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TEXT:

Ready or not, large corporate taxpayers almost certainly will be required to complete a "Schedule UTP" for taxable years beginning in 2010. n2 First announced on January 26, 2010 (in *Announcement 2010-9),* n3 and released in draft form on April 19, 2010, n4 proposed Schedule UTP represents a substantial erosion of the IRS's policy of restraint with respect to tax accrual workpapers and a sea change in the way audits will be conducted for large corporate taxpayers. n5

Because we believe that the proverbial train has left the station, this article does not weigh in on the philosophical debate about whether requiring taxpayers to disclose their uncertain tax positions (UTPs) is a good idea. Instead, we focus here on what the new disclosure requirements will mean in practice. We start with a general overview of the draft Schedule UTP and instructions (the "Draft Instructions"). We then consider how the shift from a norm of nondisclosure to a norm of disclosure will affect taxpayer decisions regarding whether to take aggressive positions. The third part of this article briefly reviews when reserves are required under FASB Interpretation No. 48 ("FIN 48") n6 and considers the interplay between FIN 48 and Schedule UTP. With that groundwork laid, we turn to evaluating specific criticisms of Schedule UTP and make suggestions for improving the Schedule, by reducing the compliance burden on taxpayers without impairing in any way the utility of the Schedule in assisting the IRS to achieve its stated goal of efficiently allocating limited audit resources. n7 We close with a discussion of how compliance with Schedule UTP can be enforced.

OVERVIEW OF THE DRAFT INSTRUCTIONS

Under the Draft Instructions, taxpayers will be required to complete Schedule UTP for a taxable year if the taxpayer:

(i) files its return on Form 1120, 1120-F (foreign corporations doing business in the U.S.), 1120-L (life insurance companies), or 1120-PC (property and casualty insurance companies);

(ii) has assets equal to or exceeding $10 million;

(iii) issues (or a related party issues) audited financial statements that require a taxpayer to record a reserve for U.S. federal income tax positions; and

(iv) such financial statements include one or more tax positions subject to disclosure.

For these taxpayers, the following tax positions must be disclosed:

(i) positions for which a reserve was recorded;

(ii) positions for which no reserve was recorded based on a belief that, although the IRS likely would disagree with the position, the taxpayer would, if challenged, successfully litigate it; and

(iii) positions for which a reserve would have been recorded but for the fact that the taxpayer has determined that the IRS has an administrative practice of not examining tax positions of a similar type.

Significantly, the proposal would have no retroactive effect. That is, no disclosure is required for UTPs that relate solely to taxable years beginning before 2010. This rule applies even if a taxpayer records a new reserve for a pre-2010 position after the new Schedule is effective. Transactions undertaken in a prior year, however, may result in tax benefits in future years. In this case, disclosure would be required if a reserve is recorded with respect to a benefit arising in a taxable year beginning in 2010 or later.

UTPs that relate to the current taxable year are reported in Part I of the Schedule, and UTPs taken on a prior year return are reported in Part II of the Schedule. Importantly, a UTP for a particular year is required to be reported only once. Thus, only prior-year UTPs that have not been reported should be included in Part II of the Schedule. This could include issues that the tax department initially missed, as well as positions that the tax department initially concluded did not warrant a reserve, but for which subsequent adverse developments prompt the tax department to reassess the position and record a reserve. Subsequent adjustments to increase or decrease a reserve do not trigger additional reporting.

Taxpayers must provide the following information for disclosed UTPs:

(i) the Internal Revenue Code sections (up to three) related to the tax position,

(ii) whether the tax benefits received are permanent, temporary, or both, n8

(iii) the EIN of any pass-through entities used,

(iv) whether the tax position is being disclosed because of the administrative practice category,

(v) the maximum tax adjustment (MTA) associated with each position, or, for valuation and transfer pricing positions, a ranking of positions according to the size of the MTA, and

(vi) a concise description of the tax position.

SCHEDULE UTP MAY HAVE A MIXED EFFECT ON TAXPAYERS' APPETITE FOR AGGRESSIVE POSITIONS

Under current law, subject to significant exceptions for tax shelters and transactions lacking economic substance, n9 a taxpayer is not subject to penalties for return positions that result in a substantial understatement of tax if there is substantial authority for the position. n10 For positions that lack substantial authority but have a reasonable basis, n11 penalties can be avoided if the position is disclosed on a Form 8275 or Form 8275-R and does not involve a tax shelter or a transaction lacking economic substance. n12 Significantly, the Draft Instructions provide that a complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP will be treated as if the corporation filed a Form 8275 or Form 8275-R. Thus, large corporate taxpayers generally will no longer be required to file separate Forms 8275 and 8275-R to avoid accuracy-related penalties, as reserves normally will have been recorded for all UTPs that lack substantial authority.

In a recent article on *Announcement 2010-9,* n13 Pamela Olson described the effect of the current regime as follows:

If sunlight is a good disinfectant, then the fear of sunlight had another salutary effect: because positions supported by substantial authority were not subject to penalty regardless of whether disclosed, the first disclosure regime incentivized taxpayers to avoid positions lacking substantial authority.

It is possible that Schedule UTP will have a similar effect for reserved positions that meet the substantial authority standard and therefore did not previously have to be disclosed to avoid penalties. In light of the new disclosure requirement, taxpayers may determine that certain of these positions are not worth the fight.

Due to uncertainties in the law, however, tax directors are unlikely to be able to dutifully minimize their company's taxes while avoiding all positions that would require a reserve. As discussed further below, under FIN 48 such a policy would limit a company to return positions for which it believed there was at least a 50.1% chance of sustaining 100% of the benefit if challenged. Such conservatism, if even possible, would be a sea change itself. Ms. Olson reports that, according to an informal audience survey conducted in March 2010, 25% of corporate taxpayers had 50 or more UTPs that would require disclosure and nearly two-thirds indicated that they had more than 10. n14

We think Schedule UTP may instead prompt taxpayers to take more reasonable basis positions, in order to help tip the scale back in their favor. Such positions no longer will have to be singled out on a Form 8275. Instead, in the Schedule UTP environment, disclosure will be the norm. Apart from requiring disclosure of the fact that a taxpayer determined that a reserve was necessary for a position, the draft Schedule does not ask for taxpayers' risk assessments of their UTPs or in any way distinguish high-risk positions from low-risk positions. Accordingly, reasonable basis positions will be indistinguishable from, and share sunlight on the Schedule with, substantial authority and more-likely-than-not (MLTN) positions that may be associated with relatively small reserves. Thus, the disincentive to take reasonable basis positions under the current system will recede somewhat when Schedule UTP is finalized. Moreover, taxpayers have voiced concerns that examination teams will fixate on the "maximum tax adjustments" reported on the Schedule UTP and propose similar adjustments for all UTPs, without independently assessing the riskiness of each position. If taxpayers expect that examination teams will indiscriminately propose adjustments for most or all of their disclosed UTPs and question the IRS's ability to single out the weakest positions, taxpayers will have an incentive to throw more darts at the board by taking additional uncertain positions on their return, with the hope that some will stick and the aggregate score will not be so different from that which would have resulted before the advent of the new Schedule.

THE INTERPLAY BETWEEN ACCOUNTING FOR TAX RESERVES AND SCHEDULE UTP

The IRS intends for Schedule UTP to rely on the output of the accounting processes that taxpayers are required to undertake for financial reporting purposes. Below, we explain how, under U.S. Generally Accepted Accounting Principles (GAAP), enterprises determine when to reserve for UTPs. We then explain how this process translates into the disclosure of positions on Schedule UTP.

