
Comments
of
Tax Executives Institute, Inc.
on
Announcements 2010-9, 2010-17, and 2010-30
relating to
Uncertain Tax Positions and
the Policy of Restraint
submitted to
The Internal Revenue Service
May 28, 2010

On January 26, 2010, the Internal Revenue Service released Announcement 2010-9, stating the IRS's intention to require certain business taxpayers to disclose on a new tax return schedule the uncertain tax positions (UTPs) for which reserves are recorded under financial accounting standards. The Announcement invites public comment about the contents of the schedule, instructions, and the IRS's proposed approach and was published in the February 16, 2010, issue of the *Internal Revenue Bulletin* (2010-7 I.R.B. 408). The Announcement was subsequently modified by Announcement 2010-17, which was published in the March 29, 2010, issue of the *Internal Revenue Bulletin* (2010-13 I.R.B. 515). Proposed Schedule UTP (*Uncertain Tax Position Statement*) and draft instructions were released with Announcement 2010-30 on April 19, 2010, and published in the May 10, 2010, issue of the *Internal Revenue Bulletin* (2010-19 I.R.B. 668).

TAX EXECUTIVES INSTITUTE

Tax Executives Institute is the preeminent association of business tax executives worldwide. Our approximately 7,000 members represent 3,000 of the leading corporations in the United States, Canada, Europe, and Asia. TEI represents a cross-section of the business community, and is dedicated to developing and effectively implementing sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works — one that is administrable and with which taxpayers can comply in a cost-efficient manner.

Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax law relating to the operation of business enterprises, including the application of financial accounting standards to analyze and determine the UTPs for which reserves are recorded and reported in their companies' financial statements. We believe that the diversity and professional training of our members enable us to bring a balanced and practical perspective to the issues raised by the Announcements, proposed schedule, and draft instructions.

ANNOUNCEMENT BACKGROUND

Announcement 2010-9 states that the IRS intends to require a “business taxpayer” with assets in excess of \$10 million to disclose its UTPs if it prepares financial statements (or is included in the financial statements of a related entity) and the taxpayer (or related entity) “determines its ‘United States federal income tax reserves’ under FIN 48, or other accounting standards relating to uncertain income tax positions involving United States federal income

tax.”¹ The proposed schedule and instructions released with Announcement 2010-30 confirm that, beginning with the 2010 tax year, the schedule is required for corporations that issue or are included in financial statements and have \$10 million or more in assets and file Form 1120 (*U.S. Corporation Income Tax Return*) or another corporate income tax return (such as Forms 1120L, 1120PC, or 1120F). The schedule will not be required in 2010 for other corporations (such as real estate investment trusts or regulated investment companies), pass-through entities, or tax-exempt organizations.

UTPs must be disclosed for which (i) the taxpayer or a related entity has recorded a reserve in its financial statements, (ii) no reserve has been recorded because the taxpayer expects to litigate the position and the taxpayer determines that if the IRS had full knowledge of the tax position it is unlikely a settlement would be reached, or (iii) no reserve has been recorded because the taxpayer has determined that the IRS has a general administrative practice not to examine the position. The schedule requires taxpayers to give a concise description of each UTP and to disclose “the maximum of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer’s risk analysis regarding its likelihood of prevailing on the merits).”² For the disclosure to be sufficient, the concise description of each UTP must provide enough detail so that the IRS can determine the nature of the issue, which will “depend on the taxpayer’s particular facts and the nature of the underlying transaction.”³ The description must include the rationale for the position and “the reasons for determining that the

¹ 2010-7 I.R.B. 408, 409. Prior to the codification of generally accepted accounting principles by the Financial Accounting Standards Board, guidance on *Accounting for Uncertain Tax Positions, an Interpretation of FASB Statement No. 109* was set forth in Financial Interpretation No. 48 (FIN 48). The guidance is currently in FASB ASC 740-10. For ease of reference, the U.S. GAAP treatment of uncertain tax positions is referred to hereinafter as FIN 48.

² 2010-7 I.R.B. 408, 409.

³ *Id.*

position is an uncertain tax position.”⁴ In addition, as expanded by the draft schedule and instructions for Schedule UTP, the description must contain:

1. Up to three Internal Revenue Code sections potentially implicated by the position;
2. A description of the taxable year or years to which the position relates;
3. A statement that the position involves an item of income, gain, loss, deduction, or credit against tax;
4. A statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both;
5. A statement whether the position involves a determination of the value of any property or right; and
6. A statement whether the position involves a computation of basis.

Draft Schedule UTP does not require disclosure of taxpayers’ tax accrual workpapers, nor does it require disclosure of specific reserve amounts.⁵ For purposes of the schedule, a tax position taken in a tax return means a tax position that would result in an adjustment to a line item on the tax return (or would be included in a section 481(a) adjustment) if the position is not sustained.⁶

GENERAL COMMENTS ON TAXPAYER BURDENS AND THE IRS POLICY OF RESTRAINT

In a January 26, 2010, speech accompanying the release of Announcement 2010-9, Commissioner Douglas H. Shulman said that transparency will aid the IRS in achieving its

⁴ *Id.*

⁵ In 1981, the IRS announced a “policy of restraint” in respect of making requests for accountant tax accrual workpapers, stating that such requests would be made only in “unusual circumstances.” See Internal Revenue Manual § 4024.4 (1981). In Notice 2002-63, 2002-2 C.B. 72, and Internal Revenue Manual § 4.10.20 (2002), the IRS significantly broadened the situations in which the IRS would seek access to tax accrual workpapers, specifically tying such requests to whether the taxpayer engaged in one or more listed transactions. In *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), the Supreme Court cited with approval the IRS’s “administrative sensitivity” to “the intrusiveness of demands for the production of “tax accrual workpapers.” 465 U.S. at 820-21 & n.17. The Court stated that the IRS’s promulgation of its so-called policy of restraint refuted the taxpayer’s argument that granting the IRS access to a roadmap of mental impressions was unfair. 465 U.S. at 821.

⁶ *Draft 2010 Instructions for Schedule UTP*, at 4 (April 19, 2010).

compliance and enforcement objectives of certainty, consistency, and efficiency. Examiners, the Commissioner explained, spend up to 25 percent of their time “searching for issues” — time, he said, that can be better spent examining, discussing, and resolving issues with taxpayers. Efficiency will be enhanced, he explained, by helping the IRS “prioritize selection of issues and taxpayers for examination” thereby reducing the time and resources devoted to examinations. In addition, taxpayers that are transparent with the IRS will achieve certainty of treatment of their transactions more quickly than under traditional examination techniques. Finally, the disclosures will enhance the IRS’s ability to achieve consistent treatment of taxpayers. According to Commissioner Shulman, the proposed schedule will not “be adding substantial new work or burden on taxpayers” because they “are already required to establish tax reserves for uncertain tax positions in determining their financial statement income under United States or foreign accounting standards, such as FIN 48.”

Since the Commissioner’s January 26 speech and the issuance of Announcement 2010-9, the IRS has engaged in an extraordinary outreach to taxpayers and the tax-practitioner community about the agency’s transparency initiative. For instance, senior IRS officials have participated in numerous conferences, webinars, and other meetings, responded to questions and concerns about the agency’s transparency initiative, and clarified numerous issues about the purpose, scope, and specific requirements of Schedule UTP. While TEI has significant reservations about Schedule UTP, we do commend the process that the IRS has employed in seeking feedback, responding to taxpayer concerns, and evincing a willingness to consider alternative approaches.

As a general matter, TEI agrees that transparency is beneficial for the tax system. Thus, many of the recent initiatives undertaken by Congress, the IRS, and the SEC to promote greater

transparency and corporate accountability have had salutary effects upon both tax administration and the financial reporting system. TEI has long supported enhanced disclosure regimes — such as that for reportable transactions — to aid the IRS in its identification and analysis of potentially abusive transactions. In addition, efficiency, certainty, and consistency are inarguable goals for tax administration. Despite agreement on these goals, TEI has reservations about proposed Schedule UTP's efficacy in achieving the desired efficiency, consistency, and certainty. Significantly, we believe the burden of preparing the schedule has been underestimated by the IRS, while its supposed utility to the agency may be exaggerated. Hence, the Institute questions whether the presumed benefits of the schedule will be realized.

Moreover, assuming the IRS has legal authority to require the schedule, we question whether as a matter of sound tax policy and administration that authority should be exercised. First, we believe that the policy considerations that gave rise to the IRS's adopting the policy of restraint in 1981 (in terms of both encouraging candid communication between taxpayers and their auditors and of not disrupting the IRS-taxpayer relationship) continue to have validity. More to the point, given the adversarial nature of tax examinations, we do not believe the schedule should be implemented absent sufficient procedural safeguards to (1) ensure that taxpayer disclosures are properly interpreted and not used as a substitute for a full and independent examination of the facts and applicable law, and (2) protect taxpayers' legitimate interests in the confidentiality of information (whether or not protected by a legal privilege). Finally, before imposing additional burdens on taxpayers, the IRS should ensure that it has the resources (in terms of well-trained personnel and well-thought-out processes) necessary to use the data properly and should commit to making significant changes in its practices to ensure the efficient and fair disposition of cases.

