

IRS to Require Uncertain Tax Position Disclosures in 2010

At the beginning of the year, the IRS announced its intent to require certain taxpayers to disclose uncertain tax positions (UTPs) as part of their annual tax return filings (Announcement 2010-9). In IRS Announcement 2010-17, the IRS made it clear that it plans to implement these disclosure requirements for tax years beginning in 2010. More recently in Announcement 2010-30, the IRS released a draft Schedule UTP and specific instructions to fulfill that requirement. IRS officials have publicly restated their position that it will not withdraw the proposal.

In Announcement 2010-9, the IRS proposed to retain its existing policy regarding the disclosure of taxpayers' tax accrual work papers — that the IRS will generally not ask taxpayers to disclose their tax accrual work papers (the subject of the *Textron*¹ litigation) on audit. Instead, the IRS will require certain taxpayers file a new Schedule UTP listing a concise description of each UTP for which the taxpayer or a related entity has recorded a reserve in its financial statements.

Announcement 2010-30 contains a draft Schedule UTP and instructions. The instructions provide that only certain corporations with assets equal to or exceeding \$10 million and that have audited financial statements need to complete Schedule UTP, specifically:

- Corporations that are required to file a Form 1120, U.S. Corporation Income Tax Return
- Insurance companies that are required to file a 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
- Foreign corporations that are required to file Form 1120 F, U.S. Income Tax Return of a Foreign Corporation

The instructions also outline the definition of a UTP, which is any position that the taxpayer records a reserve with respect to that tax position (regardless of whether the accounting system is GAAP (i.e., FASB Interpretation No. 48 (FIN 48)), IFRS, or other country-specific accounting standards, including a modified version of any of the above. The taxpayer also must include as UTPs positions that the taxpayer did not to record a reserve based on an expectation that the taxpayer will litigate the issue or based on IRS administrative practice. Schedule UTP requires a concise description of each position and the amount of the maximum tax adjustment.

Under the draft instructions, an affiliated group of corporations filing a consolidated return will file a Schedule UTP for the affiliated group.

Potential Implications

Disclosure of UTPs will probably have a significant effect in how IRS auditors operate. Taxpayers' primary objection to IRS access of tax accrual work papers is that the work papers present a road map to the taxpayer's vulnerable tax positions. With the tax accrual work papers in hand, an IRS auditor will likely discover UTPs. While the IRS has said that it will not ordinarily ask for tax accrual work papers, the disclosure schedule is, as a practical matter, the equivalent. IRS auditors will likely rely heavily on the schedule to evaluate the taxpayer's return and to pinpoint potential adjustments. Schedule UTP will give auditors a guide to focus their examinations instead of the auditor having to sift through large amounts of information.

This may mean that auditors simply address the issues disclosed on Schedule UTP and end their audits more quickly. Taxpayers may find that auditors ask for less information and the audit may be less time consuming. However, auditors may be more willing to assess issues that have been disclosed with the knowledge that the taxpayer estimated that many of these issues were less than likely to be resolved in the taxpayer's favor.

Disclosure of UTPs may make the IRS and its auditors far more efficient. To the extent that advisory firms are promoting tax positions or tax planning that includes a UTP subject to disclosure under the rules, disclosure will allow the IRS to focus in and target "tax products" and taxpayers much faster and more efficiently. The proposed disclosure schedule also represents hours of work that auditors currently have to do themselves. This means that, if the number of auditors remains constant, the IRS will be able to audit more taxpayers, more tax years, and more issues.

Schedule UTP will allow IRS auditors to focus on the issues that will lead to the largest adjustments. Auditors may focus on certain issues (i.e., Tier I and Tier II issues) and less on far-ranging and off-the-radar issues. With Schedule UTP, auditors' inquiries may become

shorter and focus on the positions disclosed on Schedule UTP for adjustments; the IRS may neglect other issues for adjustments.

Schedule UTP will increase taxpayer compliance costs, particularly for mid-sized corporations that are not publicly reporting corporations. These corporations may find that their current accounting processes are insufficient and will require additional work to complete Schedule UTP.

The proposal may make the auditor-client relationship even more contentious. Since the passage of Sarbanes-Oxley and the resulting additional potential liabilities, auditors have found themselves in a more adversarial position vis-à-vis their clients. Under the proposal, the auditor's determination that an issue requires a FIN 48 tax reserve will not only trigger an adverse accounting result but also a disclosure to the IRS.

It is unknown exactly how Code Section 6694 (tax-return preparer penalties) will interact with the new schedule. As written, Code Section 6694 does not penalize tax-return preparers for not making disclosures (disclosure does provide a defense in certain situations). However, the Treasury Department may seek to change Code Section 6694 to ensure that tax-return preparers are liable for the nondisclosure of UTPs. Such a change would be in line with the current IRS strategy of making taxpayers' advisors liable for penalties in some situations when the taxpayer did not file a proper return. If disclosure increases the likelihood that a taxpayer will face an adjustment, the Treasury Department will look for a mechanism to ensure that taxpayers disclose appropriately.

Taxpayers and their professional service providers may also find it difficult to complete the Schedule UTP and retain their attorney-client privilege, the Section 7525 tax practitioner privilege, and the work product doctrine. Taxpayers generally waive these privileges by disclosure. Because Schedule UTP requires a concise description of uncertain tax issues, the taxpayer should take care to protect, as much as possible, disclosure of privileged information and work product linked to future litigation.

Taxpayers who take UTPs will be much more likely to have those uncertain positions subjected to close scrutiny. Thus, the return on efforts to create a good record for the IRS is now higher (because there is less of a chance that the auditor will fail to ferret out the issue). Taxpayers should take greater care to create a good record (and to eliminate bad facts) if they wish to take (and later defend) a UTP.

Schedule UTP specifically asks for information regarding tax positions that taxpayers do not disclose under FIN 48 based on the administrative practice of the IRS. This will allow the IRS to value the amount of tax revenue lost based on any of its administrative practices. The Treasury (and Congress) may, in the future, become more self-aware of the effect of its administrative practices on tax revenue and, as a result, may undertake future efforts to modify those practices.

Lastly, state revenue departments will, and some already are, explore requiring taxpayers to make similar disclosures on their state income or franchise tax returns. In any event, many states require taxpayers to attach their federal tax return to their state tax returns and thus will have the benefit of the federal disclosures.

¹ *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009), *cert. denied*, U.S. Lexis 4373 (2010)

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