When Taxpayers Must Reserve Under FIN 48

Although many practitioners assume that a FIN 48 reserve will equal the expected settlement value for a position, which in turn reflects an assessment of the hazards of litigation, this is not necessarily the case. As most practitioners know by now, FIN 48 mandates a two-step process for evaluating most tax positions, separating the determination of whether to recognize a benefit from the measurement of the amount of benefit to recognize. The mechanics of both steps play a part in producing reserve amounts that often are counterintuitive.

The Recognition Threshold

In the first step, a taxpayer recognizes a benefit for an income tax position only if it is MLTN that the position would be sustained based solely on its technical merits. Thus, a full reserve is recorded for positions that do not meet the MLTN recognition threshold, even when this determination is a close call. In this situation, FIN 48 assigns no value to a taxpayer's belief that the IRS might nonetheless settle a non-MLTN issue for a portion of the benefit claimed.

The recognition threshold does not apply to positions for which the uncertainty relates solely to valuation, as is the case for many transfer pricing positions. These positions always meet the MLTN recognition threshold because some minimal portion of the benefit is certain to be sustained, and any uncertainty with respect to the amount is dealt with at the measurement phase. n15 Similarly, the recognition threshold is deemed to have been met for all UTPs that relate solely to timing (e.g., there is no dispute that the entire cost eventually is deductible, the only question is when), and any uncertainty regarding the proper period for deducting the item is dealt with at the measurement stage. n16

The Measurement Phase

Although application of the recognition threshold can produce harsh results for close questions, the mechanics of the measurement phase (referred to as a measurement "attribute" in the parlance of GAAP) are of greater interest in the context of Schedule UTP, because it can operate to produce no reserve (and therefore no disclosure) in situations where substantial uncertainty exists.

For tax positions that make it past the MLTN recognition threshold, the benefit recognized is measured as the largest amount of benefit from the position that has a greater-than-50% chance of being realized. This is also referred to as a cumulative probability approach, because all possible outcomes are ordered from largest tax benefit to smallest, and then the probabilities of each outcome are cumulated until a 50.1% cumulative probability is reached.

For example, assume that tax benefits of $100, $60, and $10 are each one-third likely. As depicted in the table below, the cumulative probability of $100 is 33.3%, the cumulative probability of getting at least $60 is 66.7%, and the cumulative probability of getting at least $10 is 100%. In this example, the reserve would be $40 ($100 - $60), because the tax benefit of $60 is the greatest possible benefit with a cumulative probability of more than 50%.

Possible Outcomes -- Amount of tax benefit	Individual Probability	Cumulative Probability
$100	33.3%	33.33%
$60	33.3%	66.67%
$10	33.3%	100.00%

By contrast, a reserve based on expected value, under which the benefits from a UTP would be recorded based on the weighted average of all the possible outcomes, would equal $43.33 ($100 - (33.3% * $100) - (33.3% * $60) - (33.3% * $10)). n17

The FIN 48 measurement attribute effectively ignores the least favorable outcomes to the extent that their aggregate probability is less than 50%. Thus, as depicted below, FIN 48 mandates no reserve for a position if there is a 50.1% chance that the full benefit will be sustained. This effect is most often discussed in the context of so-called "binary" issues.

Possible Outcomes -- Amount of tax benefit	Individual Probability	Cumulative Probability
Litigate and win - $100	50.1%	50.1%
Litigate and lose - $0	49.9%	100%

In light of the IRS's settlement-driven Appeals system, truly binary issues, where the only possible outcomes are a complete win or loss, should be confined to the relatively few issues that a taxpayer expects to litigate if raised. However, it is not necessary to have a binary case to avoid recording a reserve for an uncertain position. Under the FIN 48 cumulative probability approach, taxpayers can avoid recording a reserve for any position for which the taxpayer believes there is a greater-than-50% chance the IRS would fully concede the issue. For "should"-level issues, it would not be unusual to conclude that there is at least a 50.1% chance of a full concession by the IRS, and it is not inconceivable that a taxpayer could reach this conclusion for an MLTN position that does not rise to the level of a should-level position. If so, FIN 48 would assign no value to what might be as much as a 49.9% possibility that the taxpayer would lose the case or settle by giving up a portion of the benefit.

In practice, we are finding that surprisingly fewer issues fall into the middle category of recording a partial reserve than one would expect. It is our impression that no reserve is being recorded for many MLTN positions that may very well have settlement value to the IRS. It may be that taxpayers are representing that they would litigate the issue if challenged, thereby making it a binary issue. Alternatively, some of these positions may in reality be should-level positions, for which it is not unreasonable to assume that there is at least a 50.1% chance of a full concession by the IRS.

Even if taxpayers have heretofore emphasized an intention to litigate to justify no reserve for a marginal MLTN position, the popularity of this approach may recede with the advent of Schedule UTP. As discussed in greater detail below, in addition to positions for which a reserve is recorded, the Draft Instructions would require taxpayers to include on the new Schedule positions for which the taxpayer recorded no reserve after determining that there was a less than 50% chance of settling with the IRS if it had full knowledge of the position (often referred to as the "expectation to litigate" category). Thus, when possible, under the new disclosure regime taxpayers will prefer to justify recording no reserve based on the cliff effect of the FIN 48 measurement attribute for non-binary positions. Under this approach, taxpayers will be able to avoid reporting a position on the Schedule if (i) in identifying possible outcomes the taxpayer assigns at least a 50% probability to some form of settlement with the IRS, and (ii) the taxpayer concludes that, through a combination of settlement and litigation scenarios, there is at least a 50.1% chance of retaining 100% of the benefit.

For example, a taxpayermight conclude that it would be willing to settle a $100 position for no less than $80, but that there is a possibility the IRS would fully concede the issue. The taxpayer could also conclude that the IRS may refuse to settle for $80, in which case the taxpayer would litigate.

Possible Outcomes -- Amount of tax benefit	Individual Probability	Cumulative Probability
Litigate and win - $100	30%	30%
Settle for $100	25.1%	55.1%
Settle for $80-$99	24.9%	80%
Litigate and lose - $0	20%	100%

If the probabilities of the various outcomes are as depicted above, the taxpayer would not be required to record a reserve or disclose the position on the Schedule. This is the case even though the single most likely outcome is a complete win in litigation, because the taxpayer believes there is at least a 50% chance of settlement.

Under this scenario, the need to assign a meaningful probability to a full concession by the IRS may prompt taxpayers to seek more should-level opinions from advisers. Although, in theory, the support of a "should" opinion does not inoculate a UTP from a reserve, in practice, the 70% generalized "chance of success" that a "should" opinion provides usually supports a decision not to record a reserve and therefore to exclude the position from Schedule UTP.

"Unit of Account" Under FIN 48

Under FIN 48, a unit of account is used to determine the appropriate level of granularity or disaggregation (transaction, portion of transaction, election, cost category) at which each UTP must be identified and analyzed. The level of disaggregation used in identifying units of account under FIN 48 can be particularly significant because for positions that do not relate to valuation or timing, the MLTN recognition threshold, an "on-off" switch, will apply separately to each "unit of account." The unit of account now takes on a new significance for all UTPs because, under the Draft Instruction discussed below, it forms the foundation for reporting on the new Schedule.

