

E-ALERT | Tax

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IRS MAKES CHANGES TO UNCERTAIN TAX POSITION REPORTING PROPOSAL

On September 24, 2010, the Internal Revenue Service substantially modified the rules on the disclosure of uncertain tax positions (UTPs) and published a final Schedule UTP and accompanying instructions (the Schedule UTP). The IRS also announced an expansion of its policy of restraint to cover workpapers that relate to uncertain tax positions, and it issued a directive to examiners regarding the use of information reported in Schedule UTP. See Announcement 2010-75, Announcement 2010-76, Directive for All Large Business and International Division (LB&I) Personnel, *Reporting of Uncertain Tax Positions* (Sept. 24, 2010). The key changes from the proposed Schedule UTP are described below.

Five-year Phase-in Period

The final Schedule UTP retains the previously announced rule concerning the types of corporations that are required to file Schedule UTP. Thus, certain public and privately held corporations that issue or are included in audited financial statements and that file a Form 1120, Form 1120-F, Form 1120-L, or Form 1120-PC will eventually be required to disclose their UTPs. However, the IRS will implement the disclosure rules over a five-year phase-in period. The original time-line will not change for corporations with total assets of \$100 million or more—they must file the Schedule UTP with their tax returns beginning with the 2010 tax year. The asset threshold will be reduced to \$50 million starting with the 2012 tax year and to \$10 million starting with the 2014 tax year.

Sizing of Tax Adjustments

The final Schedule UTP no longer requires the reporting of a maximum tax adjustment amount for UTPs. Instead, taxpayers must rank all of the reported tax positions, including transfer pricing and valuation positions, based on the relative size of the United States federal income tax reserve (including interest and penalties) recorded for each position. In addition, taxpayers must designate the tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all of the positions reported on Schedule UTP. Schedule UTP also provides that taxpayers need not determine the size of tax positions that they expect to litigate, and the schedule gives taxpayers the flexibility to assign any rank to such positions.

Highly Certain or Immaterial Positions

The final Schedule UTP clarifies that no disclosure is required for tax positions that are either immaterial or “sufficiently certain” that no reserve is required under applicable accounting standards.

No Reporting of Administrative Practice Tax Positions

The final Schedule UTP no longer requires that taxpayers report positions for which they record no reserve because of the Service’s administrative practice of not raising the issue.

Required Description

The proposed Schedule UTP required taxpayers to disclose the rationale for and nature of an uncertain position. The final Schedule UTP requires, instead, that the description of the UTP include relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue. The final Schedule UTP provides that the description should not include an assessment of the hazards of a tax position or an analysis of the support for or against the position. This provision presumably reflects the IRS's attempt to insulate the Schedule UTP reporting requirements from privilege challenges.

Coordination with Forms 8275 and 8886

Schedule UTP clarifies that a complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP will be treated as a disclosure under Forms 8275 or 8275-R regarding the tax position, and that separate Forms 8275 or 8275-R need not be filed to avoid accuracy-related penalties. Similarly, in the case of a transaction that is not a reportable transaction, proper disclosure on Schedule UTP will be treated as adequate disclosure for purposes of Section 6662(i) (which provides for increased penalties in the case of nondisclosed noneconomic substance transactions).

Miscellaneous Changes and Clarifications

- Schedule UTP requires the reporting of U.S. federal income tax positions but not foreign or state tax positions.
- UTPs must generally be reported on Schedule UTP once (a) a reserve for the position is recorded and (b) a tax position is taken on a return, regardless of the order in which those two events occur. Transition rules may override this rule in particular cases.
- Tax positions taken on returns for years before 2010 need not be reported in 2010 or a later year even if a reserve is recorded in audited financial statements issued in 2010 or later.
- In determining whether a corporation that files a Form 1120-F (including a protective return) has sufficient assets to trigger an obligation to file Schedule UTP, the taxpayer must take into account its worldwide assets.
- An audited financial statement is one in which an independent auditor expresses an opinion. A financial statement that is merely compiled or reviewed is excluded from the definition of an audited financial statement.
- "Recording a reserve" includes the recording of a reserve for United States federal income tax, interest, or penalties. Notably, reserves for liabilities relating to temporary differences must be reported on Schedule UTP (if they otherwise satisfy the reporting requirements).
- For corporations included in multiple audited financial statements, the recording of a reserve in any one audited financial statement in which the corporation is included triggers reporting of the tax position if the position is taken on a return filed by the reporting corporation.

Expansion of the Policy of Restraint

Under an existing policy of restraint, the IRS generally refrains from seeking documents that constitute tax accrual workpapers. Otherwise privileged documents that are found in an auditor's files constitute tax accrual workpapers; these documents are subject to the existing policy of restraint and thus ordinarily will not be sought by the IRS from the auditor, even though the IRS may

take the view that disclosure of such documents to the auditor waived applicable privileges. The new guidance expands this policy and provides that the Service will not assert a waiver theory when otherwise privileged documents are shown to an auditor even if the documents do not constitute tax accrual workpapers. The new guidance also permits taxpayers to redact certain information from any copies of tax reconciliation workpapers relating to the preparation of uncertain tax positions, including (a) working drafts, revisions, or comments concerning the concise description of the UTP, (b) the amount of any reserve related to a UTP, and (c) computations used to rank tax positions in the Schedule UTP.

Notwithstanding the foregoing, taxpayers rely on the IRS's policy of restraint at their hazard, as the policy may be changed at any time.

Exchange of Information with Foreign Governments

Announcement 2010-75 explains that the IRS will refrain from sharing information from Schedule UTP with foreign governments except in the rare situation where there is a reciprocal arrangement with the foreign government regarding uncertain tax positions and the information is relevant to the foreign government. The nonbinding nature of the Service's intentions in this regard and the vague boundaries of the IRS's commitment to refrain from disclosure make the significance of this provision questionable.

Directive to Large Business and International Division Personnel

Steven T. Miller, the Deputy Commissioner of Services and Enforcement, issued a directive regarding the planned use and treatment of information on Schedules UTP by Large Business and International Division (LB&I, formerly LMSB) examiners and other personnel.

A centralized function within LB&I will review and analyze Schedule UTP to determine compliance with the schedule's instructions and to select issues and returns for audit. This process will also be used to identify and understand gaps in guidance and publish new guidance to eliminate uncertainty if it is deemed necessary.

The directive instructs LB&I examiners to approach uncertain tax positions on audit "keeping in mind their responsibility to apply the law as it currently exists, not how [the IRS] would like it to be[,] . . . without bias in favor of the government or the taxpayer." According to the directive, this approach entails understanding that tax positions are uncertain for a number of reasons, "including ambiguity in the law and a lack of published guidance on issues." Accordingly, the directive notes, not every tax position disclosed in Schedule UTP will require an examination or an audit adjustment.

The directive encourages examiners to discuss with taxpayers the UTPs disclosed in Schedule UTP in advance of issuing the initial information document requests and to eliminate any uncertainty as quickly as possible.

If you have any questions concerning the material discussed in this client alert, or if you believe that you might benefit from continuing legal education (CLE) on these or any related topics, please contact the following members of our tax practice group:

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