1. *Taxpayer Burdens.* Based on an informal canvass of TEI members, the scope and amount of information required by draft Schedule UTP are greater than most taxpayers prepare and retain in their FIN 48 (or other accounting standards) workpapers. For this reason, requiring taxpayers to complete Schedule UTP would impose significant and substantial burdens. Specifically, there is no requirement under current accounting standards to analyze *every* tax position that affects *a* line item on a tax return. The legal justification for many tax positions is so well-grounded (*e.g.*, compensation paid to rank-and-file employees) that there is no affirmative obligation to document in the financial statement workpapers the basis for claiming the tax benefit. (Similarly, beyond the general requirement that taxpayers maintain books and records, there is no obligation to document the legal justification for every deduction claimed in a tax return.) The broad definition of “tax position” in the Schedule UTP instructions assumes that workpapers are prepared contemporaneously not only for the *uncertain* tax positions (*i.e.*, those for which a reserve is recorded under FIN 48 or other accounting standard), but also for those positions for which a decision is made *not* to record a reserve. Taxpayers, however, do not document (for FIN 48, IAS 12, or other accounting standards) every *tax position* that they would litigate if the IRS were to propose an adjustment because there are many tax positions about which taxpayers have a high degree of confidence. Similarly, taxpayers rarely document a decision not to record a reserve because of an “IRS administrative practice” not to examine an issue.⁷ By not distinguishing between unassailable tax positions for which no reserve is recorded and the two categories of tax positions that must be disclosed when no reserve is recorded, the schedule and instructions are creating a substantial documentation burden. Since taxpayers

⁷ There is also an evidentiary issue. A taxpayer could be expected to know when a reserve is recorded because it is based on an objective act that can be verified directly in the financial statement workpapers. In contrast, a decision not to record a reserve because the tax position is, in the taxpayer’s mind, unassailable is difficult to distinguish by objective or manifest actions from a decision not to record a reserve based on an expectation to litigate or an IRS administrative practice.

would be unwilling *to settle* tax positions for which they have a high degree of confidence, there are likely many issues that taxpayers would expect to litigate because the likelihood of “a settlement” is less than 50 percent. Absent modification of the instructions, the schedule will require taxpayers to undertake an extensive analysis of their highly confident tax positions (*i.e.*, those where no reserve is established) in order to distinguish those they *might* “settle” if challenged from those they would *not* “settle” absent a full concession.

In addition, there is also no requirement under current accounting standards to identify the maximum amount of potential tax liability. By including a requirement to state the “maximum tax amount” attributable to a tax position, the IRS may spawn differences of opinion between taxpayers and their financial statement auditors as well as between taxpayers and the IRS, thereby adding to the costs and complexities of preparing tax accrual workpapers as well as tax returns.⁸

Moreover, financial accounting and auditing standards afford companies significant flexibility in determining how (or how extensively) UTPs are documented. Since documentation practices vary according to the issues, the materiality of those issues, company processes, and external auditor requirements, the burden of complying with Schedule UTP will vary widely. Thus, although nearly all taxpayers document the rationale supporting a company’s material tax positions, relatively few provide a detailed rationale for each and every UTP and even fewer will document reasons why *a* UTP is uncertain.⁹ As important, taxpayers do *not* generally document (or calculate an amount for) positions that the IRS has an administrative policy not to examine, not only because there is no requirement to do so under FIN 48, but because the scope of

⁸ In other words, short of a jeopardy assessment approach, there is likely a range of reasonably identifiable maximum tax amounts attributable to a tax position.

⁹ For example, where a taxpayer’s valuation amount is uncertain, the most likely explanation is that reasonable valuation experts, economists, or tax professionals may disagree about a range of valuation amounts.

unexamined “administrative positions” is potentially unknowable. We have additional specific comments on each of these items below.

The incremental burdens imposed by draft Schedule UTP may not be facially insurmountable, but FIN 48 (or other financial statement standard) workpapers are not prepared on a tax basis. Specifically, the unit-of-account methodology on which FIN 48 depends is intentionally flexible so that financial statement issuers can prepare financial statements that best reflect the conditions of their business and industry. In addition, there is a substantial element of subjective judgment in the FIN 48 (or other UTP) analysis that varies from taxpayer to taxpayer even within the same industry. Thus, the workpapers summarize the best judgments of taxpayers and their advisers in reflecting the tax position of the company and its financial condition. The draft instructions acknowledge the lack of uniformity in documenting UTPs under FIN 48 (or other accounting standards) by requiring taxpayers to use the same unit of account for Schedule UTP purposes as they use for financial statement purposes. The analysis and recording of the reserves by each taxpayer, however, often do not align with the objectively determined “specific items of income, gain, loss, deduction, or credit” that must be identified on the schedule. Hence, to comply with the disclosures on the schedule, taxpayers will be compelled to review their FIN 48 analyses, disaggregate the information, reanalyze it, and reassemble it to fit the schedule’s requirements.¹⁰

Not surprisingly, the burden imposed on taxpayers will be inconsistent among taxpayers depending on the financial statement methodology employed to reserve for UTPs. Indeed, some large nonpublic companies may not prepare statements on the basis of U.S. GAAP and, hence, might have no disclosures. On the other hand, small-to-medium enterprises with assets at or

¹⁰ Taxpayers that have an accounting firm other than their financial statement auditor prepare or review their returns will incur substantially increased compliance costs because the return preparer will undertake additional due diligence of the taxpayer’s financial statement reserves in order to complete the schedule.

above the \$10 million threshold may well be required to use FIN 48 because of covenants in debt instruments. In addition, taxpayers using International Financial Reporting Standards (IFRS) or other accounting standards will not approach the reserve analysis in the same fashion as taxpayers employing FIN 48 and consequently may not reach the same conclusion in respect of whether a reserve is required in respect of the same or similar transactions.¹¹ Thus, despite the objective of ensuring consistency among taxpayers, the schedule will unavoidably produce inconsistent disclosures and, as a result, may produce inconsistent *taxpayer* selection criteria. (The Appendix to the comments illustrates the disparate Schedule UTP reporting results for three identical UTPs for three companies employing different accounting standards.)

In addition, the instructions to draft Schedule UTP state that, in the case of audited financial statements prepared under “other” (*i.e.*, non-GAAP) standards, taxpayers are not permitted to follow that other standard to the extent the “unit of account” is based on the “entire tax year or entire income tax return for a tax year.”¹² Such taxpayers must use a unit of account that includes “any level of detail that is consistently applied and reasonably based on the items of income, gain, loss, deduction, or credit.”¹³ Although the instructions evince an intention to accord taxpayers not using U.S. GAAP (or modified GAAP) flexibility for UTP disclosures, more guidance is desirable. Thus, we urge the IRS to confirm that, to the extent taxpayers employ other accounting standards they may use those standards to determine their UTP reserves

¹¹ Under an exposure draft that would revise IAS 12 of IFRS, financial statement issuers use a one-step method and accrue a tax liability for a UTP based on the “weighted average risk” of an assessment. Under that standard, even “highly confident” tax positions may have some risk. Thus, taxpayers may be required to record a reserve and disclose an amount that would not be required under FIN 48.

¹² *Draft 2010 Instructions for Schedule UTP*, at 5 (April 19, 2010). The reason for not permitting taxpayers to use the “tax year” or “tax return” methodology for disclosing the UTP reserve is not stated; presumably, it is because the approach lacks the granularity of disclosure the IRS is seeking.

¹³ *Id.*

and are under no obligation to restate their books and records on a U.S. GAAP basis or report *pro forma* FIN 48 reserves for UTPs.

Finally, the compliance burdens imposed by Schedule UTP cannot help but adversely affect the competitiveness of the United States in attracting business investment, not only in absolute terms by imposing substantial costs at the same time businesses struggle to overcome the ongoing effects of the economic recession, but also vis-à-vis foreign jurisdictions that do not impose similarly extensive disclosure regimes. These burdens will only grow if state governments, as expected, adopt similar disclosure provisions.

2. “*Road Test*” *Draft Schedule UTP Before Mandating Its Widespread Use.* TEI is concerned that the IRS’s expectations about the salutary effect of the UTP schedule in terms of issue identification may exceed what the schedule actually generates or what the IRS can use effectively. To help validate the IRS’s goals for Schedule UTP and allow time to refine the form in response to user feedback (from taxpayers and IRS personnel), TEI recommends that the IRS “road test” the schedule before broadly mandating its use.

One reason for a potential disconnect between the IRS’s expectations for the schedule and what it receives is that financial statement issuers — and their independent auditors — have differing perceptions of tax risk and uncertainty. Hence, all material tax positions (and “material” is itself a term that is subject to varying interpretations) are potentially subject to the schedule’s disclosure requirement and there is considerable room for the exercise of professional judgment whether a tax position is uncertain. Some financial statement issuers and their auditors will be more conservative in their estimates of uncertainty and risk and, hence, may identify more issues than issuers adopting a more moderate or aggressive interpretation. Thus, despite the goal of enhancing transparency and efficiency in the selection of taxpayers and issues, the efficacy of the

schedule may be uneven across classes of taxpayers. Ironically, more conservative taxpayers (or financial statement issuers) could be more greatly burdened and tagged for greater IRS audit scrutiny than their less conservative counterparts. By testing the proposed schedule before its full-fledged launch, the IRS will have an opportunity to gain empirical data about the potential for “false positives” arising from differing taxpayers’ judgments about tax risks, uncertainty, and materiality.