Rather than define the unit of account definitively, FIN 48 provides:

The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. n18

Taxpayers are instructed, however, to consider the following two nonexclusive factors in determining the appropriate unit of account:

(i) the manner in which the enterprise prepares and supports its income tax return; and

(ii) the level at which the enterprise anticipates the taxing authority will address issues during an examination, assuming the taxing authority has full knowledge of all the relevant facts. n19

Thus, taxpayers have a great degree of flexibility in determining their units of account under FIN 48. n20 FIN 48 contains a series of examples demonstrating that, depending on the circumstances, in evaluating a research and experimentation (R&E) credit claimed on a return, it may be appropriate to treat as the unit(s) of account, and therefore to apply the MLTN recognition threshold at the level of (i) the entire R&E credit claimed on the return, (ii) each individual research project for which the credit is claimed, or (iii) each functional category of expense within each project for which the credit is claimed. n21 Accordingly, depending on the circumstances, the unit of account may be an entire line item or a smaller subcomponent of a line item on a return. Further, it would appear from these examples that the FIN 48 drafters assumed that a unit of account could, in some circumstances, include both the certain and the uncertain portions of a position taken on a return. n22

At its most granular, the "unit of account" for purposes of FIN 48 could be each factual situation where the nature of the facts might affect the outcome of the issue. In contrast, when a class of transactions shares the same tax issue, and factual differences among the transactions should not affect the resolution of the issue, the class of transactions is probably the "unit of account" for purposes of FIN 48.

Whether different levels of risk for the various sub-issues that comprise a return position warrant disaggregating the position into additional units of account depends, in part, on the materiality of the position. For example, materiality will affect the level of detail in a taxpayer's tax return workpapers for the position and the level of granularity at which the position will be examined by the IRS. In addition, when different sub-issues are interrelated, it may be impossible to evaluate them as separate units of account, necessitating a more aggregate approach. Because of these issues, the FASB concluded that it could not provide definitive guidance on how to determine units of account. n23

The Definition of a "Position" for Schedule UTP Purposes

The Draft Instructions require taxpayers to report separately each "position" taken on a tax return for which the corporation or a related party has recorded a reserve for federal income taxes (or determined not to record a reserve based on intent to litigate or administrative practice). The meaning of "position" thus defines the granularity with which tax exposures must be reported and is therefore crucial to assessing the impact of the new Schedule. The Draft Instructions provide:

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 a line 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.

Thus,"position" is defined with respect to the "unit of account" used in the financial statements, with an important caveat. For U.S. GAAP purposes, the same unit of account may affect multiple tax years. For purposes of the Schedule, such a UTP must be treated as a separate position in each year and therefore may have to be reported in multiple years.

In addition, although there has been confusion on this point, the Draft Instructions provide that taxpayers are required to report a position only if the taxpayer has recorded a reserve for U.S. federal income taxes with respect to that position for that year. n24 In other words, taxpayers are not required to include on the Schedule positions that, if resolved against the taxpayer, would produce a U.S. federal income tax benefit. An example adapted from the Draft Instructions illustrates the point:

A calendar-year corporation incurs an expenditure in 2010 and claims the entire amount as a deduction in its 2010 return. The taxpayer records a reserve because it is uncertain whether the expenditure should instead be amortized over five years. The corporation has taken a position in each of the five years because in each year's tax return there would be an adjustment to a line item if the position taken in that year is not sustained. The tax position taken in 2010 must be reported on Schedule UTP because a reserve was recorded with respect to that position. None of the 2011 to 2014 positions must be reported because the corporation did not record a reserve for federal income tax purposes with respect to any of those positions. n25

Similarly, taxpayers should not include on Schedule UTP a position for which the only reserves for additional liability relate to foreign or state taxes. This is the case even if the uncertain foreign or state position could affect the taxpayer's U.S. federal income tax liability by producing a federal tax benefit in the form of a foreign tax credit or a deduction for state income taxes. n26 Thus, throughout the instructions, all references to reserves should be interpreted to refer exclusively to reserves for U.S. federal income taxes. The IRS should further clarify this point.

AN EVALUATION OF SELECTED CRITICISMS OF SCHEDULE UTP

In this part we discuss the most criticized aspects of the new Schedule, including: (i) the requirement to report an MTA for each UTP, (ii) the requirement to disclose positions for which no reserve was recorded due to an intent to litigate or based on an IRS administrative practice not to examine the position, (iii) the requirement to provide a concise description for each position, and (iv) the application of the Schedule to Form 1120-F filers.

Maximum Tax Adjustment (MTA)

One of the most criticized aspects of the Draft Instructions is the requirement to report the maximum tax adjustment for all disclosed UTPs other than valuation and transfer pricing UTPs. The Draft Instructions provide:

The MTA for a tax position taken ina tax return is an estimate of the maximum amount of the potential U.S. Federal income tax liability associated with the tax year for which the position was taken. The MTA is determined on an annual basis. For tax positions that relate to items of income, gain, loss, and deduction, estimate the total amount in dollars and multiply by 0.35 (35%). For items of credit, estimate the total amount of credit in dollars.

Background of the MTA Proposal

In *Announcement 2010-9,* the IRS indicated that taxpayers would have to compute an MTA for all disclosed UTPs. Not surprisingly, the reaction from many quarters was decidedly negative. Many of these critics asserted that the MTA was misleading for purposes of determining the potential exposure from a tax position, n27 because the MTA does not take into account a taxpayer's risk assessment of a position. n28 As a result, the MTA of a fairly conservative position may appear commensurate with that of a more aggressive position with a comparatively high reserve. While some of the comments acknowledged that, at least in limiting the disclosure to the MTA, the IRS was exercising prudent restraint, n29 others were concerned that exam teams would be overly focused on positions with a high MTA to the exclusion of other positions that were less certain. n30

The most frequently cited examples of positions for which the MTA was a poor fit were transfer pricing and valuation UTPs. For example, the New York State Bar Tax Section asserted that:

[T]he maximum amount of potential liability may simply be unknowable, for example, in cases involving transfer pricing and valuation generally, especially with respect to intangibles. It seems inappropriate to require taxpayers to assume extreme and unrealistic values, but that may be required or even insufficient under a "maximum amount of potential standard." n31

Comments submitted by Steptoe & Johnson LLP expressed concerns regarding the complexity of the required computation:

It may be impossible to calculate a "maximum tax adjustment" for a tax position. For example, if a taxpayer's transfer pricing is challenged, there may be many ways to compute the maximum adjustment. In addition, the calculation of the maximum liability can become incredibly complex, such as under §199 or Regs. §1.861-8 et seq., especially if the U.S. tax liability interacts with foreign liability through foreign tax credits, etc. n32

In response to these criticisms, the IRS made several changes to the MTA in the Draft Instructions. The Draft Instructions clarify that the MTA does not include interest or penalties, and that secondary effects of a federal tax position on state, local or foreign taxes are disregarded. The IRS has also indicated that other ancillary effects of a UTP on federal taxes, such as effects under §§199 and 861, should not be considered for purposes of the MTA calculation. n33 In addition, the IRS abandoned the requirement to report an MTA altogether for transfer pricing and valuation UTPs. Instead, taxpayers are directed to rank such positions according to either (i) each position's reserve or (ii) the "estimated adjustment to U.S. Federal income tax that would result if the tax position taken in the tax return is not sustained." n34

The IRS's decision to alter the approach for transfer pricing and valuation UTPs has not stopped attacks on the MTA. Typical of the criticisms contained in the comments after the Draft Instructions were released were those of Ernst & Young LLP, which "recommend[ed] eliminating the MTA so that taxpayers and examiners will focus on the technical issues, rather than potentially misleading dollar amounts." n35 We agree with this comment, and also believe that, even under the modified proposal, the MTA will be difficult to compute in many cases. Transfer pricing and valuation positions were only the most obvious examples of this difficulty and of how misleading an MTA could be. Rather, many UTPs for which the Draft Instructions would continue to require an MTA involve mixed questions of law and fact that make defining a maximum potential adjustment difficult. For the reasons described below, we strongly urge the IRS to allow taxpayers to designate a range for each MTA rather than require taxpayers to report a specific amount.

