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presents

Uncertain Tax Positions: Evolving Risks for U.S. Companies

Making Complex Disclosure Decisions In Light of New Developments

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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Tuesday, August 3, 2010

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Uncertain Tax Positions: Evolving Risks for U.S. Companies Webinar

Aug. 3, 2010

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Today's Program

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(Michael Desmond)

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(Lawrence Hill, Kim Boylan, Edward Froelich, Michael Desmond)

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Schedule UTP Basics

Michael Desmond, Bingham McCutchen LLP

Uncertain Tax Position Information: Historical Perspective

- IRS compliance objectives
 - Certainty, consistency and efficiency
 - Evolution of the income tax return
- *Arthur Young & Co.* (1984)
 - IRS’ “policy of restraint”
 - Notice 2002-63
- Financial statement reporting requirements
 - FASB Statement 109
 - FIN 48

Announcement Of Schedule UTP

- Inquiry by the Senate Permanent Subcommittee on Investigations
- Fall 2009: Comments by Commissioner Shulman and Chief Counsel Wilkins
- January 2010: Announcement 2010-9 and Shulman speech to the New York Bar Tax Section
- April 2010: Announcement 2010-30 and draft Schedule UTP and instructions

Taxpayers Subject To Schedule UTP Reporting Requirement

- All taxpayers that:
 - Prepare financial statements (or are included on the financial statements of a related entity)
 - Determine reserves for uncertain federal tax positions under FIN 48 or other accounting standards
 - Have \$10 million or more in assets
 - File Form 1120 series income tax returns (with some exceptions)

Schedule UTP Reporting Triggers

- A position must be disclosed on Schedule UTP if it meets one of three reporting triggers:
 - The taxpayer recorded a reserve for the position
 - The taxpayer did not record a reserve because it expects to litigate the position and prevail
 - The taxpayer did not record a reserve because it concluded that the IRS has an administrative practice not to challenge the position
- IRS has indicated some receptivity to changes but also has made clear that Schedule UTP will be implemented.

Timing Of Schedule UTP Disclosures

- Schedule UTP is proposed to be effective for tax years beginning on or after Jan. 1, 2010.
- Any uncertain tax position recorded within 60 days of filing the (2010 or later) return must be disclosed.
- Disclosure also must be made for any determination made within 60 days of filing *not* to record an “expect to litigate” or “administrative practice” position.

Schedule UTP Content Requirements

- Eight information items must be disclosed on the Schedule UTP for each uncertain tax position:
 - UTP control number
 - Up to three relevant Code sections
 - Whether the position is permanent or temporary
 - *Whether the uncertain position derives from a flow-through entity*
 - Whether the position is an “administrative practice position”
 - *The maximum tax adjustment (MTA)*
 - The tax year the uncertain position was taken (when taken in a prior year)
 - *A “concise description” of the position*

Schedule UTP Content Requirements (Cont.)

- Whether the uncertain position comes from a flow-through entity
 - As currently drafted, the Schedule UTP does not apply to partnerships or other pass-throughs.
 - Corporate taxpayers, however, may have to disclose uncertain tax positions that flow through and are reported on their Form 1120 returns.
 - Information challenges to reporting these uncertain positions

Schedule UTP Content Requirements (Cont.)

- The maximum tax adjustment (MTA)
 - The MTA is seen by the IRS as less invasive than disclosure of the actual reserve amount.
 - The requirement to disclose the MTA is intended to give the IRS some sense of the magnitude of the position.
 - Arguably requires a “with and without” analysis for each uncertain position
 - Special rules are provided for valuation and transfer pricing positions.

Schedule UTP Content Requirements (Cont.)

- A “concise description” of the position should include:
 - Whether the position relates to an item of income, gain, loss, deduction or credit
 - Whether the position involves a valuation question
 - The “rationale for the position”
 - “The reasons for determining the position is uncertain”
- Disconnect between the instructions and the examples on what might qualify as an adequate “concise description”

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Unanswered Questions About Schedule UTP

Kim Boylan, Latham & Watkins LLP

In The Beginning ...