There are a variety of potential sources for taxpayers (or other tax professionals) to “road test” the draft schedule. During the March 11, 2010, liaison meeting between TEI and the IRS National Office, TEI suggested that the IRS consider asking taxpayers that participate in the Compliance Assurance Process (CAP) to provide comments on the schedule. For one thing, CAP taxpayers have entered into a Memorandum of Understanding (MOU) that guarantees a significant amount of transparency in respect of issues or potential issues. For another, these taxpayers will likely have few or no reserves for UTPs attributable to United States federal income tax liabilities. In addition, the IRS could approach a select number of Coordinated Industry Case (CIC) taxpayers and request their participation in a pilot program regarding Schedule UTP. Should the IRS decide to “road test” the schedule, TEI would be pleased to assist the agency in identifying potential participants in the pilot.

Another approach to implementing the enhanced disclosure regime would be to phase in disclosures by categories of transactions rather than categories of taxpayers. For example, the schedule might initially call for disclosure of reportable transactions (*i.e.*, those reportable under Treas. Reg. § 1.6011-4) and then be expanded to other issues identified by the IRS (*e.g.*, issues identified in the Industry Issue Focus program as Tier 1, then Tier 2, then Tier 3). TEI’s suggested approach will provide taxpayers with certainty about what should be disclosed and is

better than using UTPs to flag issues since it targets known transactions of interest rather than theoretical or inchoate concerns.

3. *Centralize Administration of Disclosures; Ensure Disclosures Are Not Revenue Targets.* During TEI’s annual liaison meetings with the IRS National Office and with LMSB (as well as in numerous public presentations on Announcement 2010-9), officials of the IRS and LMSB acknowledged that issues disclosed on draft Schedule UTP are not equivalent to aggressive tax positions that necessarily should merit notices of proposed adjustments from an IRS examination team. Reserves for UTPs are established for many reasons, including lack of clarity in the law, especially in respect of Code provisions for which little guidance exists. Moreover, the IRS committed to ensuring that the schedule not become the sole focus of examination teams and expressly affirmed that agents must be trained properly and supervised to ensure that the disclosure of the “maximum tax adjustment” is viewed as neither a revenue target nor a negotiating position.

TEI appreciates the IRS’s commitment to ensuring that Schedule UTP is used properly by the field. Regrettably, the requirement to state the maximum tax adjustment (MTA) for a UTP will draw significant attention to the position — whether substantively warranted or not — and may well prompt the field to invest significant audit resources in pursuing an adjustment. To diminish the likelihood that the MTA will become a revenue target or negotiating position for field agents, TEI recommends that the requirement to state the MTA be eliminated and replaced by one of several alternatives (discussed below) for identifying significant issues.¹⁴ We also recommend that, at least initially, the IRS establish a central office to receive, analyze, and administer the disclosures; train field agents in the proper use of the information; monitor

¹⁴ In addition, the IRS should consider issuing for public comment any instructions, training manuals, or guidance to the field in respect of the use of Schedule UTP.

taxpayer compliance; and report on the issues identified through the schedule and their resolution (e.g., through audit adjustments, appeals settlements, litigation, or the issuance of new guidance). Finally, TEI recommends that the IRS establish a mechanism whereby a taxpayer that believes its examination team is misusing the disclosures on Schedule UTP may challenge the team's issuance of a notice of proposed adjustment, for example, through revision of the rules of engagement.

4. *The Proposed Schedule Improperly Requires Disclosure of Taxpayer Thought Processes and Mental Impressions.* Announcement 2010-9 states that Schedule UTP is not intended to require taxpayers to disclose their risk analysis regarding the likelihood of prevailing on the merits of any UTP. TEI agrees with the stated objective to preserve the IRS's policy of restraint against generally seeking tax accrual workpapers.¹⁵ We regret, however, that the requirement to provide a "concise description of each uncertain tax position," including the "rationale for the position and a concise general statement of the reasons for determining that the position is an uncertain tax position," is anything but restrained. In practical effect, Schedule UTP in its current form would require taxpayers to disclose the pros and cons of each UTP. Moreover, the IRS's intention notwithstanding, the schedule will plumb the taxpayer's "mental impressions" and "thought processes" nearly as intrusively as a requirement to disclose reserve amounts and risk assessments. By requiring taxpayers to provide a summary of UTPs and the reasons for the uncertainty — whether because the law is unclear or because the taxpayer has embraced a favorable interpretation of the facts — the IRS will have access to the judgments taxpayers might include in their FIN 48 workpapers. More important, disclosure of the taxpayer's thoughts about the reasons for the uncertainty may well affect the disposition of the substantive issue, at least through the IRS's administrative processes, to the extent the

¹⁵ See note 5 *supra*.

examination team relies on the taxpayer's impressions rather than performing its own analysis of the law and facts.

For the foregoing reasons, TEI recommends that the IRS substantially modify (if not abandon outright) the requirement that taxpayers disclose the rationale for each position as well as the reason the position is uncertain. Specifically, the required description should be limited to a brief recitation of facts and a statement of the Code section, regulation, or issue sufficient to inform the IRS why a reserve was established. For example, if there is uncertainty whether a section 199 deduction is available for goods produced pursuant to a contract manufacturing arrangement the taxpayer might include a statement, as follows:

Widgets are produced under a contract manufacturing arrangement; the issue is whether the taxpayer has the benefits and burdens of ownership under Treas. Reg. § 1.199-3(f).

Similarly, if a taxpayer incurs environmental remediation expenditures that it fully deducts, there may be an issue whether some amounts should be capitalized. The taxpayer might include a statement, as follows:

Environmental clean-up costs for [a site location] are deducted in part and capitalized in part; the issue is whether the allocation to the costs of production under section 263A and Treas. Reg. § 1.263A is sufficient.

By contrast, Examples 14, 15, and 16 on page 9 of the draft 2010 Instructions to Schedule UTP suggest the IRS is expecting a description with far more detail than what taxpayers might view as "concise." Thus, in Example 14, nothing more should be required than the following:

The taxpayer investigated several potential business acquisitions during the year, completed one and abandoned the others. Costs of \$x associated with the completed transactions were capitalized and costs of \$y associated with the abandoned transactions were deducted.

In Example 15, the required statement should state no more than that the taxpayer pledged the CFC stock during the year and there was no investment in U.S. property because the CFC had no earnings and profits. And in Example 16, the taxpayer should similarly be required to state only

that it received a distribution from Venture LLC that was treated as a return of partnership capital. Example 16 is especially overbroad and burdensome. Whether the partnership anti-abuse or the disguised sale rules apply to the transaction in Example 16 requires sophisticated legal analysis and judgments that the taxpayer should not be required to disclose.¹⁶

The level of analysis and documentation implied by these examples would substantially increase taxpayers' legal and administrative costs for the preparation of tax returns (and for audited financial statements) because the proposed schedule would require detailed legal analyses and conclusions.¹⁷ Indeed, the amorphous nature of the requirement that a “concise description” of UTPs be provided is at the heart of why taxpayers are so concerned about the requirement: Absent safeguards against misuse, there is no guarantee that agents will be satisfied with anything less than language that can be incorporated into a Notice of Proposed Adjustment. Moreover, since it is unclear that FIN 48 or another applicable accounting standard would ever be interpreted to require taxpayers to engage in this level of analysis, there is a substantial risk that Schedule UTP will prompt examination teams to second-guess the taxpayer's FIN 48 analysis and disclosure despite assurances from senior IRS officials that such a “gotcha” use of Schedule UTP is not intended. Since the goal of the schedule is to streamline audits by disclosing areas of uncertainty, limiting disclosures to brief factual statements followed by the Code sections at issue achieves that goal.

¹⁶ While the taxpayer would perform such an analysis in determining whether to treat the distribution as a return of capital on its return, requiring more than a description of the transaction raises the specter of an agent's challenging a disclosure as not sufficiently detailing any or all of the variety of anti-abuse doctrines that might potentially apply to a transaction.

¹⁷ Although larger taxpayers with in-house legal counsel and tax departments may be able to bear the increased burdens better than smaller taxpayers, even larger taxpayers will be compelled to obtain outside legal or tax advice more frequently to complete the “concise description” required for Schedule UTP. The increased costs of obtaining legal or tax advice for return preparation purposes — whether by engaging outside advisors or diverting in-house resources — is, in our view, not justified.

