken in the 2010 tax year must be reported on Part I of Schedule UTP filed with the 2010 tax return. None of the 2011 to 2014 tax positions must be reported on Schedule UTP because the corporation did not record a reserve with respect to any of those tax positions.

**Example 7. Multiple year positions.** A corporation incurs an expenditure in 2010 and takes the position that the expenditure may be amortized over 5 years beginning on its 2010 tax return. During the course of reviewing its tax positions for purposes of establishing reserves for U.S. federal income taxes for its 2010 audited financial statements, the corporation

determines it is uncertain whether any deduction or amortization of this expenditure is allowable. In the 2010 audited financial statements, the corporation records a reserve with respect to the amortization deduction to be claimed in each tax year. The corporation has taken a tax position in each of the 5 tax years because on each year's tax return there would be an adjustment to a line item on that return if the position taken in that year is not sustained. The corporation must report the 2010 tax position on Part I of Schedule UTP for the 2010 tax year. In addition, the tax position to be taken in each of the 2011 to 2014 tax years must be reported on Part I of the Schedule UTP filed with the tax return for the respective tax year in which the tax position was taken. The result would be the same if, instead of recording the reserve in 2010 for all of the tax positions taken in each of the five years, the corporation records a reserve in each year that specifically relates to the tax position taken on the return for that year.

**Example 8. Transition rule.** The facts are the same as in Example 7, except that the corporation incurred the expenditure and recorded the reserve in 2009. The corporation has taken a tax position in each of the 5 tax years (2009 through 2013) because on each year's tax return there would be an adjustment to a line item on that return if the position taken in that year is not sustained. However, the corporation should not report the tax position taken in the 2009 tax year because it was taken in a tax year beginning before January 1, 2010. The tax position taken in each of the 2010 to 2013 tax years must be reported on Part I of the Schedule UTP filed with the tax return for the respective tax year in which the position was taken.

**Example 9. Creation and use of net operating loss (NOL).** 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.

## Specific Instructions

### Part I Uncertain Tax Positions For the Current Tax Year

#### When to Complete Part I

Part I is used to report tax positions taken by the corporation on its 2010 tax return.

#### Information from Related Parties

Check the box at the top of Part I if the corporation was unable to obtain sufficient information from one or more related parties and was therefore unable to determine whether a tax position taken on its current year's tax return is required to be reported in Part I of this schedule.

#### Column (a). UTP No.

Enter a number in column (a) for each tax position reported. A corresponding number will be used in Part III for reporting the concise description of the tax position. Begin with the number 1 and do not skip any whole numbers.

#### Column (b). Primary IRC Sections

Provide the primary IRC sections (up to three) relating to the tax position.

#### Column (c). Timing Codes

Check "T" for temporary differences, "P" for permanent differences, or check both "T" and "P" for a tax position that creates both a temporary and permanent difference. Categorization as a temporary difference, permanent difference, or both must be consistent with the accounting standards used to prepare the audited financial statements.

#### Column (d). Pass-Through Entity EIN

If the tax position taken by the corporation relates to a tax position of a pass-through entity, enter the EIN of the pass-through entity to which the tax position relates. For example, if the corporation is a partner in a partnership

and the tax position involves the partner's distributive share of an item of income, gain, loss, deduction, or credit of the partnership, enter the EIN of the partnership. A pass-through entity is any entity listed in section 1(h)(10). If the tax position is not related to a tax position of a pass-through entity, leave this blank. Enter "F" if the pass-through entity is a foreign entity that does not have an EIN.

#### Column (e). Major Tax Position

Check this box if the relative size of the tax position is greater than or equal to 0.10 (10%). The relative size of a tax position is the amount computed by dividing the size of that position by the sum of all of the sizes for all of the tax positions listed on Parts I and II. Disregard expectation to litigate positions for column (e) purposes. Round amounts using rules similar to those on page 5 of the Instructions for Form 1120 for rounding dollar amounts.

#### Column (f). Ranking of Tax Position

Enter a letter and a ranking number for each tax position. Use the letter T for transfer pricing positions and the letter G for all other tax positions.

Rank all tax positions in Parts I and II together, regardless of type. Starting with the largest size, assign the number 1 to the largest, the number 2 to the next largest, and so on, in order. This number is the ranking number for the tax position. Expectation to litigate positions may be assigned any ranking number.