Contrary to the IRS's Presumed Intent, a Literal Interpretation of the Draft Instructions Could Include in the MTA Amounts that Are Not Subject to Challenge

The IRS's stated purpose for requiring disclosure of the MTA for each position is to allow the IRS to prioritize the examination of taxpayers and of UTPs. n36 Consistent with this purpose, the natural reading of a requirement to report the "maximum tax adjustment" associated with a UTP would be to require a taxpayer to report its assessment of its maximum exposure with respect to the legal or factual uncertainty that prompted the taxpayer to record a reserve for the position. This is consistent with the IRS's statement in *Announcement 2010-9* that taxpayers would be required to disclose "the maximum amount 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)."

Nonetheless, a literal reading of the Draft Instructions would appear to allow taxpayers to include in the MTA portions of an item (such as a deduction) that the IRS would not challenge even under the most extreme scenarios. As explained in Part II, the Draft Instructions provide that a "tax position is based on the unit of account used in the audited financial statements," and the same unit of account could lump together certain and uncertain portions of a particular deduction or other item. n37 Thus, by defining the MTA as the total amount of potential U.S. federal tax liability that is "associated" with a position (i.e., a unit of account), n38 the Draft Instructions could be interpreted to require a taxpayer to report the amount associated with the entire unit of account, including amounts that the IRS would not challenge. Under this interpretation, the MTA will often be a meaningless number that would not help the IRS prioritize issues for audit. We doubt that this was the IRS's intent, and we expect the IRS to clarify in the final instructions that the MTA should include only amounts that the IRS might realistically challenge.

Moreover, unless the Draft Instructions are changed, taxpayers who would prefer not to assist the IRS with the selection of issues for audit or to share their assessment of maximum exposures may be tempted to use fewer units of account for GAAP purposes. n39 As discussed above, the unit of account concept is highly flexible. Moreover, when the

MLTN threshold is met for each issue that might affect a single tax item the number of units of account used should not have any effect on the total reserve recorded for the item.

For example, assume a taxpayer makes a payment to settle a False Claims Act suit brought by the Department of Justice. A portion of the payment may clearly have been made for compensatory purposes, and therefore would certainly be deductible as an ordinary and necessary business expense. The remainder of the payment, however, may be at risk of being treated as having been imposed for punitive purposes and, therefore, as a nondeductible fine or penalty under §162(f). If the tax exposure is highly material to the taxpayer's financial statements, one might expect, as a theoretical matter, for the uncertain portion of the payment to be treated as a separate unit of account from the portion of the payment that is certainly deductible. If the uncertain portion meets the MLTN threshold, however, the financial reporting for the tax effect of the settlement payment would not be affected by treating the total settlement as a single unit of account. In either case, at the measurement phase the taxpayer would have to determine the maximum portion of the settlement payment that had at least a 50.1% chance of being sustained. Thus, even in this circumstance of a large payment that is subject to a single discrete issue, taxpayers may not think of the item as including two units of account.

Regardless of whether the IRS clarifies that the MTA should include only the portions of a position that are realistically subject to challenge, taxpayers may be tempted to use fewer units of account in order to report less detailed information to the IRS. While many of the comments submitted to the IRS have expressed, in a general way, a concern that the new Schedule will cause some tax departments to feel a tension between minimizing the effective tax rate and full and fair financial reporting, n40 the flexibility accorded companies when selecting units of account leaves that area particularly susceptible to considerations of the impact of Schedule UTP.

Computation of the MTA Will Be Burdensome; IRS Should Allow Taxpayers to Report MTAs in Ranges

Assuming that the IRS will clarify that the MTA should include only amounts that realistically are subject to challenge, computation of the MTA will be burdensome. The maximum exposure from an issue is not a figure that is calculated as part of the normal accounting process. n41 Instead, for positions that meet the MLTN threshold, taxpayers need only calculate the greatest amount of tax benefit that is greater than 50% likely of being realized upon settlement. Thus, in the example above dealing with the False Claims Act settlement, if the MLTN recognition threshold is met for both portions, then, regardless of whether the settlement payment is treated as one or two units of account, the taxpayer would not be required for GAAP purposes to draw the line between the highly certain compensatory portion and the portion that is susceptible to being characterized as punitive. Instead, the taxpayer would only have to identify the portion of the settlement payment that does not have at least a 50.1% chance of being sustained.

Although this example may not be as challenging as others, defining the worst case scenario for many items -- especially where there are interrelated issues -- will be incredibly difficult. Many UTPs suffer from the same issue of extreme possibilities that caused the IRS to rethink the MTA approach for transfer pricing and valuation issues. Moreover, taxpayers are legitimately concerned that examination teams will put undue weight on the amount of MTA reported, as reporting an exact figure suggests a misleading level of precision. In addition, in cases where a taxpayer is able to develop a theoretical basis for computing an MTA, it is also possible that the IRS may be able to work backwards from the computation to gain inappropriate insights into the taxpayer's mental impressions of the legal issue.

The IRS's express purpose for requiring the MTA is to aid it in allocating its audit resources among taxpayers and issues. As this purpose should require identifying issues only within orders of magnitude, we can think of no legitimate reason for requiring taxpayers to report a specific amount for the MTA. Instead, as has been suggested in numerous comments, n42 including those of Senator Carl Levin, n43 taxpayers should be permitted to report the MTA for each position as falling within one of a handful of broad but meaningful ranges. For example, taxpayers might be required to categorize each tax position according to whether the associated MTA is in one of the following ranges:

(i) $0 to $100,000

(ii) $100,001 to $1,000,000

(iii) $1,000,001 to $25,000,000

(iv) greater than $25,000,000

The IRS could also reduce the number of ranges by calibrating their size to the size of the taxpayer, as determined by total revenue or total assets.

Identification of UTPs as falling within such ranges would allow the IRS to focus its resources on issues with the greatest impact, while sparing taxpayers the burden of identifying the exact contours of the worst case scenario for each UTP. In addition, using ranges would alleviate the risk that examination teams will focus inappropriately on the false precision of the MTA. Regardless, the IRS should state more precisely what it means by "maximum tax adjustment," and clarify that this amount includes only the portions of a unit of account that realistically could be subject to challenge by the IRS.

Reintegration of Transfer Pricing and Valuation UTPs

If the IRS modifies the MTA proposal to allow taxpayers to place every UTP within broad ranges based on the maximum adjustment that the IRS might realistically propose for the position, the IRS should also consider applying the same system to transfer pricing and valuation UTPs. We make this suggestion, not because we think it is easier to compute MTAs for transfer pricing and valuation issues than was suggested by the comment letters cited above, but rather because we think that many UTPs are plagued by the same difficulties of how to identify the line between the certain and uncertain portions of a position when there is no theoretical basis for defining that line. These difficulties are best addressed by allowing taxpayers to designate all UTPs as falling within broad ranges based on the maximum adjustment that might realistically be proposed by the IRS.