- “We tried to approach this without getting into the heads of taxpayers as to the strengths or weaknesses of their positions. We’re only asking for a list of issues that the taxpayer has already prepared for financial reporting purposes.”
 - “Shulman Says IRS to Propose Filing on Uncertain Tax Positions; Practitioners Say Proposal Will Change Landscape of Disclosure,” 6 Acct. Pol’y & Prac. Rep. (BNA) No. 115 (2/5/10)
- The Service “intends for the issues disclosed on the new schedule to piggyback on and be the building blocks of the accounting work that’s done for the financial reserves.”
 - Tax Notes, 3/11/10
- The Service is “looking at the order of magnitude” rather than being concerned about having the right amount on Schedule UTP.
 - “Wilkins Discusses Need for Uncertain Tax Position Reporting,” Tax Notes, 3/3/10

**“Say what they mean, One thing leads to another, You told me something wrong ... One thing leads to another” –
The Fixx**

- Did the Service tell us something wrong? Is one thing leading to another?
- The information sought on the proposed Schedule UTP goes well beyond what is required under FIN 48 for financial accounting purposes, including:
 - Maximum tax amount is not computed for FIN 48
 - Items not included in FIN 48 disclosure would have to be disclosed

“The only way to know how much is enough, is to do too much and then back up.” - Jerry Jeff Walker

- Even basic questions remain unanswered, including:
 - Does the \$10 million asset threshold apply on a U.S. basis or worldwide basis?
 - Most important for companies filing 1120F
 - Will foreign tax positions have to be disclosed?
 - Even if not, the draft schedule may implicate some foreign positions as a result of E&P and FTC calculations
 - Will pass-through entities eventually have to file Schedule UTP?
 - Indications that pass-through entities will not be subject to the requirements, except to the extent a reserve was taken in response to uncertainty as to the appropriate status of the entity as a pass-through
 - Will disclosure requirements apply only to members of a consolidated group?

The Maximum Tax Amount

- Will the current requirement of the Schedule UTP to provide an MTA for *each* uncertain position remain?
 - Individual issue disclosures were specifically rejected by FASB.
 - Moving significantly beyond what is required by FIN 48 increases the compliance burden with little or no corresponding benefit.
 - Individual issue disclosure ignores the complex interrelationship and inter-dependence among tax positions.
 - Individual issue disclosure could provide a misleading indication of the relative magnitude of a taxpayer's various uncertain tax positions.

Disclosure Where No Reserve Is Established – Litigation

- Will the current requirement of Schedule UTP to disclose uncertain positions, and compute an MTA where no reserve has been established because the taxpayer intends to litigate the issue, remain?
 - Goes well beyond a taxpayer's FIN 48 disclosures
 - Focuses on the likelihood of settlement rather than the probability that the taxpayer's position will prevail
 - How are taxpayers supposed to reliably assess the Service's unknown willingness to settle an issue?

Disclosure Where No Reserve Is Established Because Of General Administrative Practice

- Will the current requirement of Schedule UTP to disclose uncertain positions and compute an MTA where no reserve has been established, because the taxpayer has determined that the Service has a general administrative practice not to examine the position, remain?
 - Not required under FIN 48 to make a more-likely-than-not determination with and without consideration of general administrative practice
 - Administrative practice may not be the determining factor – simply part of the overall analysis
 - What may not be challenged can vary substantially based on, for example, the size of the company. Will this require new analysis of the potential application of every Code section or regulation?
 - Will the Service provide a list of positions there is a practice of not challenging and allow taxpayers to check all that apply?

Valuation And Transfer Pricing

- MTA not required under the proposal
- Instead, must provide a ranking based on either the amount recorded as a reserve or the estimated adjustment to U.S. tax that would result if the “position” taken in the return “is not sustained”
 - What is the “position”?
 - Business structure? Comparables? Method?, etc.
 - What does “is not sustained” mean in this context?
 - Impossible to accurately estimate the U.S. tax that “would” result if the position is not sustained
 - Such estimate would depend on the as-yet-unknown valuation assertion that may potentially be asserted by the Service.
 - Will this effectively default to ranking based on reserve amount?
 - What if there is no reserve?
 - Anticipated litigation or administrative practice?
 - Reserve not solely for “United States federal income tax” (e.g., made on consolidated, net basis)
 - Will basis for ranking be sought on audit?
- Must provide a concise description of valuation or transfer pricing position “in sufficient detail so that the Service can determine the nature of the issue.”
 - Almost all transfer pricing and valuation positions are, by definition, “uncertain.”