5. *Requiring Disclosure of Mental Impressions or Thought Processes May Impinge on Work-Product or Attorney-Client Privileges.* In affirming the policy of restraint and announcing the IRS’s intention to issue Schedule UTP, Commissioner Shulman said that the IRS did not intend to “get into the heads of taxpayers as to the strengths and weaknesses of their positions.”¹⁸ We agree with that goal, not only for the policy reasons long undergirding the policy of restraint, but because forced disclosures of the type contemplated by Schedule UTP could be barred by the work-product or attorney-client privileges. Thus, although the Supreme Court in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), affirmed the IRS’s general authority to summons tax accrual workpapers from a taxpayer’s financial statement auditor, that decision did not address whether matters protected by attorney-client or work-product privilege can be summoned; it dealt only with whether a general accountant-client privilege should be fashioned to protect such documents.¹⁹ Moreover, despite the First Circuit’s decision in *Textron*, much uncertainty remains about the extent to which the attorney-client or work-product privilege protects tax accrual workpapers from disclosure.²⁰ In addition, many taxpayers and practitioners have voiced concern that the disclosures mandated by Schedule UTP may constitute a subject-matter waiver for any documents associated with the disclosed items. TEI submits that the promulgation of a new reporting schedule is not the proper place to sort out the application of legal privileges. Accordingly, to avoid drawn out disputes that could impede the IRS’s goal of increased transparency, TEI recommends that the IRS confirm that there is no requirement to disclose privileged documents.

¹⁸ Remarks of IRS Commissioner Douglas H. Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City, IR-2010-13 (January 26, 2010) (available electronically at <http://www.irs.gov/newsroom/article/0,,id=218705,00.html>).

¹⁹ Interestingly, in upholding the government’s summons in *Arthur Young*, the Court noted with approval the IRS’s policy of restraint. It is unclear how the Court would rule in the absence of the policy. See note 5 *supra*.

²⁰ See *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009), *cert. denied*, 560 U.S. ___, No. 09-750 (May 24, 2010).

6. *The Schedule Duplicates Other Disclosure Requirements.* Schedule M-3 of Form 1120 (*U.S. Corporation Income Tax*) requires taxpayers to reconcile their financial statement income with their U.S. taxable income, listing any difference as either permanent or temporary or arising outside of the U.S. taxpayer’s group. Even before the introduction of Schedule M-3, the workpapers summarizing and reconciling the book-tax accounting differences on Schedule M-1 were the target of substantial IRS audit resources. Indeed, the more detailed disclosure and reconciliation requirements for Schedule M-3 have continued to evolve as the IRS gains experience with the scope and quality of the information provided by taxpayers. Although it has been more than five years since Schedule M-3 was promulgated, it is unclear to what extent the IRS is using the information in refining its risk compliance metrics. Hence, the question arises whether another, more robust disclosure form — proposed Schedule UTP — is premature. At a minimum, as part of a “road test” of the new disclosure schedule, the IRS should compare taxpayer disclosures on Schedule UTP with the information provided on Schedule M-3 to determine whether any new issues are identified that cannot be identified apart from disclosure on Schedule M-3. If Schedule UTP is ultimately retained, the IRS should eliminate Schedule M-3 because it will be duplicative. Taxpayers currently required to file Schedule M-3 would then revert to completing Schedule M-1 to reconcile from financial to taxable income.

7. *Correlative Changes in Tax Administration.* For nearly half a century, TEI’s Standards of Conduct have required its members to agree to “present the facts pertinent to the resolution of questions at issue to representatives of the government imposing the tax.” A self-assessment system requires no less. But within that statement lies the essence of our concern about Schedule UTP: *Is a financial statement reserve for a UTP — or the rationale for establishing it — a fact pertinent to the resolution of a tax question?* Moreover, even assuming resolution of the “legal” issue whether Schedule UTP seeks improperly to “get into the heads of

taxpayers” in the government’s favor, there are policy considerations — *i.e.*, those underlying the policy of restraint — that militate against dramatically altering the dynamic of IRS examinations by requiring taxpayers to disclose why positions are uncertain. Stated differently, not all “game changers” are good, and before moving forward with Schedule UTP, the IRS should commit to altering the tax administration and examination process. We offer the following recommendations:

a. The IRS should refine its measures for reviewing both programs and individual IRS employees to remove any bias that favors higher adjustments. Thus, we note that outside of the CAP program, IRS personnel are not evaluated based on the number of “no change” audit reports they submit, but one sign of improved voluntary compliance would be an increase in the number of such reports. Moving forward, therefore, there should be more attention to balanced measures.

b. The IRS should expand and make permanent the CAP program. In addition, taxpayers in the CAP program should be exempt from filing Schedule UTP upon their signing an MOU providing for increased transparency. A taxpayer in the CAP program shares information with the IRS on a “real time” basis and makes affirmative representations that (1) it has disclosed all completed transactions and items with a material effect on the taxpayer’s federal income tax liability, and (2) there are no undisclosed transactions or tax positions related to the taxpayer’s federal income tax liability that would require the taxpayer to report reserves for financial reporting purposes. Consequently, the disclosures called for on Schedule UTP are redundant for CAP taxpayers. Moreover, as discussed earlier, CAP taxpayers would generally have very few UTPs to be disclosed.

c. The IRS should commit to reduce its audit cycle time and to close examinations more quickly than currently is the case in the Coordinated Industry Case or Industry Case programs.²¹ Thus, if Schedule UTP works to improve the IRS's issue identification and audit efficiency, there should be no expectation that extensions of the statute of limitations will be executed to permit the conclusion of administrative action, including Appeals' consideration of disputed issues. Moreover, efficiency gains in issue identification for particular taxpayers should not be used to expand their examinations simply because more time is available. In other words, the IRS's compliance risk assessment thresholds and materiality standards should not be reduced.²² The efficiency gains should lead to a reduction in examination hours per taxpayer and the time should be used elsewhere (*e.g.*, increasing the number of taxpayers subject to examination).

d. The IRS should work to increase the number of cases and issues eligible for Appeals Fast Track Settlement and Early Referral to Appeals and consider expanding the use of alternative dispute resolution techniques.

e. The IRS should expand the resources devoted to requests for private letter rulings, changes in accounting methods, and other forms of formal and informal guidance in order to increase certainty for taxpayers (and examination teams). In addition, the Pre-Filing Agreement and Industry Issue Resolution programs should be expanded.

²¹ For example, LMSB should commit to issuing audit plans earlier in the process and those plans should provide mutually agreed timelines for reviewing issues and determining whether the IRS agrees with the taxpayer's position. In addition, if the examination team requests advice from counsel, taxpayers should be permitted to review the statement of facts provided to counsel.

²² In addition, where Schedule UTP discloses no new issues for the year, the IRS should consider not examining that year or using the limited issue focus examination (LIFE) approach.

f. Assuming some form of Schedule UTP is retained, the IRS should, in its analysis of legal issues (*e.g.*, Chief Counsel Advice memorandums, or other internal advice or external guidance), include a discussion of the rationale for its position. Examining agents (and ultimately legal counsel for litigated cases) should similarly include an analysis of the level of certainty underlying proposed adjustments in their Forms 5701. This measure of reciprocal transparency will help ensure that adjustments are more than a reflexive, “human nature” response to disclosures on Schedule UTP.

SPECIFIC COMMENTS AND RECOMMENDATIONS ON SCHEDULE UTP AND INSTRUCTIONS

1. *Eliminate or Substantially Modify the Requirement to State the Maximum Amount of Potential Tax Liability.*

To establish a measure of significance for each uncertain tax position, draft Schedule UTP would require taxpayers to disclose the maximum amount of potential federal tax liability attributable to each UTP. Specifically, the schedule “will require a taxpayer to specify for each uncertain position the entire amount of United States federal income tax that would be due if the position were disallowed in its entirety on audit. This amount is the maximum tax adjustment for the position reflecting all changes to items of income, gain, loss, deduction, or credit if the position is not sustained.”²³ We have a number of recommendations and comments about the requirement to state the MTA.

a. Clarify that only U.S. federal income tax amounts are required to be disclosed. As a preliminary matter, TEI recommends that the IRS formally state that the schedule applies solely to UTPs for *United States federal income* tax liabilities.

²³ 2010-7 I.R.B. 408, 409.

The instructions to draft Schedule UTP note that the purpose of the form is to collect information “about tax positions that affect the United States federal income tax liabilities of certain corporations”²⁴ The definition of “tax position taken in a tax return” set out on page four of the draft instructions, however, is less precise. It states: “Schedule UTP requires the reporting of a corporation’s *federal income* tax positions” The instructions continue by defining a tax position taken in a tax return as “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.”²⁵

Since FIN 48 applies to the determination of income tax liabilities for all jurisdictions (U.S., state, local, and foreign) in which an enterprise is doing business and is potentially subject to income taxes, the taxpayer may have reserves relating to non-U.S. federal taxes. During the March 2010 liaison meetings with TEI and in numerous public forums, senior IRS and LMSB officials have stated that UTPs relating to U.S. state and local income taxes and foreign income tax liabilities will *not* be subject to disclosure on the proposed schedule. TEI applauds those statements, but recommends that the instructions be clarified to ensure that result. For example, where a company records a reserve for a transaction undertaken between two foreign subsidiaries, the instructions would seemingly require the transaction to be disclosed on Schedule UTP because a foreign adjustment could result in an adjustment to *a line or lines* on Form 5471 (*Information Return of U.S. Persons With Respect To Certain Foreign Corporations*) of the U.S. federal income tax return even though there is no direct effect on the taxpayer’s U.S. tax liability.²⁶ Similarly, a UTP for state taxes paid should not be required to be disclosed

²⁴ *Draft 2010 Instructions for Schedule UTP*, at 1 (April 19, 2010).

²⁵ *Draft 2010 Instructions for Schedule UTP*, at 4 (April 19, 2010) (emphasis added).

