

# Disclosing Uncertain Tax Positions from A to Z: (Not Just Schedule UTP)

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## **Types of Disclosures of Uncertain Tax Positions**

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- **Questions on Income Tax and Information Returns**
- **Forms 8275 and 8275-R (“Disclosure Statement” and “Regulation Disclosure Statement”)**
- **Form 8886 (“Reportable Transaction Disclosure Statement”)**
- **Schedule M-3 (“Net Income (Loss) Reconciliation”)**
- **Schedule UTP (“Uncertain Tax Position Statement”)**
- **Disclosures required by regulation (Reg. § 1.707-8)**

## A Step Back (part I) – A Primer on Penalty Standards

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### ■ Substantial Authority

- “weight of the authorities [set forth in § 1.6662-4(d)(3)(iii)] supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment”
- Positions with substantial authority generally are removed from determination whether there is a substantial understatement – *not for tax shelter items or § 7701(o) violations*.

### ■ Reasonable Basis

- “reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments)”
- reasonable basis + adequate disclosure + adequate records = substantial authority

### ■ Reasonable Cause and Good Faith

- A defense to all accuracy-related penalties (other than § 7701(o) violations).
- “the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability”
- Concealing a transaction shows a lack of good faith (*Long-Term Capital Holdings*).

## A Step Back (part II) – The Failure-to-File Penalties

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### ■ The Penalties

- § 6651(a)(1) civil monetary penalty – generally up to 25% of the amount required to be shown on the return.
- § 6501(a) – the statute of limitations does not begin to run until return is filed.
- § 7203 criminal penalties on willful failures to file a return, supply information or pay tax – misdemeanor up to \$25,000 (\$100,000 for corporations) and 1 year of imprisonment.

### ■ ***Beard* Test for Whether a Return has been Filed under Section 6651(a)(1)**

- “First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury.”

### ■ Authorities Dealing with Supplemental Schedules

- Failing to attach a W-2 is not a failure to file the return. *Blount; In re Draiman*.
- Preparing a Form 8886 does not make one a tax return preparer. Reg. § 301.7701-15(b)(3)(iv).



## Disclosures through Questions on Returns

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### ■ Examples

- Form 1065, Schedule B, Questions 13 and 14 (potential abuse of section 1031).
- Form 5500, Schedule H, Questions 4m and 4n (blackout period notices) (Form 5500 jointly administered by Dept. of Labor).

### ■ Costs of Leaving these Questions Blank

- Failure-to-file penalties are possible (particularly with Form 5500).
- Weakens reasonable cause and good faith defense.

# Form 8275 – Disclosure Statement

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## ■ Background

- Introduced in 1985.
- Is currently the exclusive means of reducing understatements under § 6662, though Rev. Proc. 2012-51 provides that a Schedule UTP counts as if it were a Form 8275.
- Rev. Proc. 2012-51 also lists specific transactions for which filing a Form 8275 is not necessary (*e.g.*, casualty and theft losses).

## ■ Benefits of Filing a Form 8275

- Reduces understatements under § 6662(d) if (i) there is reasonable basis for the position, (ii) books & records are adequate and (iii) it is not a tax shelter item, § 7701(o) violation or reportable transaction understatement.
- Protects against § 6662(c) penalty on disregard of rules if (i) there is reasonable basis for the position and (ii) books & records are adequate.

## ■ Costs of Not Filing a Form 8275 or Filing an Incomplete One

- § 6662(i) penalties on § 7701(o) violations increase from 20% to 40%.
- Weakens reasonable cause and good faith defense.

# Form 8275 – Disclosure Statement – Content

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## ■ Part I – “General Information” (for up to 6 Items)

- Identification of rule(s), if any, to which position is contrary (*e.g.*, Revenue Ruling, Revenue Procedure or statutory provision).
- Description of the Item(s).
  - ❖ Title (*e.g.*, entertainment expenses).
  - ❖ Complete description (*e.g.*, theater tickets, catering expenses and banquet hall rentals).
- Location of the Item(s) on the Return (Form or schedule #, line number and amount).

## ■ Part II – “Detailed Explanation”

- 3 lines per item on page 1, with carryover onto completely blank page 2 (**Part IV – “Explanations”**). *Attached statements or letters not permitted.*
- Description of the relevant facts affecting the tax treatment of the item.
- “To satisfy this requirement you must include information that reasonably can be expected to apprise the IRS of the identity of the item, its amount, and the nature of the controversy” (which “can include a description of the legal issues presented by the facts”).