For example, the corporation has 1 transfer pricing tax position and 2 other tax positions. The transfer pricing position is the largest and one of the other tax positions is the expectation to litigate position. The expectation to litigate position is assigned a rank of 2. Enter T1 for the transfer pricing position, G2 for the expectation to litigate position, and G3 for the second other tax position.

### [Part II will not be completed in 2010]

### Part II Uncertain Tax Positions For Prior Tax Years

#### When to Complete Part II

Part II will be used in tax years after 2010 to report tax positions taken by the corporation in a prior tax year that have not been reported on a Schedule UTP filed with a prior year's tax return. It will not be completed in 2010, because corporations are not required

to report a tax position taken in a tax year beginning before January 1, 2010. See *Transition rule* on page 1.

#### Information from Related Parties

Check this box if the corporation was unable to obtain sufficient information from one or more related parties and was therefore unable to determine whether a tax position taken in a prior year's tax return is required to be reported on Part II of this schedule.

#### Column (a). UTP No.

Continue the numeric sequence based on the last UTP number entered on Part I. For example, if the last UTP listed on Part I is 10, enter 11 for the first UTP listed on Part II.

#### Column (b). Primary IRC Sections

See the instructions for Part I, column (b).

#### Column (c). Timing Codes

See the instructions for Part I, column (c).

#### Column (d). Pass-Through Entity EIN

See the instructions for Part I, column (d).

#### Column (e). Major Tax Position

See the instructions for Part I, column (e).

#### Column (f). Ranking of Tax Position

See the instructions for Part I, column (f).

#### Column (g). Year of Tax Position

List the prior tax year in which the tax position was taken and the last month of that tax year, using a six-digit number. For example, enter 201012 for tax years ending December 31, 2010, and 201108 for tax years ending August 2011.

### Part III Concise Description of UTPs

#### When to Complete Part III

Part III must be completed for every tax position listed in Part I (or Part II in tax years after 2010). Enter the corresponding UTP number from Part I, column (a), related to the description.

**Concise description.** Provide 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. In

most cases, the description should not exceed a few sentences. Stating that a concise description is “Available upon Request” is not an adequate description.

A concise description should not include an assessment of the hazards of a tax position or an analysis of the support for or against the tax position.

### **Examples of Concise Descriptions for Hypothetical Fact Patterns**

The following examples set out a description of hypothetical facts and the uncertainties about a tax position that would be reportable on Schedule UTP. Following each set of hypothetical facts, which would not be disclosed on the schedule, is an example of a sufficient concise description that would be reported in Part III to disclose that hypothetical case.

#### **Example 10.**

**Facts.** 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 corporation established a reserve for financial accounting purposes in recognition of the possibility that the amount of costs allocated to the uncompleted acquisition attempts was excessive.

**Sample concise description.** The corporation incurred costs of completing one business acquisition and also incurred costs investigating and partially negotiating 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 uncompleted acquisitions and the completed acquisition is appropriate.

#### **Example 11.**

**Facts.** The corporation is a member of Venture LLC, which is treated as a U.S. partnership for tax purposes. During the taxable year, Venture LLC raised funds through (i) admitting a new member for a cash contribution and (ii) borrowing funds from a financial institution, using a loan partially guaranteed by the corporation. Also during the tax year, Venture LLC made a cash distribution to the corporation that caused its membership interest in Venture LLC to be reduced from 25% to 2%. The corporation has taken the position that the cash distribution is properly characterized as a nontaxable distribution that does not exceed its basis in its Venture LLC interest, but has established a reserve for financial accounting purposes, recognizing that the transaction might be recharacterized as a taxable sale of a portion of its Venture LLC interest under section 707(a)(2).

**Sample concise description.** 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.

#### **Example 12.**

**Facts.** The corporation incurred costs during the tax year to clean up environmental contamination caused in prior years by its operations at Site A. Site A contains both the corporation’s manufacturing plant and its corporate headquarters. Based on its analysis that the cleanup activities equally benefited both the manufacturing plant and its corporate headquarters, the corporation allocated the environmental cleanup costs equally between them. It capitalized the portion of environmental cleanup costs allocated to its manufacturing plant to inventory produced during the taxable year and deducted the portion of environmental cleanup costs allocated to its corporate headquarters. The corporation established a reserve for financial accounting purposes in recognition of the possibility that a portion of the current year deduction of costs allocated to the corporate headquarters might be reallocated to the manufacturing plant.

**Sample concise description.** The corporation incurred costs during the tax year to clean up environmental contamination that was caused by its activities in prior years at site A, which contains both its manufacturing facility and its corporate headquarters. The issue is the allocation of the cleanup costs between X’s production and non-production activities under section 263A.