Potential Alternatives To Individual MTA Disclosures

- Potential alternatives include:
 - Disclosure of issues without MTA
 - Disclosure of aggregate MTA tied to FIN 48 disclosure
 - Ranking of uncertain positions without specific MTA disclosure
 - Disclosure of tax positions only if above a particular materiality threshold
 - Check-the-box type categories

“Concise Description”

- How much must be disclosed?
- Examples in the draft instructions, as written, “present a notable risk of subject matter waiver of privileged legal advice.” Comments of the American Bar Association Section of Taxation, 5/28/10
- Inconsistent with the spirit of the Service’s policy of restraint
- Will requirement to provide the “rationale” for the position be dropped?

Will The Duplication Be Eliminated Or Minimized?

- Much of the information that would appear on the Schedule UTP is already found, in large part, in the return or elsewhere
 - Schedule M-3
 - 8275
 - Other disclosures
 - Sect. 6662 studies

Will Schedule UTP Information Be Shared?

- Will information be shared with foreign tax authorities
 - Only in strict compliance with existing tax treaties and Tax Information Exchange Agreements?
- Will information be shared with state tax authorities?
 - If so, under what circumstances?

Other Unanswered Questions

- What constitutes sufficient disclosure on Schedule UTP for it to be considered accurate and complete?
- Penalties? Which ones?
- SEC's adoption of IFRS Accounting Standards
 - FIN 48, the basis for Schedule UTP, would be fundamentally affected if IFRS is mandated – Why the rush?
- Will/should CAP taxpayers be exempted? Others?
- Will filing be optional for at least the first year after the schedule is finalized?
- Will disclosure of a position as “uncertain” create a negative presumption with respect to a taxpayer's application for an accounting method change?

What Information Will Ultimately Be Required?

“You can’t always get what you want
But if you try sometimes you might find
You get what you need.” – Mick Jagger, Keith Richards

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**Legal Lessons From
Textron, Deloitte Cases**

Edward Froelich, Morrison & Foerster

Stepping Back – The UTP In Context

- Putting aside the draft UTP and the IRS' current view of the application of privileges to workpapers, consider the following scenario:
 - IDRs Nos. 1 and 2 are the standard requests for general information; e.g., corporate organizational chart, prior-year returns, list of officers, listed transactions.
 - IDR No. 3 requests you to list all positions on the return which the IRS could reasonably reject, and the basis on which the IRS could reject that position.
- What would your response have been to IDR 3?
- What has changed?

An Altered Landscape

- General trend in tax administration to rely on increased disclosure
- FIN 48
- Reconsideration of policy of restraint
- *Textron*
- Draft UTP Proposal
 - Chief Counsel Wilkins’ March 5, 2010 Remarks at FBA Tax Law Conference: “Why would the IRS choose to spend time finding these issues or risk not finding them when the issues are there for the asking and not protected by any privilege?”
- *Deloitte*

The Clash (Of The Circuits)

- *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009): Documents created for the ultimate purpose of obtaining a certified financial statement are not work product.
- *United States v. Deloitte* 106 AFTR 2d 2010-5053 (D.C. Cir. 2010) : Documents created for the ultimate purpose of obtaining a certified financial statement can be work product.

Textron

- First Circuit en banc 3-2 decision
 - Binding only in courts in the First Circuit
 - *Deloitte* shows that other “majority view” circuits are unlikely to follow it.
- Holding: Textron’s internal tax accrual workpapers are not protected work product.
- Scope of holding: FIN 48 workpapers, GAAP workpapers (internal or external) cannot be work product.

Textron (Cont.)

- IRS sought Textron's internal risk analyses regarding each position on its tax return for the 2001 tax year. These internal workpapers were prepared by in-house counsel or in-house accountants under the supervision of in-house counsel.
- After an evidentiary hearing, the district court upheld work product. The First Circuit affirmed in large part, but this decision was vacated by the rehearing.
 - Key analytical proposition for both the district court and the original panel decision: Workpapers would not have been created but for the possibility of litigation.

Textron (Cont.)