The same issues that make transfer pricing and valuation UTPs difficult are present for many UTPs that raise mixed questions of law and fact. For example, costs frequently must be allocated into different taxable categories, such as an allocation of investigatory and acquisition costs among a number of successful and failed acquisitions, or the allocation of a Department of Justice settlement payment between compensatory and punitive components. Such allocations will often result in a single UTP that is divisible into certain and uncertain portions, leaving taxpayers to deal with the question of how far the IRS might go in challenging its allocation. These examples are no different from a UTP that relates to the appropriate arm's-length price. In all cases, there is a range of reasonable allocations or prices with a floor and a ceiling. Within the range, the taxpayer will be uncertain as to the "correct" price or allocation. At the same time, there usually is some minimum price or allocation that the IRS could notrealistically challenge, though putting an exact figure on this amount would be burdensome and is not required under current accounting processes.

Thus, it is not sufficient for the IRS to propose a solution to these challenges that is limited to transfer pricing and valuation positions. Using MTA ranges that are based on realistic worst case scenarios is a better approach for ameliorating this challenge for all positions. By bringing transfer pricing and valuation positions within the same framework as all other positions, the MTA ranges will provide the IRS with more information as to the magnitude of UTPs. It will also eliminate false precision problems created by ordinal rankings. Two UTPs can be close together in rank yet very far apart in the value of their reserves or MTAs.

No Reserve Because Settlement Is Unlikely

In addition to UTPs for which a reserve has been recorded, Schedule UTP requires taxpayers to disclose certain UTPs for two categories for which no reserve is recorded. The first such category includes UTPs for which the taxpayer believes that the probability of settlement is less than 50%. n44 If one accepts the notion that it is legitimate for the IRS to require taxpayers to disclose positions that the taxpayer has determined through its reserve process would likely be challenged by a fully informed examination team, it makes sense for the IRS to require disclosure of UTPs in this category. n45

As discussed above, the FIN 48 measurement attribute can cause no reserve to be recorded for issues for which substantial uncertainty exists, because all that is required to avoid a reserve is a conclusion that there is a 50.1% chance the entire benefit will be sustained, either in settlement or in litigation. Recall the following example, discussed above:

Possible Outcomes -- Amount of tax benefit	Individual Probability	Cumulative Probability
Litigate and win - $100	30%	30%
Settle for $100	25.1%	55.1%
Settle for $80-$99	24.9%	80%
Litigate and lose - $0	20%	100%

In this example, no disclosure is required because there is no reserve (because there is a 55.1% that the full benefit will be sustained) and the position does not fall into the "expectation of litigation" category because a 50% probability is assigned to the possibility of settlement. However, if the facts are changed slightly as follows, there would still be no reserve, but the taxpayer nonetheless would have to disclose the position on Schedule UTP because the taxpayer assigns only a 45% probability to the possibility of settlement:

Possible Outcomes -- Amount of tax benefit	Individual Probability	Cumulative Probability
Litigate and win $100	35%	35%
Settle for $100	20.1%	55.1%
Settle for $80-$99	24.9%	80%
Litigate and lose	20%	100%

Thus, the "expectation of litigation" category is not limited to truly binary situations in which litigation is the only possible outcome if the issue is discovered. Instead, the Draft Instructions require disclosure whenever the odds of reaching a settlement are less than 50%. It is logical for the IRS to want to be informed of positions with which the taxpayer has determined there is less than a 50% chance the IRS will agree with the position taken on the return. Moreover, as can be seen from the first example, above, a taxpayer can avoid disclosure even for cases where the IRS is likely to disagree with the return position, so long as the taxpayer concludes that the IRS and taxpayer will MLTN be amenable to a settlement.

A number of the comments submitted to the IRS dealing with the expectation of litigation category have raised the possibility that it would capture certain positions that are uncontroversial because taxpayers would happily litigate such positions if challenged, as success would be virtually guaranteed. n46 We disagree with these comments. In order for a UTP to fall into the "expectation of litigation" category, the taxpayer must conclude, at a minimum, that there is at least a 50% chance that the IRS would litigate rather than fully concede the issue. Thus, the "expectation of litigation" category will not result in disclosure of uncontroversial positions, for which there would always be at least a 50% chance of a full concession by the IRS.

Commentators have also criticized the "expectation of litigation" category as posing a significant compliance burden, since taxpayers do not need to specially identify positions that fall into this category for FIN 48 purposes. Thus, commentators have posited that taxpayers will be forced to re-examine all of their "certain" tax positions to see which, if any, must nevertheless be disclosed. n47 While determining which positions fall into the expectation of litigation category will require additional analysis, we would expect that positions that fall into this category would have been carefully considered before the taxpayer concluded that (i) the UTP is likely to be challenged by the IRS, and (ii) in such case, litigation is the likely result because neither the IRS nor the taxpayer would be willing to settle on terms amenable to the other party.

No Reserve on Account of an Administrative Practice

The third category of UTPs that must be disclosed on Schedule UTP, referred to as the "administrative practice category," consists of positions "for which a reserve would have been recorded in the audited financial statement but for a determination that, based upon past administrative practices and precedents of the IRS in dealing with the tax position of the taxpayer or similar taxpayers, the IRS has a practice of not challenging the tax position during an examination." This category derives from FIN 48, which permits companies to consider, in addition to the technical merits, the "widely understood" administrative practices of a taxing authority when applying the recognition threshold and measurement attribute. According to IRS Chief Counsel William J. Wilkins, the administrative practices category is intended to be a "check for an administrative practice that all the tax directors know about, but the IRS doesn't." n48

We are not aware of any evidence that taxpayers are relying on administrative practices that the IRS would view as specious. While we understand the desire of the IRS to collect information about the use of such practices by taxpayers, this objective is inconsistent with Schedule UTP. Instead of narrowly focusing on taxpayer positions of great interest, this category is being used to gather general information. It therefore has the effect of transforming the more targeted approach of Schedule UTP into the old and inefficient scattershot approach of burdening taxpayers with information requests in the nature of fishing expeditions. Schedule UTP is not intended to be a generalized taxpayer survey.

Abandoning the administrative practices category will save the IRS and taxpayers time without materially reducing the quality of the information Schedule UTP provides. If the IRS wants to know more about perceived administrative practices, it should start by surveying its field agents before imposing another general information request on taxpayers.

Concise Description of Tax Positions on Schedule UTP

The Draft Instructions require taxpayers to include in Part III of the Schedule a "concise" description of each UTP, no longer than a few sentences in most cases, including:

(i) whether the position involves an item of income, gain, loss, deduction or credit against tax;

(ii) when applicable, identification of the position as involving the determination of the basis or value of property or a right;

(iii) the rationale for the position; and

(iv) the reasons the taxpayer believes the position is uncertain.