²⁶ The instructions should clarify that tax reserves for state or foreign UTPs that indirectly affect federal tax liabilities in ancillary ways need not be reported. Thus, state (or, more frequently, foreign) adjustments affecting

simply because the line for the deduction for state income or franchise taxes (e.g., line 17 of Form 1120) might be adjusted.

Hence, TEI recommends that the definition of “tax position” be revised, as follows:

A tax position taken in a tax return means a tax position that would result in an adjustment to a line item on ~~that a United States income~~ tax return other than a line on Form 5471 or line 17 of Form 1120 for foreign, state, or local income or franchise taxes (or would be included in a section 481(a) adjustment) if the position is not sustained. (Deletions to the text are noted by strikethroughs and additions are in italics.)²⁷

b. The requirement to state the “maximum tax adjustment . . . if the position is not sustained” is burdensome and misleading. As a part of their FIN 48 calculations, taxpayers do not compute a “maximum tax adjustment for the position reflecting all changes to items of income, gain, loss, deduction, or credit if the position is disallowed.” The draft instructions clarify that valuation amounts and transfer prices are not subject to the requirement to report an MTA since the determination of the MTA in such cases is affected by the complexity of the facts and law.²⁸ In addition, the effects of a tax position on state, local, or foreign taxes are to be disregarded in computing the MTA. These limitations are intended to ease taxpayer burdens,²⁹ but they do not go far enough and they do not fully address the distended nature and overstated amount of the potential taxes required to be disclosed by the draft schedule. Specifically, the computation of the MTA in many cases depends on myriad interdependent variables. For

lines on the return should similarly be exempted from reporting on Schedule UTP. For example, UTPs for which the taxpayer’s reserve relates to the determination of the foreign tax liability should not be required to be reported on Schedule UTP simply because a foreign tax adjustment may give rise to greater (lesser) earnings and profits or a greater (lesser) U.S. foreign tax credit and section 78 gross-up. All these *lines* on the tax return might be affected as a result of a foreign adjustment for which a foreign reserve is recorded.

²⁷ In conjunction with the proposed change, the instructions should also confirm that the schedule does not apply to reserves for other tax matters such as federal payroll, excise, or withholding taxes.

²⁸ Moreover, valuation amounts and transfer prices are often based on estimates, complex calculations, and subjective judgments about the comparability of data. The determination of an MTA itself will thus be subject to reasonable differences of expert economic opinion.

²⁹ For financial statement purposes, a UTP tax reserve is stated net of state, local, and foreign tax effects.

example, adjustments to nearly any income or expense item will affect the allocation and apportionment of expenses under Treas. Reg. § 1.861-8 for the determination of the production deduction under section 199 or the foreign tax credit limitation. How would taxpayers determine the maximum amount of tax *attributable to the UTP* versus the amount of tax attributable to a shifting of the allocation and apportionment of expenses? Would taxpayers be required to do a “with and without” calculation for each UTP that affects the production deduction or foreign tax credits? Requiring such a calculation to determine the MTA for each UTP would be extremely burdensome. In addition, certain valuation amounts will affect the calculation of other tax limitations (*e.g.*, section 382 and 383 limitations on net operating loss and credit carryovers). It is unclear whether these limitations would require stating a specific MTA or whether the proposed treatment of valuation amounts would apply. We recommend that the MTA be defined as the direct effect of a change to a tax position without regard to ancillary federal income tax effects such as to the foreign tax credit, research credit, alternative minimum tax (AMT) calculations, section 382 (or 383) limitations on net operating loss deductions (or credit amounts), and the allocation and apportionment of expenses to the determination of foreign tax credits and the domestic production deduction. Such ancillary effects should be disregarded.

c. Alternatives to “maximum tax adjustment” amount for measuring the significance of an issue. Because including the MTA requirement would undermine good tax administration, the IRS should adopt less burdensome means for measuring the significance of an issue. We offer the following possible alternatives:

(i) As a first option, consider using the same methodology adopted for valuation and transfer pricing issues. Thus, rather than requiring an explicit statement of a tax amount in dispute for each UTP, permit taxpayers to rank their UTPs by the estimated amount of tax liability on the return related to the particular UTP.

(ii) As a second option, have taxpayers disclose only the issues for which a reserve is recorded and for which the tax amount of the item on the return exceeds, say, 5 percent of the amount disclosed under ASC 740-10-50-15(a)(1). In other words, disclose (without specifying either the amount of the reserve addition or the amount of the tax position on the return) a tax position for which the gross amount of the increases in unrecognized tax benefits exceeds 5 percent of the tabular roll-forward amount in the taxpayer's footnote disclosure.³⁰ This threshold would provide the IRS with a measure of significance based on information that is readily available and disclosed in the taxpayer's financial statements. Companies preparing financial statements on a basis other than U.S. GAAP might be required to disclose UTPs for which the reserve recorded in the period exceeds 5 percent of the gross addition to the tax reserves for the year.

(iii) As a third option, require taxpayers to segregate their reserves for UTPs into two buckets — significant and insignificant — with the threshold dependent on the taxpayer's size as measured by income or assets. Then, limit the absolute number of issues to be disclosed by each taxpayer to, say, a certain number of issues that exceed a fixed dollar threshold and establish a sliding scale of fixed dollar thresholds based on taxpayer size. For example, taxpayers with assets in excess of \$10 million but less than or equal to \$100 million in assets might be required to disclose the top 5 significant U.S. federal income tax issues where the reserve for a particular federal income tax position exceeds \$250,000 or where the total reserve for uncertain U.S. federal income tax positions exceeds \$1 million. Taxpayers with assets in excess of \$100 million but less than or equal to \$250 million might be required to disclose the top 10 significant U.S. federal income tax issues with a reserve in excess of \$1 million or aggregate reserves for uncertain U.S. federal income tax positions exceeds \$5 million. Taxpayers

³⁰ Non-public companies, however, are not required to perform the roll-forward. An alternative method would be required.

with assets in excess of \$250 million but less than \$1 billion might be required to disclose the top 15 significant U.S. federal income tax issues with a reserve in excess \$3 million or an aggregate reserve in excess of \$10 million. Taxpayers with assets in excess of \$1 billion but less than \$10 billion might be required to disclose the top 20 significant U.S. federal income tax issues with a reserve in excess \$5 million or an aggregate reserve in excess of \$20 million. Proportionally higher thresholds could be established for taxpayers with assets in excess of \$10 and \$50 billion.

By establishing a disclosure threshold dependent on taxpayer size, the IRS would be better able to compare the significance of issues for similarly sized taxpayers. By limiting the number of disclosures to the top 5 (or, alternatively, 10, 15, or 20) federal income tax issues exceeding a specific threshold, the IRS could obtain a sense of the significance of individual issues for each taxpayer without burdening the taxpayer with a requirement to disclose every issue for which a reserve has been (or could be) established. Moreover, to avoid “getting into the heads” of taxpayers, the schedule should not require taxpayers to assign a specific dollar amount to any particular issue for which the reserve exceeds the selected threshold; instead, taxpayers might be required to rank the issues by estimated exposure.

(iv) In lieu of using a dollar amount for the disclosure threshold or requiring any dollar amount to be assigned to a UTP, permit taxpayers to disclose the tax issues that in the aggregate constitute more than, say, 80 percent of the taxpayer’s reserve for uncertain federal income tax positions. Again, this proposal is similar to the draft schedule’s treatment of valuation and transfer pricing issues, but does not require each and every UTP to be listed.

(v) In lieu of options (i)-(iv), require taxpayers to disclose only the uncertain federal income tax positions where the potential tax liability exceeds, say, 5 percent of revenues, expenses, or assets shown on the Form 1120 (or other corporate income tax return).

d. Other Comments on MTA Disclosure Requirement. The instructions to the draft Schedule UTP state that taxpayers should determine the MTA by applying the maximum corporate tax rate (35 percent) to the amount of income or deduction estimated to be at issue in the UTP. Credits are estimated dollar for dollar. The dollar estimates for all applicable items of income, gain, loss, deduction, or credit relating to a particular UTP are combined to determine the MTA. The MTA, however, excludes estimated amounts of interest and penalty arising from the tax position and the effects of a tax position on state, local, or foreign taxes are also disregarded.

TEI commends the IRS for omitting interest and penalties from the determination of the MTA for tax positions. Omitting these amounts will temper the inflated estimate of the MTA and maintain focus on the tax issues in the UTP. Also, even though we believe the use of the MTA as a measure of the significance of an issue is misleading, the calculation specified in the draft instructions is generally clear and helpful in determining the disclosed amount as long as ancillary federal income tax effects are also ignored (*e.g.*, the effect of the UTP on AMT, Treas. Reg. § 1.861-8 calculations, or section 382 limitations as noted above).

2. *Establish a Disclosure Threshold Based on the Tax Benefit Claimed.*

Draft Schedule UTP would require disclosure of *all* issues where a reserve is established. Under FIN 48, reserves may be required to be established even where the amount at risk for a potential tax adjustment is small compared with the tax benefit claimed. Thus, where a taxpayer claims a research and experimentation (R&E) credit, it may establish a small reserve based on its experience in previous audits that the IRS will disallow some percentage of its claimed expenditures. Although the taxpayer believes that its expenditures are fully qualified when it files the return, it may reserve a small amount for, in effect, a nuisance settlement. To minimize taxpayer burdens and better focus IRS examination resources, TEI recommends that the IRS

establish a threshold amount for the disclosure schedule. For example, taxpayers should not be required to disclose UTPs where the reserve is less than, say, 25 percent of the tax benefit claimed on the return.