## ■ Part III – “Information about Pass-Through Entity”

# Form 8275-R – Regulation Disclosure Statement

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## ■ Background

- Introduced in 1992.
- Used for disclosing positions contrary to regulations. Form 8275-R is almost identical to Form 8275.
- Rev. Proc. 2012-51 lists specific transactions for which filing a Form 8275-R is not necessary (*e.g.*, casualty and theft losses).

## ■ Benefits of Filing a Form 8275-R

- Reduces understatements under § 6662(d) if (i) there is reasonable basis for the position and (ii) it is not a tax shelter item, § 7701(o) violation or reportable transaction understatement.
- Protects against § 6662(c) penalty on disregard of regulations if (i) there is reasonable basis, (ii) books & records are adequate and (iii) is a good faith challenge of regulation. Rev. Proc. 2012-51 does not apply in these situations.

## ■ Costs of Not Filing a Form 8275-R or Filing an Incomplete One

- § 6662(i) penalties on § 7701(o) violations increase from 20% to 40%.
- Weakens reasonable cause and good faith defense.





# Form 8886 – Reportable Transaction Disclosure Statement

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## ■ Background

- Introduced in 2003.
- Required disclosure statement for “reportable transactions.”
- Rev. Proc. 2012-51 provides that Schedule UTP does not count as filing a Form 8886.

## ■ Types of Reportable Transactions

- Listed Transactions (or substantially similar to Listed Transactions)
- Confidential Transactions
- Transactions with Contractual Protection
- Loss Transactions
- Transactions of Interest (added in 2007)
- Transactions a Significant Book-Tax Difference (removed in 2007)
- Transactions Involving a Brief Asset Holding Period (removed in 2007)

## Form 8886 – Reportable Transaction Disclosure Statement

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### ■ “Substantially Similar” – Reg. § 1.6011-4(c)(4)

- (a) Same or similar tax consequences and (b) either (i) factually similar or (ii) based on same or similar strategy tax strategy

### ■ Data on Transactions Reported (from 5/11 GAO Report):

Type	2007	2008	2009
Listed Transactions	6,139	1,348	1,293
Loss Transactions	88,371	50,782	88,582
Everything Else	6,283	712	292
<b>Total</b>	<b>100,793</b>	<b>52,842</b>	<b>90,167</b>



## Form 8886 – Reportable Transaction Disclosure Statement

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### ■ Listed Transactions

- Most up-to-date list at <http://www.irs.gov/Businesses/Corporations/Listed-Transactions---LB&I-Tier-I-Issues>. *See also* Notice 2009-59.

### ■ Transactions of Interest

- Most up-to-date list at <http://www.irs.gov/Businesses/Corporations/Transactions-of-Interest---Not-LMSB-Tier-I-Issues>.

### ■ Loss Transactions

- For corporations and partnerships with only corporate partners, § 165 losses of \$10 million over 1 year or \$20 million over 6 years (\$2 million and \$4 million respectively for all others, and \$50,000 over 1 year for § 988 losses of individuals and trusts).
- Losses are determined on a gross basis.
- *See* Rev. Proc. 2013-11 for exceptions to disclosure (generally for losses directly tied to cash expenditures).

## Form 8886 – Reportable Transaction Disclosure Statement

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### ■ Office of Tax Shelter Analysis (OTSA)

- One copy of Form 8886 is attached to return; the other goes to OTSA.
- If you learn of reportable transaction from a Schedule K-1, you have 60 additional days to send to OTSA.
- If transaction later becomes “listed” or “of interest” before statute closes, send Form 8886 to OTSA within 90 days of listing.

### ■ Costs of Not Filing a Form 8886 or Filing an Incomplete One

- § 6707A(a) penalty of lesser of (a) \$10,000 (\$5,000 for natural persons) and (b) 75% of tax benefit of transaction, capped at \$200,000 for listed transactions and \$50,000 for other reportable transactions (\$100,000 and \$10,000, respectively, for natural persons).
- No reasonable cause defense. Rescission theoretically possible for non-listed transactions, but it has not happened yet.
- § 6707A(e) requires that § 6707A(a) penalties be reported to the SEC.
- Under § 6501(c)(10), the statute of limitations for a listed transaction generally does not begin to run until it is disclosed.
- § 6662A accuracy-related penalty increased from 20% to 30%.



## Form 8886 – Content

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### ■ Identity of the Transaction

- Whether a “protective” disclosure (still required to fill everything out).
- Name of the transaction.
- Reportable transaction number (if any).
- Type(s) of Reportable Transaction.
- Listing notice (if any).
- Information regarding entity participated through.
- Number of substantially similar transactions on same Form.

### ■ Identity of Promoters and Advisors and Amount of Fees Paid

- If person promoted, solicited or recommended the transaction, or provided tax advice with respect to it, and was paid a fee.