- On rehearing, the court held that tax accrual workpapers are not protected by the work product doctrine because they were not “prepared for use in possible litigation.”
 - What exactly does it mean?
 - Can you meet this test by having litigation counsel prepare or supervise preparation of workpapers?
- Appeal to IRS, wasting resources hunting through complex return, puts cart before the horse
- Dissent: The majority decision is “misleading” and a “corruption of the proper role of an appellate court”
 - Ignores dual purpose doctrine and leading cases
 - Ignores fact that workpapers would not have been created but for possible litigation

Deloitte

- Unanimous panel decision affirming district court and remanding in part
 - Affects rules of evidence in all proceedings before the U.S. Tax Court
 - Distinguishes and criticizes *Textron*
- Holding: Two tax analyses from counsel and one memorandum from outside auditor contained protected work product.
- Scope of holding: Documents prepared with respect to financial audits, including workpapers, can contain protected work product.

Deloitte (Cont.)

- Department of Justice subpoenaed Deloitte, Dow Chemical's outside auditor, to produce its files related to Deloitte's review and audit of Dow's reserves with respect to the tax treatment of certain Dow partnerships.
- Dow claimed work product regarding three documents:
 - A July 1993 draft memorandum created by Deloitte based on a meeting with Dow's attorneys regarding possible litigation of the tax treatment of the partnerships
 - A September 1998 analysis created by Dow's in-house counsel
 - A June 2005 tax opinion from Dow's outside counsel
- DOJ moved to compel in the District Court for the District of Columbia, which upheld the claims of work product.

Deloitte (Cont.)

- The key analytical conclusions of the D.C. Circuit:
 - Work product protects intangible content
 - Work product is determined through an examination of the contents of a document
 - *Textron* is distinguishable and limited to its facts
 - Disclosing work product to outside auditors is not a waiver
- The three documents contain protected work product.
- The Deloitte memorandum must be inspected *in camera* by the lower court to determine if portions contain non-work product information.

Practical Considerations

- Keep a record regarding the purpose of meetings with outside auditors and their intention to discuss litigation evaluations as part of their meeting agenda
- Supplement existing ethical requirements of confidentiality for accountants regarding their attest client files with a specific agreement between the client and auditor setting forth conditions of confidentiality
- Request that the auditor segregate from its own audit workpapers work product documents received from the company
- Request that any use of such work product in the audit workpapers be specifically identified to the company

Deloitte And The UTP

- Does the D.C. Circuit opinion provide a rationale for asserting work product with respect to the information requested on the draft Form UTP?
- The requirement of stating the rationale and identifying a position as uncertain is requesting at some level a company's internal legal analysis regarding the strengths and weaknesses of the particular position. How different is that from requesting an attorney's mental impressions about a case?
- Recent comments by Ronald Schultz, senior advisor to the deputy commissioner for service and enforcement, suggest that the IRS is looking closely at the privilege concerns raised by commenters (Remarks at AICPA conference, July 29).

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**Best Practices For
Completing Schedule
UTP Going Forward**

Lawrence Hill, Dewey & LeBoeuf

Kim Boylan, Latham & Watkins LLP

Edward Froelich, Morrison & Foerster

Michael Desmond, Bingham McCutchen LLP

Securing Work Product Privileges

- Privileged information should not be shared with third parties or internal auditors unless prior approval has been received from in-house tax counsel (“tax counsel”).
- Any production of documents, whether privileged or not, to a third party should be supervised by an attorney.
- Privileged and confidential information should only be shared with company personnel on a “need to know” basis (subsequently referred to as the “privilege group”).
- When forwarding an e-mail containing privileged information outside of the privilege group, review and delete any privileged information.

Securing Work Product Privileges (Cont.)

- Enter into explicit non-disclosure agreements, or refine existing agreements, with independent auditors.
- Carefully document the circumstances under which work product is created and disseminated.
- Establish and review privilege policies and procedures to implement the above best practices.

Completing Schedule UTP

- The draft instructions to Schedule UTP explain that taxpayers must provide a concise description of each uncertain tax position on Part III of Schedule UTP, including “information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the uncertainty.”
- The draft instructions further indicate that the description must contain the rationale for the positions and the reasons for determining the position is uncertain.
- **Draft Instructions, Example 14:** “...The corporation deducted costs of investigating and partially negotiating potential business acquisitions that were not completed, and capitalized costs allocable to one business acquisition that was completed. The issue is the allocation of costs between failed acquisitions and the successful acquisition.”