Name of entity as shown on page 1 of tax return	EIN of entity
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This Part II, Schedule UTP (Form 1120) is page        of        Part II pages.

**Part II** **Uncertain Tax Positions for Prior Tax Years. Do not complete for 2010.**

(a) UTP No.	(b) Primary IRC Section (e.g., "61", "108", etc.)	(c) Timing Codes (check if Permanent, Temporary, or both)	(d) Pass-Through Entity EIN	(e) Major Tax Position	(f) Ranking of Tax Position	(g) Year of Tax Position
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DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

9/24/2010

DIRECTIVE FOR ALL LARGE BUSINESS AND INTERNATIONAL DIVISION (LB&I)  
PERSONNEL

FROM: Steven T. Miller  
Deputy Commissioner for Services and Enforcement

SUBJECT: Reporting of Uncertain Tax Positions

**Background**

Starting with the 2010 tax year certain corporate taxpayers under the jurisdiction of the Large Business and International Division (LB&I) of the Internal Revenue Service (IRS) will be required to file a Schedule UTP with their Form 1120. The Schedule UTP requires the disclosure of a taxpayer's uncertain tax positions (UTPs) as described in the Schedule UTP instructions. The Schedule UTP is intended to reduce the time it takes to find issues; ensure that the IRS and taxpayers spend more time discussing the law as it applies to their facts, rather than looking for information; identify areas of uncertainty requiring guidance; and help prioritize selection of issues and taxpayers for examination. This directive sets forth the IRS's planned treatment of these UTPs by LB&I examiners and other personnel.

**Policy on Use**

**Research & Workload Identification (RWI) Processing**

A centralized process will be established within LB&I to review and analyze UTPs. This centralized process will enable LB&I to determine whether the disclosures are in compliance with the schedule instructions and to select issues and returns for audit, identify trends, identify and understand gaps in guidance, and determine the proper treatment of the UTPs. The proper treatment may include publishing guidance necessary to eliminate uncertainty wherever possible, as well as identifying areas for possible legislative changes. In addition, possible treatment may include referral to appropriate personnel to determine the correct legal analysis or to assure fair and consistent treatment across examinations.

**Audit Techniques**

Our responsibility with respect to all of our compliance activities is to administer an equitable and balanced examination program. Key to achieving that goal is for us to

approach each examination with impartiality. LB&I examiners should approach UTPs on audit keeping in mind their responsibility to apply the law as it currently exists, not how we would like it to be. We must do this without bias in favor of the government or the taxpayer. This is the key to meeting our mission of fair and balanced tax administration.

In addition, essential 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.

The Schedule UTP is intended to advance to earlier in the process discussions with the taxpayer regarding its important issues. As a result, examiners need to engage with taxpayers early in the process to eliminate uncertainty as quickly as possible, whenever possible. Examiners should continue to use tools available to them to accomplish this early engagement including the Quality Examination Planning process introduced in June 2010. Further, as part of the Quality Examination Planning process, LB&I examiners should discuss the issues disclosed on the Schedule UTP in advance of issuing the initial information document requests (IDRs). The current quality review standards will also be adjusted to ensure that LB&I examiners follow these processes. In addition, guidance will be given to examiners regarding how the policy of restraint will apply to Schedule UTP reporting. For example, Announcement 2010-76.

Over the next year, LB&I examiners will receive training specific to the handling of UTPs.

With the principles described above along with the outlined actions to be taken over the next year, I am certain that the implementation of the Schedule UTP will be successful.



## Prepared Remarks of IRS Commissioner Doug Shulman to the American Bar Association

IR-2010-98, Sept. 24, 2010

WASHINGTON — Following is a speech delivered by IRS Commissioner Doug Shulman today in Toronto, Canada. (See links to related materials at end of this document.)

It is my great honor and privilege to be in Toronto addressing the ABA.

It is a very busy time at the IRS. And while I could speak to you today about many important issues, ranging from:

- Our international efforts, including the recent announcement of the realignment and renaming of our Large and Mid-Size Business Division to Large Business and International;
- To our return preparer initiative;
- To our efforts to implement recent legislation;

I would like instead to focus today on transparency which is part of our larger strategy to get to and resolve taxpayer issues more quickly.

I have been clear since my first day on the job that I thought transparency and increased information flow were the key to the future of sound, fair and efficient tax administration.