3. *Revise the Issues that Must Be Disclosed.*

Announcement 2010-9 states that three categories of UTPs must be disclosed on the proposed schedule: (i) positions for which a reserve has been established under FIN 48 (or other accounting standard) in the taxpayer’s financial statements, (ii) positions for which no reserve is established because the “taxpayer expects to litigate” the position, and (iii) positions for which no reserve is established because the taxpayer “has determined that the Service has a general administrative practice not to examine the position.”³¹

a. Eliminate or substantially clarify the requirement to disclose positions that are not audited because of administrative practice. As a preliminary matter, taxpayers’ workpapers rarely document whether a position is based on a general administrative practice not to examine the position. The reason is simple: The positions that the IRS may not, for reasons of administrative convenience and efficient audit practice, examine are as extensive as the Code itself. For example, for large public companies the IRS will rarely challenge whether an expense is “ordinary and necessary” under section 162, while it may routinely challenge privately held company deductions, *e.g.*, as disguised dividends. Requiring taxpayers to catalog in each return the issues that the IRS ordinarily does not examine as a matter of general administrative practice would place a substantial, unnecessary, and unknowable burden on taxpayers. Indeed, this requirement inappropriately requires taxpayers to *speculate* whether the IRS has an administrative practice of not examining an issue. IRS officials have publicly explained the

³¹ 2010-7 I.R.B. 408, 409.

“general administrative practice” requirement by using the example of *de minimis* capitalization thresholds.³² If this category of disclosures is retained, the IRS should provide substantially more guidance to clarify its scope. There should be no obligation to examine the potential application of every Code section or regulation and determine whether the IRS will — or will not — examine the taxpayer’s position. If the requirement to disclose UTPs for which the taxpayer relies on IRS administrative practice in order to avoid recording a reserve is retained, the requirement to state the MTA should be eliminated because it would be unduly burdensome to calculate.³³

b. Intent to litigate.

(i) Eliminate this category of disclosure. If a taxpayer has formed an intent to litigate a position, it is likely to be for a high-profile transaction or controversial issue for which there will be significant indicia of the issue on the return. Hence, an added disclosure on Schedule UTP would likely not aid the IRS in identifying the transaction or position. As important, the taxpayer’s intent to litigate is often based on an opinion of counsel in respect of the merits of the position. Because of uncertainty about the extent to which the attorney-client or work-product privilege protects tax accrual workpapers from disclosure as “in anticipation of litigation,” this category of items should be eliminated.

In the event this category is retained, we offer two additional comments and recommendations.

(ii) Distinguish highly confident positions — eliminate disclosure. Because of the challenge of defining what an “uncertain” tax position is, all tax positions are subject to FIN 48.

³² For example, if during previous examinations the IRS and a taxpayer have reached an agreement that fixed asset additions with a value of less than [\$x] (where “x” is determined on a taxpayer-by-taxpayer basis) will not be examined, the *de minimis* capitalization threshold will not be reserved in the FIN 48 workpapers.

³³ For example, if the taxpayer deducts all office equipment with a cost of \$1,000 or less, the taxpayer often cannot segregate, without undue burden, those costs from other expenses that have also been deducted during the year.

Taxpayers, however, are not required to establish a reserve for tax positions where, based on clear and unambiguous tax law, management has a “high confidence” level that its position will be sustained.³⁴ In other words, no reserve is required for “highly certain” tax positions. Whether a position is highly certain and requires no reserve is a matter of professional judgment for taxpayers and their financial statement auditors and there is not necessarily a direct correlation to tax opinion levels such as “will” or “should” levels of authority.

That said, there is a level of “expectation” of litigation inherent in nearly every significant tax position, including instances where the taxpayer might be surprised where one of its highly confident tax positions is challenged. By not distinguishing between highly certain tax positions where there may be no actual intent to litigate (*e.g.*, because the taxpayer anticipates no audit challenge) and other UTPs, Announcement 2010-9 and the schedule overreach. TEI recommends that the instructions for the schedule distinguish between highly confident transactions and other transactions and eliminate the disclosure requirement insofar as it pertains to “highly confident” transactions.

(iii) *Reserves established during or after examinations — eliminate disclosure.*

The instructions state that taxpayers must disclose a tax position for which a reserve is not recorded in the audited financial statements *after* the taxpayer or a related party determines that, if the IRS had full knowledge of the position, the likelihood of settlement is less than 50 percent. Example 5 illustrates the rule. There, a taxpayer believes it has a less-than-50-percent chance of settling a tax position with the IRS but has determined that it has a 60-percent chance of prevailing on the merits so no reserve is established. Consequently, Schedule UTP would require disclosure of this reserve.

³⁴ The example in FIN 48 relates to the deductibility of salaries paid to rank-and-file employees.

The instructions are unclear with respect to issues arising in the more commonplace circumstance where no reserve is established initially (perhaps because of a high degree of confidence that the taxpayer will prevail) and, as a result of an issue being raised during an examination, a taxpayer determines that a settlement is unlikely without litigation. In other words, either the uncertainty about the tax position or the probability that there will be no settlement without litigation may arise long after a position is taken on a return. In these cases, there should be no obligation to disclose the UTP, the existence of the reserve, or the MTA because the IRS is already aware of the issue. Thus, the recording of a reserve for issues under examination should, for purposes of the UTP schedule, be treated the same as a subsequent increase or decrease in a reserve for which no disclosure is required.

4. *Create Angel Lists to Omit Unnecessary Disclosures/Avoid Duplicative Disclosures.*

There are a number of UTPs that are routinely examined and will likely continue to be examined regardless whether an item or transaction is disclosed on the proposed schedule.

Indeed, many FIN 48 reserves are likely attributable to five categories of transactions:

- items reported on Forms 8275 (*Disclosure Statement*) 8275-R (*Regulation Disclosure Statement*) or 8886 (*Reportable Transaction Disclosure Statement*),
- book-tax differences subject to disclosure and reconciliation on Schedule M-3 of Form 1120 (*U.S. Corporation Income Tax*),
- international issues such as transfer pricing,
- issues identified by LMSB as “tiered issues” and “industry issues,” and
- significant corporate transactions, such as reorganizations or liquidations, or accounting method changes that are subject to specific and significant documentation and disclosure requirements.

To reduce duplicative issue identification and reporting on the proposed schedule, we recommend that the IRS establish an “angel list” of items or transactions for which taxpayers

have recorded a UTP reserve and (i) for which separate reporting in the return is already required (such as those in the first two bullets above), (ii) for which no separate reporting should be necessary to apprise the field that an issue might need to be reviewed (such as those in the last three bullets above), or (iii) are insignificant.

Under the first category of items, Forms 8886 and 8275 already provide the IRS with significant information about specific transactions or items. To the extent an item is already disclosed in those forms, the proposed schedule will yield little or no additional information for an examiner. In addition, Schedule M-3 requires taxpayers to reconcile financial statement income with U.S. taxable income, listing any difference as permanent, temporary, or attributable to entities that are outside of the U.S. tax return group. To eliminate duplicate reporting, we recommend eliminating the disclosure of items on Schedule UTP for items subject to Schedule M-3 reporting. Alternatively, taxpayers should be permitted to incorporate such items by cross-reference to the Schedule M-3 or the requirement to file Schedule M-3 should be eliminated for taxpayers subject to Schedule UTP.

Under the second category of issues — items which the IRS should already be aware may be an issue — we recommend that the IRS include transfer pricing (because documentation must already be provided by the taxpayer upon examination in order to avoid penalties), changes in accounting methods, and other corporate transactions (such as reorganizations or liquidations) that generally require a separate disclosure statement and are nearly always reviewed by IRS agents. In addition, the IRS can build upon its current approaches for managing the compliance risk and significance of potential issues. Specifically, as part of its Industry Issue Focus program, the IRS has established three tiers of issues. In lieu of requiring a description of each tiered issue for which a taxpayer has established a UTP reserve, the IRS could develop a checkbox of all the

tiered (or industry) issues that the taxpayer might check to put the IRS on notice that the issue is in the return. To provide a measure of significance for each checked Tier-1, -2, or -3 issue, taxpayers should be permitted to state the amount of tax benefits for such tiered issues included in the return.

Finally, there are likely minor issues for which taxpayers routinely record reserves and which the IRS examines from time to time because of a small compliance risk that requires periodic checks. Such issues include the proper classification of travel and entertainment expenses into allowed and disallowed categories and the proper classification of depreciable fixed assets. To focus IRS audit resources on significant issues, we recommend eliminating the requirement to disclose reserves for such insignificant issues.