The requirement to state the rationale for the position and the reasons for the uncertainty could provide a roadmap to the IRS for challenging uncertain tax positions. While this roadmap falls short of disclosing a taxpayer's assessment of its chances of success with respect to a UTP, as many of the comment letters point out, the "rationale for the position" and the "reason the taxpayer believes the position is uncertain" can be interpreted to require the taxpayer to reveal important aspects of its legal analysis that may be subject to the attorney-client privilege or the work product doctrine. n49

The three examples contained in the instructions partially belie this concern. In each case, the description of the rationale for the position and the reasons the taxpayer believes it is uncertain are conflated into a single sentence beginning either "The issue is . . ." or "The issue concerns . . ." None of the examples explain the legal argument, suggesting that it is sufficient for taxpayers to identify the issue, without supplying the arguments for and against the position. Examples 14 and 15 are illustrative:

Example 14. The corporation investigated and negotiated several potential business acquisitions during the tax year. One of the transactions was completed during the tax year, but all other negotiations failed and the other potential transactions were abandoned during the tax year. The corporation deducted costs of investigating and partially negotiating potential business acquisitions that were not completed, and capitalized costs allocable to one business acquisition that was completed. The issue is the allocation of costs between failed acquisitions and the successful acquisition.

Example 15.The corporation entered into a loan transaction in which it made a general pledge of its assets to its lender. The corporation's assets include stock of FSub, a wholly owned foreign subsidiary. FSub reports no earnings and profits for U.S. federal income tax purposes based on its treatment of an item of income that defers income recognition to a later year. The corporation has taken the position that the pledge of FSub stock did not result in an investment in U.S. property under §956. The issue is whether there was an investment in U.S. property causing a deemed distribution of FSub earnings to the corporation as a result of the treatment of an item of FSub's income that defers its recognition.

Both examples tell the IRS where to look for the UTP -- in Example 14, the allocation of investigation costs among the successful and unsuccessful acquisitions, and in Example 15, the accounting method used by the CFC to defer income -- without exposing the taxpayer's risk assessment or view of the best arguments against the position. Example 16, however, gets closer:

Example 16. The corporation received a cash distribution from Venture LLC (Venture LLC is treated as a U.S. partnership for tax purposes). The corporation claims the distribution is not taxable because it did not exceed the corporation's basis in its interest in Venture LLC. The issue concerns (1) the computation of basis in the Venture LLC interest, and (2) the application of the disguised sale and partnership anti-abuse rules of Subchapter K and regulations thereunder to recharacterize the transaction as other than a distribution.

By calling out the potential application of the disguised sale and partnership anti-abuse rules, Example 16 comes closer to presenting the taxpayer's view of the best legal arguments against the taxpayer's position.

Many critics have focused their attention on the request for the taxpayer's "rationale" and "reasons." In response to this concern, IRS Chief Counsel William J. Wilkins has said:

The wording of the instructions on issue description is going to be reviewed. The words that are there now are probably not going to be the same words that are going to be in the final version. n50

As part of that review, Wilkins also indicated that the IRS would give serious consideration to whether the concise description required by Form 8275 might be a better formulation than the current language contained in the Draft Instructions. n51 Indeed, a number of the comments submitted to the IRS have expressed a preference for the formulation contained in the instructions to Form 8275. n52 The Form 8275 instructions require that taxpayers provide (i) a "description of the relevant facts and the nature of the controversy affecting the tax treatment of the item," and (ii) "a concise description of the legal issues presented by these facts." The examples of concise descriptions in the Draft Instructions appear more illustrative of the Form 8275 instructions than of the requirements set forth in the Draft Instructions.

Although we urge the IRS to adopt instructions more akin to the Form 8275 formulation, the impact of this change should not be overstated. Even the most obtuse "concise description" could not maintain much of a role for detection risk regarding UTPs for which a reserve is recorded. For large taxpayers at least, the Schedule UTP is not the end of the audit, only the beginning. It is not likely that the IRS will walk away from a material position that is disclosed on the Schedule without at least believing that it understands why the taxpayer thought that the position was sufficiently uncertain to warrant recording a reserve.

Issues for Form 1120-F Filers

As mentioned above, included among the group of taxpayers that potentially will be required to file Schedule UTP are foreign corporations that file Form 1120-F, generally as a result of doing business in the United States. This section discusses issues that are of special concern to Form 1120-F filers. In particular, the Draft Instructions provide that Form 1120-F filers will meet the $10 million asset threshold if "the higher of the beginning or end of year total assets amounts reported on Schedule L of Form 1120-F . . . is at least $10 million." There are two ambiguities regarding the application of this threshold to Form 1120-F filers.

The first question is whether the $10 million asset threshold applies based on a foreign filer's U.S. or worldwide assets. For ease of reporting, Form 1120-F filers are given the option of reporting the balance sheet required on Schedule L in terms of either worldwide assets or U.S. assets. Allowing Form 1120-F filers to use worldwide assets allows foreign filers that otherwise would not maintain separate balance sheets for their U.S. businesses to avoid the cost of creating such a balance sheet. Taken literally, the Draft Instructions would disadvantage foreign filers with small U.S. businesses that choose to report on Schedule L in terms of worldwide assets by requiring them to file Schedule UTP, whereas similarly situated foreign filers that report only U.S. assets on Schedule L would not be so required.

We believe that, regardless of whether a foreign filer chooses to complete Schedule L based on its U.S. or worldwide assets, foreign filers with U.S. assets of less than $10 million should not be required to file Schedule UTP. Foreign filers with small U.S. businesses will face the same challenges completing the Schedule as other small businesses, and the fact that a foreign filer has substantial non-U.S. assets is not relevant to the materiality of its U.S. tax exposures. Moreover, it would be onerous to require foreign filers to prepare a separate balance sheet for its U.S. business solely in order to have the lower threshold apply. Therefore, the Draft Instructions should be modified to exclude all foreign filers of Form 1120-F with U.S. assets of less than $10 million, regardless of whether they complete the required balance sheet on a worldwide or a U.S. basis. As a means of demonstrating compliance, the final instructions to Schedule UTP could require Form 1120-F filers that report worldwide assets on Schedule L, but are relying on the fact that they have less than $10 million of U.S. assets, to attach a statement to their return identifying their gross U.S. assets as of the beginning and end of the taxable year or stating that such amounts were less than $10 million.

The second ambiguity relates to how to deal with foreign companies that file Forms 1120-F as "protective returns." For example, a foreign corporation may believe that its U.S. activities MLTN do not rise to the level of a trade or business or a permanent establishment under a relevant U.S. tax treaty, but such foreign corporation nonetheless records a reserve on its foreign books for a small exposure to U.S. income tax. In order to protect its right to claim deductions, the foreign corporation should protectively file a Form 1120-F that reports no gross receipts subject to U.S. tax.

A taxpayer that completes Schedule L based on its U.S. assets is required to include all assets used in the U.S. and all other assets used in connection with a U.S. trade or business. For Form 1120-F filers, and in particular for protective filers, whether any of the taxpayer's assets are in this latter category may itself turn on the resolution of a UTP. In order to avoid imposing significant burdens on Form 1120-F protective filers, we believe that protective filers that meet the asset threshold (however determined) and are therefore required to complete the Schedule should be required to report only any UTPs that go to the threshold question of whether they have a U.S. permanent establishment or trade or business, because, in general, the IRS would have to examine this position before any other possible uncertain U.S. income tax positions would become relevant.