If we receive information with tax returns and from third parties, we can identify potential non-compliance more efficiently and target our resources more effectively. I also believe the concept of more transparency is consistent with our nation's historic framework of a voluntary compliance system. Our tax system is set up in such a way that taxpayers fill out their own returns. This self-assessment system reflects the fact that it is the taxpayer, and not the IRS, who possesses all of the information relevant to tax liability. We then use information reported by the taxpayer to make judgments about issues to pursue, and returns to audit.

Inherent in this system is the basic assumption that a taxpayer will be forthcoming in dealing with the IRS with respect to the items it has reported on its tax return, including the underlying positions related to those items. But this is much more than an assumption – it is the foundation on which our tax system is built.

Guided by the fundamental principle that transparency is essential to achieving an effective and efficient self-assessment tax system, the IRS took a major step towards transparency with Announcement 2010-9. It described our proposal to require business taxpayers to report basic information regarding their uncertain tax positions when they filed their tax returns.

I believe that it helps achieve what most taxpayers and the IRS strive for and basically want:

- We want certainty regarding a taxpayer's tax obligations sooner rather than later;
- We want consistent treatment across taxpayers; and
- We want an efficient use of government and taxpayer resources by focusing on issues and taxpayers that pose the greatest risk of tax noncompliance.

As I said last January when the announcement was released, and as I still believe today, our proposal represented a reasonable approach. But I also believed that it was important to allow taxpayers an opportunity to provide input on the proposal.

So while it is unusual for the IRS to provide drafts of forms and instructions in advance of their implementation, in April we released a draft of the Schedule UTP and its instructions and asked for public comments regarding the overall proposal and the specifics of those drafts. I thought this step was essential to facilitate meaningful comment on the details of the proposal.

We have worked very hard to engage in a constructive dialogue to address legitimate concerns regarding the

design and implementation of the proposal.

This morning, I am pleased to announce that we have completed our review of the comments and later today will be releasing the final Schedule UTP and its instructions effective for 2010 tax years. At the same time, we will be releasing a directive to the field, and important modifications to the policy of restraint that will provide guidance to IRS examiners and other personnel regarding how we will implement UTP reporting.

But before I discuss the final Schedule UTP and how it differs from the original proposal, I want to once again discuss our goals in developing the requirement to report uncertain tax positions. These goals are simple:

- Create certainty sooner for taxpayers;
- Cut down the time it takes to find issues and complete an audit, which benefits both the IRS and taxpayers;
- Ensure that both the IRS and taxpayer spend more time discussing the law as it applies to their facts, and less time looking for information;
- Help us prioritize taxpayers for examination;
- Help us identify issues where there is uncertainty and where we need to develop further guidance;
- Help us prioritize selection of issues during an audit; and
- Obtain key information regarding uncertain tax positions without getting into the heads of the taxpayers or their advisors, as it relates to quantifying risk.

I believe the final Schedule UTP that is being released today fulfills these goals in a very balanced and sensible fashion. The final product addresses important concerns expressed by affected taxpayers and the practitioner and business community and moves us towards our shared objectives of efficiency, earlier certainty, and consistency of tax administration regarding corporate taxpayers.

Let me take a few minutes to discuss the major comment areas and describe how we made important changes to address those that we determined would improve the proposal while preserving its core objectives.

To start I would like to focus on a set of comments that could be best characterized as concerns regarding the technical aspects of and burden associated with filing the schedule.

The first of these relates to questions raised about who should have to file the new schedule beginning with the 2010 tax year. We initially proposed that it should be all companies with over \$10 million in assets who issue audited financial statements. We heard concerns that this was too much too soon for smaller companies.

In response, we have instituted a five-year phase in for filing the schedule. The largest corporations – those with \$100 million or more in assets will file beginning with 2010 tax years ... those with \$50 million in assets beginning two years later ... and those with \$10 million in assets beginning two years after that. This will give corporations with total assets under \$100 million additional time to comply with the new reporting requirement.

Next, I would like to discuss the proposed requirement that Schedule UTP filers include a calculation of the Maximum Tax Adjustment, or MTA, with respect to each tax position included on the schedule. We felt we needed to size issues in order to prioritize audit selection and issue focus. However, we asked taxpayers if there was another way to ascertain a sense of materiality or order of magnitude.

We received many comments on this proposed requirement that on the whole expressed two basic concerns: (1) that the requirement was burdensome because an MTA was not currently being calculated; and (2) that the MTA would in many cases be significantly greater than any potential adjustment with respect to an issue – giving the IRS a distorted view related to the risk of particular issues.