5. *Granularity of Disclosure Requirement Will Affect Taxpayer Burden.*

FIN 48 accords substantial discretion to the company (or other reporting entity) to determine what the “unit of account” is in determining and measuring a UTP. While there is clearly a connection between “units of account” and “tax items,” they are not coextensive. Thus, the “unit of account” may be either broader or narrower than an “item of income, gain, loss, deduction, or credit” that must be disclosed on the proposed schedule. For example, the qualification of research expenditures for the R&E tax credit is frequently challenged by examiners so companies often set up FIN 48 reserves. Even in a simple case, those projects or items may not correlate directly with the aggregation (or disaggregation) of qualifying expenditures on the tax return, and thus do not fit neatly with a particular line on a return except perhaps at the broadest line: the total research credit amount claimed.

To reduce taxpayer burdens, we recommend that taxpayers be permitted to aggregate information on the proposed disclosure schedule in the same fashion as they would their unit of

account for FIN 48 purposes. Indeed, we do not see how, without imposing a substantial burden, taxpayers will be able in all cases to aggregate (or disaggregate) their FIN 48 “units of account” in order to convert a particular UTP into a tax item.³⁵ The instructions state —

A tax position is based on the unit of account in the audited financial statements in which the reserve is recorded. A tax position taken in a tax return means a tax position that would result in an adjustment to the item on that tax return if the position is not sustained. A line item on a tax return may be affected by multiple units of account, in which case each unit of account must be reported separately on Schedule UTP.

The first sentence of this paragraph embodies TEI’s recommendation that taxpayers be permitted to use their unit of account in completing Schedule UTP. The second sentence, however, assumes that a unit of account correlates directly with line items on a return. That is a critical assumption that may not necessarily be true for all taxpayers. Before attempting to assert a penalty for noncompliance with the schedule’s requirements, the IRS should determine whether this assumption is borne out in practice. (This is a question that could be addressed during any “road test” of the schedule.)

6. “Recording a Reserve” on Temporary Differences.

Schedule UTP requires reporting of federal income tax positions for which a corporation or related party has recorded a reserve in a financial statement. According to the draft instructions, a reserve is considered recorded in respect of a tax position in an audited financial statement when any of the following occurs:

1. An increase in a liability for income taxes payable or a reduction of an income refund receivable with respect to the tax position,
2. A reduction in a deferred tax asset or an increase in a deferred tax liability with respect to the tax position, or

³⁵ Where taxpayers use hybrid entities or instruments, the tax uncertainties may not be easily disaggregated into U.S. or foreign income tax effects. Again, the principal issue is what level of granularity is required in moving from the FIN 48 analysis — which may involve aggregation of U.S., foreign, or state or local tax effects — to a single or multiple code sections or a line item on the tax return.

3. Both (1) and (2) above.

Steps 1 and 2 are clear, but step 3 confuses the analysis, may lead to situations where the net recorded “reserve” for a tax position is zero, and is generally unnecessary.

In addition, it is unclear generally what the instructions intend by the term “record a reserve” for an uncertain tax position involving temporary differences.³⁶ Under FIN 48, if a *material* temporary difference is a UTP, a liability is recorded and a corresponding, and often fully offsetting, deferred tax asset is recorded (or deferred tax liability is reversed). The asset and liability are reduced in tandem as, and to the extent, the tax item is sustained on the return. In practice, the materiality threshold for UTPs attributable to temporary differences is often very high, so taxpayers may record no net “tax reserve” for UTPs attributable to immaterial temporary differences even though they may accrue interest expense on such temporary differences until the tax item is resolved. Since the instructions state that taxpayers are not required to report interest amounts on Schedule UTP (a decision with which we concur), we believe the schedule would be improved by eliminating the requirement to report UTPs for temporary differences. At a minimum, the IRS should clarify the intended reporting for temporary differences.

7. *Reporting of Current and Prior Year Tax Positions.*

The instructions provide a rule of administrative convenience for determining when UTPs must be disclosed. Specifically, tax positions taken in the tax return for which a decision whether to record a reserve is made at least 60 days prior to filing the return are reported in Part I of the schedule. Where a reserve for a tax position is recorded within 60 days of filing the return reporting the UTP (or after the return reporting the UTP is filed), the tax position must be disclosed in Part II of the schedule in the next filed return following the recording of the reserve.

³⁶ Examples 7 and 9 in the instructions assume that a reserve is recorded for the temporary differences but do not clarify what “reserve” is recorded.

A chart in the instructions clarifies that if a taxpayer discloses a UTP for which a reserve is established within 60 days of filing the return that includes the position, there is no obligation to report the UTP in the subsequent return. In effect, reserves for UTPs established within 60 days prior to filing a return reporting the UTP can be reported at the option of the taxpayer in the tax return with the UTP or in the subsequent year's return.

The 60-day rule affords taxpayers a helpful administrative grace period for reporting the UTP. We commend the IRS for including it. We suggest, however, that the IRS clarify the header on the second column of the table on page 7 of the instructions to state the “*Date the reserve is recorded*” rather than the “*Date of determination whether to take reserve.*” As noted on page 2 of the instructions, the *date of recording a reserve* sets the start date of the 60-day period for actual reserves whereas the date a *decision* is made *not* to record a reserve is the trigger for reporting UTPs for which no reserve is recorded because of an “expectation to litigate” or “IRS administrative practice.”³⁷

In the same section of the instructions, taxpayers are instructed that they are *not* to “report a tax position on Schedule UTP before the tax year in which the tax position is taken in a tax return by the corporation.”³⁸ The purpose of this rule is not explicit, but it may relate to transactions where the uncertain tax position depends on several events or transactions separated by a substantial period of time (*e.g.*, a disguised sale under section 707 where the transaction occurs more than two years after the transfer of cash or property). For example, a transaction in year one may (or may not) create stepped-up asset basis. If there is uncertainty about the step up, the taxpayer may record a reserve in the year the basis is created. The tax position the IRS may

³⁷ In many cases, it is challenging to determine and document a date that a decision is made *not* to do something such as a decision *not* to record a reserve. This is yet another reason the “intent to litigate” and “administrative practice” categories of reportable UTPs should be eliminated.

³⁸ 2010 Instructions for Schedule UTP, at 2 (April 19, 2010).

be interested in, however, is a loss (or reduced gain) on a subsequent sale of the asset with the increased basis in year five. There are likely a number of transactions for which there may be a time lag between the recording of a reserve and the “tax position” for which the reserve is intended. We recommend that the IRS illustrate the purpose of the rule with examples.

8. *Use of Tax Attributes — Duplicative Reporting.*

Example 8 in the instructions illustrates a disclosure obligation where a taxpayer has a net operating loss (NOL) carryforward that is about to expire. In the example, the taxpayer is uncertain whether income that will be offset by the NOL carryforward is properly reported in 2010 (when the loss will expire) or in 2011. The example concludes that the taxpayer has taken a position in each of its 2010 and 2011 tax returns and must report the item or position on each year’s Schedule UTP. Although the instructions do not state the applicable tax “rule” other than the conclusion in Example 8, a similar “rule” would presumably apply with respect to expiring foreign tax credit carryovers and any uncertain tax position relating to the source of income or expenses.

We believe this duplicative reporting rule is unnecessary and may prove to be a trap for the unwary. In every other example, the recorded reserve is reported in the year in which the tax position is taken on the tax return. In the net operating loss example, that would be 2010 — the year the uncertain income is reported. Other than giving examining agents two opportunities to question the timing of the income inclusion, we do not understand why this exception to the “once is enough” rule is necessary. Taxpayers should only be required to report on Schedule UTP items attributable to the current year’s return.

9. Multiple Accounting Standards — Related Party Rules.

The proposed schedule will be filed by a business taxpayer with total assets in excess of \$10 million if the taxpayer has one or more UTPs, and either the taxpayer prepares financial statements or is included in the financial statements of a related party that prepares financial statements using FIN 48 (or another accounting standard for determining reserves for UTPs). A related entity is any entity related to the taxpayer under section 267(b), 318(a), or 707(b). Thus, where a parent prepares financial statements that include a subsidiary, the subsidiary's reserves for UTPs would be disclosed in a tax return filed by the parent (if a consolidated U.S. return is filed for the parent and subsidiary) or by the subsidiary if the subsidiary files a separate U.S. tax return.

TEI recommends that the IRS confirm that where a U.S. subsidiary is included in the financial statements prepared by a foreign parent corporation, the subsidiary can prepare the schedule for its U.S. tax return on the basis of the accounting standards used for reporting its UTPs to its parent corporation. Thus, if a U.S. subsidiary prepares its internal reporting packages to the parent on the basis of IFRS, the reserves for UTPs will be determined on the basis of IAS 12 (or successor guidance).³⁹

³⁹ TEI recommends that the IRS clarify the Schedule UTP filing requirement in respect of a subsidiary (or subsidiary group) that is part of the consolidated audited financial statements of another group (including the parent) that issues a separate, audited financial statement (*e.g.*, for credit purposes). Where the subsidiary (*e.g.*, a U.S. subsidiary or U.S. group of corporations) issues a separate audited financial statement, the materiality threshold or the accounting standards for recording a tax reserve may differ from the materiality threshold or accounting standards of the consolidated group (especially where the issuer of the consolidated financial statement is a non-U.S. company). As noted in the Appendix, different accounting standards may result in different UTPs being reported on Schedule UTP. For each subsidiary (or subsidiary group) issuing separate financial statements, the IRS should afford an election permitting taxpayers to disclose the UTPs for which reserves are recorded on the basis of either the separate financial statements or the parent consolidated financial statements. Taxpayers should also be permitted to change that election with the consent of the IRS.