## Form 8886 – Content

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### ■ Description of the Transaction

- Type(s) of tax benefits (9 choices plus an “Other” box).
- “Describe the reportable transaction you entered into and the relevant facts and tax benefits for all affected years that caused the transaction to be reportable. Describe each step of the transaction including all information known to you. Include in your description other parties to the transaction and, if known, assumptions of liabilities or other obligations, satisfaction of liabilities or obligations, sales of property or interests in property, the formation and dissolution of entities, and any agreements between or among parties to the transaction. Also describe any tax result protection with respect to the transaction.”
  - ❖ Instructions state that narrative must begin on the Form (*i.e.*, don’t write “See Attached.”).
- “Describe the economic and business reasons for the transaction and its structure. Describe market or business conditions creating the tax benefit(s) or consequence(s) and the transaction's financial reporting if known.”
- Describe why it is a reportable transaction. If a loss, explain how the basis was calculated.
- Identity of all tax-exempt, foreign, or related entities involved in the transaction.

## Form 8886 – Content and Availability of Rulings

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### ■ **Completeness of Disclosure – CCA 201045022 (9/2/10)**

- Disclosure in Situation 3: “due to the nature and volume of Taxpayer3's activities, it is not practical to determine whether the applicable reportable loss thresholds are exceeded for any specific transaction or to determine with certainty whether any specific transaction has met any of the exceptions provided in Rev. Proc. 2004-66. Taxpayer3 is reporting these transactions on a protective basis.”
- The above disclosure, by a top-tier “fund of funds” partnership, does not satisfy the requirements for a Form 8886.
- Disclosure in Situation 4 also inadequate: “Taxpayer4 claimed losses under § 165 in excess of the \$2 million threshold.”

### ■ **Availability of Rulings on Substantial Similarity to Listed Transactions**

- PLR 201234017 (5/14/12) – Foreign currency forward contracts not substantially similar to Rev. Rul. 2000-12.
- PLR 201027007 (4/13/10) – Single employer welfare benefit plans not substantially similar to Notice 95-34; but plan in PLR 201017076 was substantially similar.

## Qualified Amended Returns (QARs) – Reg. § 1.6664-2(c)

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- **Definition** – An amended return filed after the due date , but before the earlier of:
  - The date taxpayer is first contacted by IRS regarding an examination of the return;
  - The date any person is first contacted by IRS regarding an exam under § 6700 (for promoting abusive transactions) for an activity in which the taxpayer participated;
  - For pass-through items, the date pass-through entity is first contacted by IRS regarding an examination;
  - The date a § 7609(f) John Doe summons is served;
  - The date the IRS announces a settlement initiative.
  - Even more stringent rules for undisclosed listed transactions.
- **Effect of a Qualified Amended Return**
  - If the QAR effectively rescinds a tax position, such position cannot be subject to a § 6662(d) substantial understatement penalty.
  - A QAR can also be used to file a Form 8275 or Form 8275-R late, which can reduce penalties under § 6662(i) as well as § 6662(d).
  - A QAR could be used to file a Form 8886 late, which can reduce penalties under § 6662A, but not § 6707A(a).
  - Rev. Proc. 94-69 allows CIC taxpayers to use written statements instead.



## Schedule M-3 – Net Income (Loss) Reconciliation

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### ■ Background

- Introduced in 2004.
- Required for business entities with assets of \$10 million or more. Starting in 2015, business entities with less than \$50 million do not have to file parts II and III.
- Divides book-tax differences into temporary differences and permanent differences and into several dozen categories.
- “Schedule M-3 provides information that will identify taxpayers that may have engaged in aggressive transactions and therefore should be audited.” IRS News Release 2004-91.

### ■ Benefits of Filing Schedule M-3

- Section 4.02(3) of Rev. Proc. 2012-51 describes situations in which reporting on Schedule M-3 can take the place of Form 8275 or Form 8275-R.

### ■ Costs of Not Filing Schedule M-3 or Filing an Incomplete One

- Failure-to-file penalties are possible, but not likely.
- § 6662(i) penalties on § 7701(o) violations increase from 20% to 40%.
- Weakens reasonable cause and good faith defense.

# Schedule UTP – Uncertain Tax Position Statement

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## ■ Background

- Introduced in 2010.
- Required for corporations with audited financial statements and meets asset test (\$100 million for 2010 and 2011, \$50 million for 2012 and 2013, and \$10 million thereafter).
- Taxpayers must report positions for which they or a related party has recorded a reserve for U.S. federal income tax on its financial statements or did not record a reserve because of an expectation to litigate the position.