ENFORCEMENT

In *Announcement 2010-9,* the IRS stated that it was contemplating the addition of penalties to Schedule UTP. The Draft Instructions contained no new information on penalties, and *Announcement 2010-30,* which accompanied the Draft Instructions, formally reserved on the question. After the release of the draft Schedule, Large and Mid-Sized Business Division Commissioner. Heather Maloy indicated that the IRS had no plans to pursue additional penalties and would, at least initially, rely on the current penalties related to the filing of a return. n53 As explained below, we doubt that these penalties would apply to an incomplete or missing Schedule UTP.

Administrative Enforcement Concerns

Before turning to the question of what penalties might apply to taxpayers that do not comply with the Schedule UTP requirements, we first consider how the IRS might detect noncompliance. As a preliminary matter, a distinction should be drawn between failing to file a Schedule UTP altogether and filing a Schedule that the IRS views as incomplete with respect to the number of UTPs disclosed or the extent of the detail of the disclosure. The failure to file any Schedule at all will be more straightforward to police -- corporations with $10 million of assets will be expected to file a Schedule UTP unless they can show that they do not have audited financial statements or that those financial statements have no FIN 48 reserve for federal taxes.

On the other hand, incomplete disclosure on Schedule UTP will be almost impossible to police without accessing a taxpayer's tax accrual workpapers. The FIN 48 disclosures in financial statements generally are aggregated across all tax positions, including federal, state, and foreign taxes. The financial statements thus will not be useful for verifying whether a taxpayer has reported all UTPs for which it has recorded a reserve for federal taxes, let alone any tax positions that fall into the other two categories of reportable UTPs. Moreover, IRS Chief Counsel William J. Wilkins has indicated that the IRS will not second guess taxpayers' decisions on whether to record a reserve. n54

We do not expect the IRS to audit compliance with Schedule UTP directly by demanding access to a taxpayer's tax accrual workpapers and comparing them to the taxpayer's Schedule, because such a practice would plainly be contrary to the "policy of restraint." Instead, we expect Schedule UTP compliance issues to arise when examination teams discover positions that, contrary to their assessment of the position, were omitted from the Schedule. At that point, we would expect the IRS to begin with an IDR asking whether the position in fact should have been disclosed on the Schedule. This yes-or-no question is objective even for the expectation of litigation and administrative practice categories, because the question is about the taxpayer's own reasoning for determining not to book a reserve and not about whether that reasoning was correct. As with any form or schedule, there will of course be taxpayer foot-faults in completing it, and we would expect most such foot-faults to be detected by the IRS through taxpayers' truthful responses to such questions.

If a taxpayer denies that the position should have been included on the Schedule and the IRS doubts the veracity of the response, the IRS would need at least some access to a taxpayer's tax accrual workpapers. Requests by the IRS for proof that the taxpayer did not record a reserve for a position would require the least intrusion. Such proof might entail a redacted schedule from the taxpayer's workpapers that listed the positions that comprised the total reserve. Enforcement of the requirement to disclose UTPs in the expectation of litigation and administrative practices categories, however, would necessitate more intrusiveness. Most problematic is the category of expectation of litigation, because counsel's assessment of litigation outcomes is a quintessential example of information protected as attorney work product. These enforcement problems will exist regardless of whether Congress enacts specially tailored penalties for failure to file a Schedule UTP.

Legal Justification for Applying Failure-to-File Penalties to Schedule UTP

There are currently three types of sanctions related to the failure to file a return. First, §6651(a)(1) imposes a civil penalty of 5% of the amount that should have been shown on the return if the failure is for not more than one month, plus an additional 5% for each additional month up to a maximum penalty of 25%. n55 For returns filed more than 60 days after the due date, the minimum penalty is the lesser of $135 or 100% of the amount required to be shown on the return. These civil sanctions apply only when there is an underpayment. n56 Second are the criminal sanctions: Under §7203, willfully failing to supply information necessaryfor a complete return is a misdemeanor punishable by up to a $100,000 fine and one year of imprisonment, and, under §7206(a), knowingly filing a false return is a felony punishable by a fine of up to $500,000 and imprisonment for not more than three years. Finally, under §6501(a), the running of the statute of limitations on a return is delayed until the return is filed.

While the threat of imposition of any of the sanctions described above should affect taxpayers' compliance with reporting on Schedule UTP, there is serious question as to whether these failure-to-file penalties are an appropriate or legally effective means of enforcing compliance.

As for civil penalties, the U.S. Tax Court has determined that the longstanding test for whether a return is sufficient to start the running of the statute of limitations is also applicable to the sufficiency of a tax return for purposes of §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. n57

The failure to provide a supporting schedule ordinarily would not result in a failure of this test, because the information on most supporting schedules is not essential to the calculation of a taxpayer's tax liability. In Blount v. Comr., n58 the U.S. Tax Court granted the taxpayer summary judgment on the grounds that the statute of limitation had expired, despite the fact that the taxpayer had failed to attach a Form W-2 to the tax return. The Court reasoned that the return without Form W-2 qualified as a return, because "omission of a Form W-2 does not prevent the calculation of tax liability." n59 Schedule UTP similarly will not prevent the calculation of tax liability, and so the failure to file such a disclosure statement should neither implicate the penalty under §6651(a)(1) nor cause the statute of limitations to remain open under §6501(a). n60 The IRS and Treasury have indirectly admitted that disclosure statements are not integral to a tax return in recent amendments to the definition of a tax return preparer. n61 In Example 1 of Regs. §301.7701-15(b)(3)(iv), accountant C's sole activity with respect to a tax return is to prepare a Form 8886 (Reportable Transaction Disclosure Statement) to be attached to the return. The example concludes:

The preparation of the Form 8886 is not directly relevant to the determination of the existence, characterization, or amount of an entry on a tax return or claim for refund. Rather, the Form 8886 is prepared by C to disclose a reportable transaction. C has not prepared a substantial portion of the tax return and is not considered a tax return preparer under §6694.

This conclusion, which is equally applicable to Schedule UTP, bears on the applicability of not only the civil failure-to-file penalties but also the §6694 return preparer penalty. The return preparer penalty is tied to the preparation of (including providing advice relating to) positions on returns that result in understatements of tax. The filing, or nonfiling, of a disclosure statement is not directly related to the creation of an understatement, and so cannot be the cause of a §6694 penalty. n62

Setting aside the additional administrative difficulties in proving that a Schedule UTP was incomplete (discussed above), the legal justification for asserting failure-to-file penalties for an incomplete Schedule UTP, rather than a missing one, would be even weaker. In either case, it is highly unlikely that a court would uphold civil failure-to-file penalties absent the most compelling or unusual circumstances.

As for criminal penalties, it would also be difficult to characterize a tax return with an incomplete or missing Schedule UTP as a false return for purposes of §7206(a). On the other hand, an incomplete or missing Schedule UTP does appear to fit within the concept of failing to supply information under §7203. However, neither criminal penalty is likely to be raised, let alone sustained by a court, with any frequency, because of the high threshold of proving criminal intent. The penalty under §7203 applies only to "willful" violations. In order to prove that a corporation willfully failed to file a Schedule UTP or willfully filed an incomplete schedule, the IRS would need evidence to prove that the corporation intentionally failed to supply information it knew it was required to file. This generally requires proof that the taxpayer was informed of the requirement. n63

Congressional Action

As with Schedule UTP, the IRS and Treasury initially did not seek the enactment of penalties to enforce the disclosure of reportable transactions under §6011. While the current reportable transaction regime was finalized in February 2003, Congress did not enact penalties enforcing the regime, including §6707A (penalty for failure to disclose reportable transactions), until October 2004. In the interim, the regulations dealing with the §6662 accuracy-related penalties were amended to state that failing to disclose a reportable transaction was a "strong indication" that the taxpayer lacked reasonable cause and good faith for its position with respect to the transaction. n64 This rule was the only pre-existing enforcement mechanism mentioned by Congress in the legislative history to §6707A. n65 The failure-to-file penalties were not mentioned as a method of enforcing the reportable transaction disclosure rules, and such omission was appropriate, because the failure-to-file penalty regime is not a good fit for enforcing compliance with any disclosure requirement, including proposed Schedule UTP. While the IRS has stated that it is currently not seeking penalties specific to Schedule UTP, and that the failure-to-file penalties could be used to enforce compliance, it is probably only a matter of time before Congress enacts penalties to enforce compliance with Schedule UTP.