After hearing these concerns and reviewing alternative approaches, we decided to eliminate the MTA requirement as a means to quantify the reported positions. Instead of assigning a specific maximum tax adjustment to a position, the final Schedule UTP requires a filer to rank its UTPs from highest to lowest based on the size of the position. Taxpayers will use U.S. federal income tax reserve amounts to rank the positions on the schedule, but

will not be asked to provide reserve amounts anywhere on the schedule.

The last area I want to touch on in this comment category is the requirement to identify positions that a taxpayer did not reserve for either because of a taxpayer's expectation to litigate the issue or because of an administrative practice of the IRS. Related to this were comments seeking clarification regarding the reporting of tax positions that were immaterial or unambiguous.

With respect to the disclosures required for positions that are not subject to a reserve due to an administrative practice of the IRS – after reviewing the comments, we determined that the concerns about the administrability of this requirement outweighed the value of the information that may be included. Therefore, we have eliminated the requirement to report so-called “administrative practice” positions.

Regarding the “expect to litigate” category, we ultimately determined that the information provided by this requirement was necessary to meet our goals. However, we clarified the instructions to respond to concerns that this category could have been read more broadly than it was intended and could require disclosure of highly certain or immaterial positions.

Taken together, these changes – the phased-in implementation of the Schedule for corporations with assets under \$100 million; the elimination of the requirement to calculate and include a maximum tax adjustment for each position; the clarification of the expect to litigate requirement; and the elimination of administrative practice positions – address important burden and reporting concerns raised by affected taxpayers and their representatives, while still allowing us to achieve the proposal's goals.

The next major category of comments concerned how the proposal impacted privilege and the IRS' long standing policy of restraint.

We received comments about the potential sensitivity of the requirement for Schedule UTP filers to provide a concise description for all uncertain tax positions included on the Schedule UTP. These comments raised concerns that the disclosure of tax positions on Schedule UTP could enable adversaries to raise questions of waivers of privilege with respect to confidential communications related to the disclosed tax positions.

We believe these concerns principally arose from the fact that the draft instructions required Schedule UTP filers to provide the rationale for a position reported on the Schedule along with a description of the nature of the uncertainty related to that position. The final instructions eliminate these requirements and make it clear that a taxpayer need only disclose information sufficient to identify the issue and the relevant facts. In addition, the instructions now specifically state that the concise description should not include information related to the corporation's assessment of the hazards of a tax position or an analysis of the support for or against the tax position.

I believe that this significant change, made in response to comments we received, will continue to provide us with the information we need while at the same time addressing the concerns raised about privilege.

We are also releasing today an announcement that clarifies and strengthens the policy of restraint. There are three key changes described in today's announcement that I want to bring to your attention:

- We provide that disclosing issues on the Schedule UTP does not otherwise affect the protections afforded under the policy of restraint.
- We provide that drafts of issue descriptions and information regarding quantification or ranking of issues are protected under the policy.
- We adopt a policy that we will not seek documents that would otherwise be privileged, even though the taxpayer has disclosed the document to a financial auditor as part of an audit of the taxpayer's financial statements.

These changes are designed to reassure taxpayers that we are not seeking their legal analysis or risk assessments. We are instead seeking issue identification that will help accomplish our shared goals of efficiency, certainty, and consistency that I described earlier. I remain committed to the important taxpayer protections

afforded by the longstanding IRS policy of restraint and under existing privilege laws.

The final major area of comments I would like to address this morning relates to concerns raised, not about the proposal itself, but instead about how the IRS will use the information it receives on Schedule UTP. Many of the comments voiced anxiety about how IRS agents would use the information reported on the schedule during examinations.

To address these concerns, and make clear our expectations for how the information should be used, we are releasing a directive to the field later today that will provide initial guidance to the IRS personnel who will be on the front lines administering the new UTP reporting requirements.

The directive makes clear that we expect examiners to engage with taxpayers early in the process to eliminate uncertainty as quickly as possible, whenever possible. This is key to our overall philosophy and shared goal of creating certainty sooner and being more efficient and effective. Also, over the next year, our examiners will receive special training on the handling of Uncertain Tax Positions.

In addition, a centralized process or triage team will be established to review UTPs and to determine their proper treatment. We know that Uncertain Tax Positions are uncertain for a number of reasons. There may be ambiguity in tax law and a lack of published guidance. Our triage team will identify trends of areas of uncertainty, and this will become an important source of inputs to our guidance pipeline. I see working with our colleagues at the Treasury Department and publishing guidance to clarify uncertain areas based on what we learn from Schedule UTP filings as a measure of success.