## ■ Benefits of Filing a Schedule UTP

- Same as Form 8275.

## ■ Costs of Not Filing a Schedule UTP or Filing an Incomplete One

- Failure-to-file penalties are possible, but not likely. It may be only a matter of time until Congress enacts Schedule UTP-specific penalties.
- § 6662(i) penalties on § 7701(o) violations increase from 20% to 40%.
- Weakens reasonable cause and good faith defense.

## Schedule UTP – Content

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### ■ Part I – UTPs for the Current Tax Year

- List up to 3 “primary” Code sections and 3 “primary” Code sub-sections.
- Check box(es) for permanent and/or temporary differences.
- EIN of pass-through entity involved.
- Identify if a “Major Tax Position” – federal income tax reserve for position for the year is 10% or more of total federal income tax reserves.
- Ranking of Tax Position (*e.g.*, G1, G2, T3, G4, etc.):
  - ❖ Ranking based on size of reserve for the year.
  - ❖ Use T for transfer pricing positions and G for everything else.
  - ❖ If penalties and interest separately stated, don’t count them.
  - ❖ Expectation of litigation positions can be ranked anywhere.

### ■ Part II – UTPs for Prior Tax Years

- Same as above, but for UTPs for prior years not previously disclosed on a Schedule.
- Positions for tax years beginning before January 1, 2010 should not be disclosed.



## Schedule UTP – Content

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### ■ Part III – Concise Descriptions of UTPs

- Include a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue.
- Instructions state that in most cases concise description will be no longer than a few sentences.
- “A concise description should not include an assessment of the hazards of a tax position or an analysis of the support for or against the tax position.”
- Intended to be consistent with the information required to be reported on Form 8275. *See* Announcement 2010-75.

## Schedule UTP – Reported Data on 2010 Schedules

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### ■ Data on UTPs Reported from news stories:

- 2,138 taxpayers filed Schedule UTP in 2011 (2,143 in 2010).
- 77% of 2011 filers also filed a Schedule UTP in 2010.
- 2011 Schedule UTPs averaged 2.6 UTPs per taxpayer (2.4 in 2010).
- 41% of 2011 Schedule UTPs reported only one UTP (48% in 2010).
- The top three issues were:
  - ❖ Section 41 (research credit) – 24% of total in 2011
  - ❖ Section 482 (transfer pricing) – 22% of total in 2011
  - ❖ Section 263(a) (capital expenditures) – 6 % of total in 2011
- About one quarter of disclosed UTPs were identified as Major Tax Positions.
- The IRS sent 578 taxpayers education and outreach letters identifying 982 concise descriptions on 2011 Schedules UTP that were considered incomplete. The IRS sent less than 100 such letters for 2010, but expanded its review.



## UTP Pop Quiz – Question 1

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- **Research Credit**– which of the following is a proper concise description?
  - A. “This is a research credit issue.”
  - B. “The taxpayer incurred support department costs that were allocated to various research projects based upon a methodology the taxpayer considers reasonable. The issue is whether the taxpayer’s method of allocating these costs is acceptable by the IRS.”
  - C. “This is an issue that we know is subject to IRS scrutiny.”



## UTP Pop Quiz – Question 2

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- **Transfer Pricing** – which of the following is a proper concise description?
  - A. “This is a transfer pricing issue.”
  - B. “The taxpayer allocated management service costs between its domestic subsidiaries and a foreign subsidiary located in Country X using a methodology the taxpayer considers reasonable. The issue is whether the taxpayer’s method of allocating these costs is acceptable by the IRS.”
  - C. “This issue is under audit for a prior year.”

## UTP Pop Quiz – Question 3

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- **Section 199** – which of the following is a proper concise description?
  - A. “The Taxpayer claimed a domestic production activities deduction.”
  - B. “The domestic production activities deduction is highly factual and subject to review by the IRS. The Taxpayer claimed the domestic production activities deduction on certain production activities income for 2010. The issue is whether costs incurred for product aging processes that occur in designated areas located at the Taxpayer’s distribution facility are considered manufacturing or production costs of the tangible personal property, and therefore, a component of Qualified Production Activities Income.”
  - C. “This is an issue for which we have recorded a reserve because the appropriate tax treatment of this position is unsettled and we are awaiting published guidance and we are awaiting the outcome of pending litigation.”