10. *Partnerships.*

Announcement 2010-30 states that the draft schedule will not apply to partnerships for the 2010 tax year. The delay will afford time to the IRS and taxpayers to determine how to apply the disclosure requirements for entities that generally do not record tax reserves in their financial statements. Generally, the only issue on which a flow-through entity will establish a reserve is on the question whether the entity is subject to tax. Other reserves are generally established at the partner level. TEI is considering the implications of the disclosure requirement on partnerships, and our only recommendation at this time is that the IRS *not* impose an affirmative obligation on a partner to disclose UTPs for partnership transactions unless (1) the taxpayer-partner owns more than 50 percent of the partnership interests, or (2) the partnership discloses transactions or tax items or otherwise provides information to the partner sufficient to inform it that a UTP exists for which a reserve is required.

11. *Effective Date and Transition Rule.*

Announcement 2010-30 clarifies that the IRS intends to require filing of the new schedule for corporation tax returns relating to calendar year 2010 and for fiscal years that begin in 2010. The draft instructions confirm that a corporation is “not required to report on Schedule UTP a tax position taken in (a) a tax year beginning before December 15, 2009, or (b) a tax year beginning on or after December 15, 2009, and ending before January 1, 2010, regardless of when a reserve was recorded with respect to that tax position.” Thus, the disclosure obligation is prospective only with no requirement to disclose on a “catch-up basis” reserves recorded prior to 2010.

TEI welcomes the clarification of the effective date and applauds the transition rule. In order to afford time to “road test” the schedule with a group of volunteer taxpayers, adjust it to

take account of taxpayer behavior, and afford time for taxpayers to revise their data collection and reporting regimes, we recommend that the IRS delay the schedule's implementation date until tax years *beginning after* release of the final form.

12. Penalties.

a. General. Announcement 2010-9 states that the IRS is evaluating additional options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure of the required information regarding its UTPs. One option would be to seek legislation imposing a penalty for failure to file the schedule or make an adequate disclosure.

TEI recommends that the IRS clarify what penalties would currently apply for failure to include the schedule in the taxpayer's return. Section 6651 provides a penalty for failing to file a return, including failing to include sufficient information upon which the IRS can determine the taxpayer's tax liability. It is unclear, however, whether section 6651 or any other penalty provision would apply to a taxpayer's failure to include a schedule that does not directly affect the computation of the taxpayer's liability even though it may provide information to the IRS about items on the return. Indeed, a return is generally sufficient if it includes enough information to calculate the tax liability and is a reasonable attempt to comply with the law. To apprise taxpayers of the scope of any penalty and defenses to the assertion of a penalty, TEI recommends that the guidance clarify the authority under which the IRS would impose penalties for failing to include the schedule in the return. Moreover, we recommend that the IRS confirm that taxpayers may avoid the assertion of any current (or subsequently legislated) penalty by filing a "qualified amended return" within the 15-day grace period that is accorded to taxpayers by Rev. Proc. 94-69⁴⁰ at the commencement of an audit.

⁴⁰ 1994-2 C.B. 804.

Finally, we recommend that the IRS clarify that it will provide a transition period of at least three tax years before it will attempt to assert any potentially applicable penalties. Schedule UTP introduces a whole new layer of complexity in tax return preparation, including new terms (such as tax position and uncertain tax position) and subjective reporting requirements (such as the MTA and “concise description”). Consequently, taxpayers should be afforded sufficient time to develop proper reporting mechanisms and the IRS should assess the adequacy of the disclosures received during that period to (1) clarify the Schedule UTP reporting requirements, and (2) provide guidance on unacceptable or incomplete disclosures. So long as a taxpayer files Schedule UTP and makes a good faith effort to comply with the schedule’s requirements during the transition period, there should be no penalty for “incomplete” disclosures.

b. Schedule UTP and Instructions — Coordination with Other Reporting Requirements. The instructions state that a complete and accurate disclosure of a tax position on the appropriate year’s UTP will be treated as if the corporation filed a Form 8275 or Form 8275-R for the tax position. A separate Form 8275 or 8275-R will not be required to be filed. We applaud the IRS’s decision to permit taxpayers to avoid duplicate disclosure of the UTPs on Forms 8275 and 8275-R, and have the following comments and questions in respect of the instructions.

For positions that would *not* otherwise be required to be disclosed on Form 8275 or 8275-R, the instructions (or other guidance) should clarify the standard for determining whether the taxpayer has made a “complete and accurate” disclosure. For example, if multiple Code sections apply to a particular provision, is the schedule incomplete if the taxpayer lists only one rather than three “primary IRC sections”? In addition, apropos our comments on the challenges of calculating the MTA for any particular tax position, will revenue agents, Appeals Officers, or personnel from the Office of Chief Counsel be permitted to second guess taxpayers’ estimates of

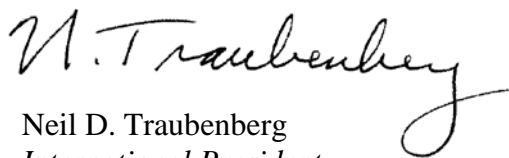
the MTA and assert the application of a penalty for incomplete disclosure even where all the other information is correct but the MTA is erroneous? Also, the instructions require a “complete and accurate” disclosure including a “concise” description of the UTP. Again, apropos our comments on the requirement that taxpayers provide a “concise” description of their UTPs, we regret that there is ample room for controversy about whether the taxpayer’s “concise” description of the UTP would be considered “complete and accurate.” Because we do not believe it appropriate to impose the Form 8275 or 8275-R reporting standards on UTPs that do not otherwise require disclosure, the IRS should clarify the expected standard of taxpayer behavior as well as reasonable cause exceptions before penalties are asserted for failing to provide a “complete and accurate” description of the UTP or the MTA on Schedule UTP.

CONCLUSION

Tax Executives Institute appreciates this opportunity to present its views on Announcements 2010-9, 2010-17, and 2010-30, relating to a proposed new Schedule UTP and draft instructions for disclosure of uncertain tax positions. We would welcome the opportunity to meet with IRS officials to discuss our comments, elaborate on our concerns, and respond to any questions. If you should have any questions about TEI’s submission, please do not hesitate to contact either Eli J. Dicker (edicker@tei.org) or Jeffery P. Rasmussen (jrasmussen@tei.org) of the Institute’s legal staff; both may be reached at 202.638.5601.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.



Neil D. Trautenberg
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Appendix

Example Illustrating the Effect of Different Accounting Standards on Required Schedule UTP Disclosures

Assume COMPANY A is a U.S. public company that accounts for uncertain tax positions under FIN 48.

Assume COMPANY B is a non-U.S. company that accounts for uncertain tax positions under a local country accounting standard that is similar to SFAS 5 (which was used in the United States before the adoption of FIN 48). Under this standard, a reserve may only be recorded if a loss is “probable,” and where there is a range of possible outcomes, the minimum amount of the loss is recorded.

Assume COMPANY C is a non-U.S. company that accounts for uncertain tax positions under a local country accounting standard that is similar to the proposed approach under the exposure draft for IAS 12 of IFRS. Under this standard, reserves are based upon probability-weighted outcomes.

Each company has three tax positions:

- POSITION 1 for \$100 is highly certain (*i.e.*, 98 percent certainty of being sustained) but not completely certain.
- POSITION 2 for \$100 is more likely than not to be sustained, but the company acknowledges the possibility that it would have to concede a portion of the position upon settlement on examination or at appeals. The Company determines that the cumulative probability of sustaining \$100 at settlement is 49 percent but the cumulative probability of sustaining \$80 at settlement is 100 percent.
- POSITION 3 for \$100 is a temporary difference and the company believes that no reserve is required based upon tax authority administrative practice.

Under the respective financial accounting standards applicable to each company the results are:

COMPANY A would, for financial accounting purposes, record no UTP for POSITIONS 1 and 3, and a UTP of \$20 (\$100 minus \$80, the outcome with a cumulative probability of more than 50 percent) for POSITION 2. It would be required to disclose on Schedule UTP an MTA of \$100 for POSITION 2 and, depending on how temporary differences are reported, potentially a reserve of \$100 for POSITION 3.

COMPANY B would, for financial accounting purposes, record no UTPs. In none of the three POSITIONS is a loss considered “probable.” Furthermore, there is no

administrative practice exception under its local country accounting standard, so the company would not be required to make any Schedule UTP or MTA disclosures.

COMPANY C would record a UTP for POSITION 1 of \$2 (\$100 minus 98 percent of \$100), a UTP for POSITION 2 of \$10 (\$100 minus (49% x \$100) minus (51% x \$80)) and no UTP for POSITION 3. It would be required to disclose an MTA on Schedule UTP of \$100 for POSITION 1 and \$100 for POSITION 2, but no MTA for POSITION 3, since no administrative practice exception is relied upon. (The Company assigned a probability of 100% to the \$100 benefit.)

Summarizing the results in tabular fashion, the resulting Schedule UTP disclosures would be:

COMPANY	POSITION 1	POSITION 2	POSITION 3
A		X	X
B			
C	X	X	

Hence, the use of different accounting standards will result in different disclosure requirements for the same tax positions.