The directive to the field also reinforces longstanding principles of fairness and impartiality that are essential to balanced and principled tax administration.

Now I recognize that issuing such a directive cannot and will not ensure perfection, but we are committed to the positions and principles contained in the directive. However, should you see a problem, I urge you to make us aware of it. That will provide us the best chance to work out any bumps along the road to implementation as quickly as possible.

Some also expressed concerns that the reported UTP information would be automatically disclosed to foreign governments under treaties or information exchange agreements. Let me assure you that there will be no automatic release of UTP information to other governments. Our treaties and information exchange agreements do not require disclosure of information in cases in which there is no reciprocity, so it would be very, very rare to exchange such information unless the requesting government has similar information it can make available to the IRS. Further, even if reciprocity did exist, we would consider other factors in determining whether to disclose the information, including the relevance of the information to the foreign government, which in many cases would not be present.

Before I close this morning, I would like to talk for a little bit about some of the other important initiatives we provide aimed at earlier and speedier issue resolution and greater efficiency and certainty. They are a major part of the overall re-tooling of our relationship with large corporate taxpayers.

A perfect example is the CAP program. In exchange for more openness and transparency on the corporate taxpayer's part, we help resolve issues early and ensure accurate returns are filed. Taxpayers who are transparent with us get certainty with respect to their obligations at the time their return is filed, rather than waiting for the regular examination.

I am a staunch advocate of CAP and believe that it is time to make the pilot permanent. We soon will be issuing guidance that will make CAP permanent and available to a greater number of taxpayers.

The permanent CAP will also include elements missing from the pilot, such as a Pre-CAP process that provides taxpayers a defined path to get into CAP and a CAP maintenance program for taxpayers already in CAP for a number of years where we will address and resolve issues with taxpayers as they arise.

Our toolkit also includes Industry Issue Resolution Projects. These involve the cooperative efforts of industry

representatives, our operating divisions, our Chief Counsel, and the Treasury Department to reach administrable, common sense solutions for uncertain tax areas.

Industry Issue Resolution is really another form of guidance and helps reduce uncertainty on business tax issues within particular industries, such as our forthcoming guidance for the telecommunications and electric utility industries to resolve capitalization versus repair issues for network assets.

We have also made a major change to the Fast Track Settlement Program which should encourage more use of this issue resolution tool.

Our LB&I and Appeals functions have recently removed internal barriers that may have discouraged the use of the program. For example, it used to be that an examiner's case was left open in our tracking system during the time it went to Fast Track Appeals. This increased the examiner's cycle time and created a potential disincentive for the use of Fast Track. We have fixed this and an examiner will get credit for closing a case at the time it goes to Fast Track. I have also ensured that our Appeals function has the resources to handle more fast track cases, and now every taxpayer will have the opportunity to use the process.

Now, rather than spending time on a full audit...ending with a dispute and thus opening up an appeal... the process will be collapsed, speeding up issue resolution. The program's historical success rate in resolution is 80 percent, so it is a win/win for the IRS and taxpayers in the category of certainty sooner.

The last issue I want to discuss is the Schedule M3. The M3 has been a very useful tool in specific areas for specific taxpayers. It has helped us square up US and Global accounting and better understand permanent versus temporary issues.

However, I have always believed in continuous improvement. But it is especially important that when we look for new information...like the Schedule UTP...that we examine the other information that we already require.

To this end, we are forming an M3 working group with industry involvement to look at ways to reduce burden and duplication.

I believe that the combination of steps we are announcing today demonstrates our commitment and our preparedness to implement reporting of uncertain tax positions, while taking into account the legitimate concerns of taxpayers and their representatives.

The Schedule UTP we are releasing today is a principled and balanced approach that will improve tax administration concerning our largest and most complex taxpayers. It will also provide significant benefits to taxpayers, including getting them earlier certainty as to their uncertain tax positions, while preserving important taxpayer protections and respecting the important relationships the taxpayer has with its tax advisors and independent auditors.

This enhanced transparency, coupled with our extensive set of initiatives aimed at improving issue resolution, is a positive step forward for our nation's tax system.

By working together we can achieve an improved relationship between the IRS and corporate taxpayers, and mutual benefits in the areas of earlier certainty, efficiency, and consistency as to corporate tax administration.

I appreciate your attention this morning and I look forward to continuing the dialogue on important issues that affect us all.

Thank you.