Completing Schedule UTP (Cont.)

- The examples of concise descriptions contained in the draft instructions (i.e., examples 14, 15, and 16) do not describe the “nature of the uncertainty.” They do, however, describe the “nature of the uncertain tax position,” which is the information the IRS presumably is seeking.
- A requirement that taxpayers identify the legal issues related to uncertain tax positions does not implicate privilege waiver concerns to the same extent as a requirement that taxpayers provide rationales for positions and the reasons for determining that the positions are uncertain.

Completing Schedule UTP (Cont.)

- The additional tax and audit analysis required on the part of the taxpayer will result in the creation of Schedule UTP tax work papers (“UTP work papers”) that heretofore have not existed.
- As a result of risk management and professional ethics considerations, tax return preparers and outside auditors can be expected to review and exchange UTP work papers in the ordinary course of their respective functions.
- The IRS may also argue that UTP work papers do not qualify for work product protection because they were prepared not in anticipation of litigation, but in connection with the preparation of the tax return.
- The IRS should clarify that UTP work papers will be subsumed under the IRS policy of restraint that currently extends to tax accrual work papers.

Preventing Subject Matter Waiver Through IRS Agreement

- An explicit confidentiality agreement with the IRS may prevent a subject matter waiver and may also allow the taxpayer to retain privileges vis-à-vis third parties. Case law in the applicable circuit should be analyzed to determine if a confidentiality agreement will be effective.
- Key elements of a confidentiality agreement:
 - A statement that the disclosures are, at a minimum, protected by the attorney work product doctrine, the attorney-client privilege and any other applicable privilege; and that the taxpayer does not intend to waive the protection of any such privilege
 - A statement that the IRS will not assert that the disclosures constitute a waiver of the protection of the attorney work product doctrine or attorney-client privilege, or any other privilege

Preventing Subject Matter Waiver Through IRS Agreement (Cont.)

- Agreement that the IRS will maintain the confidentiality of the disclosures and will not disclose them to any third party
- A request that the IRS maintain the confidentiality of the disclosures under the Freedom of Information Act
- A statement that the privileged information was provided to the IRS in reliance on the IRS's agreement to return the privileged information at a future scheduled meeting, and not retain any copy
- A statement that the disclosures do not constitute a general waiver of privilege to the subject matters discussed, that there was no waiver to third parties at all, and that the information was disclosed for the agency's investigating staff alone

Structuring Documents For Schedule UTP

- Tax compliance files are not generally privileged and should be kept separately from privileged tax material.
- Tax opinions and other privileged tax memoranda should, where possible, not be shared with members of the tax compliance function.
- To the extent possible, third parties should inspect, rather than be provided copies of, privileged documents.

Tax Risk Management

- Consider setting a threshold confidence level for taking a tax position
- Consider obtaining pre-filing certainty for tax positions through, for example, private letter rulings and advance pricing agreements
- Use an independent tax firm to review major tax positions.

Tax Risk Management (Cont.)

- Assess channels of communication between corporate directors and the finance and tax departments
- Review internal controls and processes for identifying uncertain tax positions

Potential Penalties

- What penalties could apply for failure to file Schedule UTP or failure to properly complete the schedule?
 - Failure to file?
 - Return preparer?
- Is substantial compliance enough?
 - What does it mean to substantially comply?
 - Will disclosure of only FIN 48 items be sufficient? Safe harbor?
 - Can the Service second-guess the taxpayer's determination of which tax positions are "uncertain"? If so, does this make the Schedule UTP itself an uncertain tax position?
- How will Schedule UTP interact with new strict liability non-economic substance transaction disclosures?
- What if something is omitted from Schedule UTP, but is otherwise disclosed in the return or at the start of an audit? Impact on a penalty analysis?

Best Practices – Audit Committee

- The UTP may increase pressure on tax departments to characterize positions as certain.
- To the extent that tax departments might take more aggressive positions, the audit committee should consider instituting procedures for enhanced review of FIN 48 determinations.
- IRS corporate governance initiative
 - Companies need to identify and address systemic tax risk
 - Initiative in early stages