## UTP Pop Quiz – Question 4

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- **Travel & Entertainment** – which of the following is a proper concise description?
  - A. “The Taxpayer incurred costs during the year that are deductible as ordinary and necessary business expenses under IRS Section 162 and that are included in “Other deductions” on Line 26 of Form 1120.”
  - B. “The Taxpayer claimed a deduction for travel and entertainment expenses for conventions and sales meetings. The issues are whether adequate documentation has been retained to substantiate the deductions claimed and whether some of the expenses constitute entertainment subject to a 50% limitation.”
  - C. “This issue is one for which we have recorded a reserve because it was unresolved in prior years and is currently in Appeals.”



## UTP Pop Quiz – Question 5

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- **Investigatory Costs** – which of the following is a proper concise description?
  - A. “This is an issue related to the treatment of investigatory costs.”
  - B. “The corporation incurred costs of completing one business acquisition and also incurred costs investigating and partially negotiating potential business acquisitions that were not completed. The costs were allocated between the completed and the uncompleted acquisitions. The issue is whether the allocation of costs between uncompleted acquisitions and the completed acquisitions is appropriate.”
  - C. “The issue relates to how we have characterized certain expenditures and related deductions.”

## UTP Pop Quiz – Question 6

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- **Disguised Sale** – which of the following is a proper concise description?
  - A. “This is a partnership disguised sale issue.”
  - B. “The corporation is a member of Venture LLC, which is treated as a U.S. partnership for tax purposes. The corporation received a cash distribution during the year from Venture LLC. The issue is the potential application of section 707(a)(2) to recharacterize the distribution as a sale of a portion of the corporation’s Venture LLC interest.”
  - C. “The corporation is a member of Venture LLC, which is treated as a U.S. partnership for tax purposes. The corporation received a cash distribution during the year from Venture LLC. The issue is the potential application of section 707(a)(2) to recharacterize the distribution as a sale of a portion of the corporation’s Venture LLC interest. The fact that another member of Venture LLC contributed the same amount of cash to the LLC at exactly the same time suggests that recharacterization may be appropriate.”

## UTP Pop Quiz – Question 7

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- **Capitalization of Inventory Costs**– which of the following is a proper concise description?
- A. “This is a section 263A issue regarding the treatment of environmental cleanup costs.”
  - B. “The corporation incurred costs during the tax year to clean up environmental contamination that was caused by its activities in prior years at Site A, which contains both its manufacturing facility and its corporate headquarters. The issue is the allocation of the cleanup costs between X’s production and non-production activities under section 263A.”
  - C. “The corporation incurred costs during the tax year to clean up environmental contamination that was caused by its activities in prior years at Site A, which contains both its manufacturing facility and its corporate headquarters. The issue is the allocation of the cleanup costs between X’s production and non-production activities under section 263A. A reserve was created because of *Jones v. Commissioner*, which was decided in another Circuit.”



## Schedule UTP Concise Description Do's and Don'ts

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### ■ **Do:**

- Include at least two sentences. At least one sentence stating the facts and at least one sentence beginning “The issue is ...”
- Do describe the facts and the issue with enough detail to give the IRS a general idea of what the potential controversy is really about.

### ■ **Don't:**

- Discuss past history you have had with this issue.
- Discuss your strategy for dealing with this issue going forward.
- Provide any analysis of how the law applies to your facts.
- Include any case names.

# Schedule UTP and the Modified Policy of Restraint

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## ■ **Announcement 2010-76**

- The IRS will not assert during an examination that the attorney-client or § 7525 privilege or the work product doctrine have been waived by the disclosure of a document to the taxpayer's independent auditor as part of the audit of the taxpayer's financial statements.
  - ❖ Exceptions for listed transactions and "unusual circumstances" (defined in IRM 4.10.20.3.1).
- When providing tax reconciliation workpapers to IRS examiners, taxpayers can redact:
  - ❖ Drafts, revisions or comments to Schedule UTP concise descriptions.
  - ❖ The amount of any reserve reported on Schedule UTP.
  - ❖ Computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a Major Tax Position.
- Other than requiring the disclosure of the information on the Schedule, the requirement to file Schedule UTP does not affect the policy of restraint.

## Disclosures Required by Regulation

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### ■ **Reg. § 1.707-8 (disguised sale of property to a partnership)**

- Contributions to and distributions from partnerships (including constructive contributions and distributions through the assumption of liabilities) within 2 years of each other are presumed to be sales, unless the distribution is a guaranteed payment for capital, a reasonable preferred return, an operating cash flow distribution or a reimbursement of preformation expenses.
- Taxpayers are required to disclose such combinations of transactions, unless the distribution is a guaranteed payments for capital, a reasonable preferred return or an operating cash flow distribution.
- Disclosure can take the form of a statement or a Form 8275 attached to the return.
- Costs and benefits of compliance similar to those of Schedule UTP.



# Questions?

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## Section 230 Disclaimer

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- This document was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.