FOOTNOTES:

n2 The IRS intends to require the new Schedule for returns filed for calendar year 2010 and for fiscal years that begin in 2010. *Announcement 2010-17, 2010-13 I.R.B. 515.*

n3 *2010-7 I.R.B. 408.* The IRS originally requested comments on its proposal by March 29, 2010. The IRS extended this deadline to June 1, 2010, in *Announcement 2010-17*.

n4 See Announcement 2010-30, *2010-19 I.R.B. 668.*

n5 The IRS has made an effort to preserve some of the policy of restraint by refraining from asking taxpayers for the amount of a reserve, as such disclosure would be tantamount to asking for the taxpayer's risk assessment for each UTP. Still, by requiring taxpayers to disclose the fact that they determined that a reserve was necessary, Schedule UTP represents a substantial encroachment into a taxpayer's risk assessment for a position.

n6 Under the codification of accounting standards, the relevant portion of FIN 48 is now contained in Accounting Standards Codification subtopic 740-10, Income Taxes. FASB ASC 740-10.

n7 See Prepared Remarks of IRS Comr. Doug Shulman to New York State Bar Association Taxation Section Annual Meeting in New York City, Jan. 26, 2010, available at http://www.irs.gov/newsroom/article/0,,id= 218705,00.html; Prepared Remarks of Comr. of Internal Revenue Douglas H. Shulman Before the Tax Executive's Institute 60th Mid-Year Meeting, April 12, 2010, available at http://www.irs.gov/newsroom/article/0,,id=221280,00.html; see also Amy S. Elliot, "Wilkins Responds to Concerns About Uncertain Tax Position Rules," *126 Tax Notes 1307 (2010).*

n8 The instructions provide that the categorization of an item as temporary versus permanent must be consistent with the accounting standards used to prepare the taxpayer's financial statements. Thus, taxpayers would seem to be required to take into account a determination that the earnings of a foreign subsidiary are permanently reinvested under Accounting Principles Board Opinion No. 23 ("APB 23"). Under APB 23, Para. 12, if a U.S. company represents that a controlled foreign corporation's accumulated unremitted earnings are indefinitely reinvested, the company does not have to record deferred U.S. taxes on those earnings. Thus, certain subpart F issues and issues that affect the allocation of income between a U.S. company and a foreign subsidiary could be treated as permanent differences on the Schedule UTP.

n9 For "tax shelters," defined as transactions for which the taxpayer has a significant purpose of tax avoidance, taxpayers must demonstrate that they reasonably believed their positions are more likely than not correct in order to avoid a penalty. §§6662(d)(2)(C)(ii), 6664(d)(3)(C). Transactions lacking economic substance are now subject to a strict liability penalty. §6662(b)(6).

n10 A position has substantial authority "only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." Regs. §1.6662-4(d)(3)(i).

n11 If the authorities supporting a position are not substantial in relation to the contrary authorities, but the position is still reasonably based on the favorable authorities, then a tax position is considered to have a "reasonable basis." Regs. §1.6662-3(b)(3).

n12 Disclosure of a position on a Schedule M-3 can substitute for a Form 8275 or Form 8275-R. See *Rev. Proc. 2010-15, 2010-7 I.R.B. 404* (also exempting certain routine deductions and other items from the requirement to file a Form 8275 or Form 8275-R).

n13 Pamela Olson, "Announcement 2010-9: Can This Marriage Be Saved?" *51-14 Tax Management Memorandum 230 (2010).*

n14 See *id. at 232.*

n15 See Rolfes, FIN 48, §1.04[2][d].

n16 See Rolfes, FIN 48, §1.06. Positions that relate solely to timing must be evaluated under FIN 48, even though resolution of the uncertainty will not affect earnings. Although timing positions are deemed to meet the recognition threshold, at the measurement phase companies are required to record separately, on a gross basis, a reserve, which is treated as taxes payable on the financial statement, for any tax benefits that in a particular year do not meet the measurement criterion for recognition in that year and an offsetting increase to a deferred tax asset or decrease to a deferred tax liability.

n17 The International Accounting Standards Board (IASB) is in the process of updating IAS 12 to include guidance on UTPs. The upcoming exposure draft on IAS 12 is expected to depart significantly from FIN 48's two-step recognition and measurement process. The IASB tentatively has provided that UTPs should be evaluated using a one-step process with no recognition threshold. Thus, benefits could be recognized for positions that are not MLTN. In addition, at the measurement phase, the IASB's tentative decision would require companies to recognize the "expected value" of a UTP.

n18 See FIN 48, Para. 5.

n19 See FIN 48, Para. Para. 5, B13-B14.

n20 The selection of a unit of account is not an accounting policy choice. See FIN 48, Para. Para. A8-A9, B13-B14. Thus, companies can change their units of account as factual circumstances change. However, once a company establishes the units of account for a particular return item, the units of account should be applied consistently, for both recognition and measurement purposes, to similar items in future periods, unless a change in facts and circumstances indicates that a different unit of account is more appropriate. See FIN 48, Para. A9.

n21 See FIN 48, Para. Para. A5-A9.

n22 It is also possible to interpret these examples as illustrative of how R&E credits would be evaluated solely in cases where no portion of the credit was certain due to questions about the creditability of the research project as a whole, for example, because the research might be considered related to taste or design factors. See §41(d)(3) (providing that research shall not be treated as qualified research if it relates to style, taste, cosmetic, or seasonal design factors).

n23 Id.

n24 See, for example, the last sentence of Example 9 in the Draft Instructions.

n25 This example is based on Example 9 in the Draft Instructions.

n26 Under FIN 48, Para. 7c, such multi-jurisdictional positions are not netted for FIN 48 purposes. That is, the uncertainty in each jurisdiction is treated as a separate unit of account. Accordingly, because no reserve for additional U.S. federal income taxes would be recorded with respect to the uncertain federal position (i.e., the contingent U.S. tax benefit that might be recognized if the taxpayer loses the foreign or state position), the uncertain federal position would not be subject to disclosure on Schedule UTP. For a discussion of the accounting for contingent deferred tax assets that are created under the FIN 48 accounting for an unrecognized tax benefit, see Rolfes, FIN 48 §1.04[3][c][ii].

n27 See, e.g., Ernst & Young LLP Comments on *Announcement 2010-9, Announcement 2010-17, Announcement 2010-30* on Reporting Uncertain Tax Positions (June 1, 2010) ("Because the MTA does not reflect the strength of a taxpayer's technical position, it can be misleading and may not provide a reliable basis for audit selection.").

n28 As mentioned above, risk assessment is taken into account in that only MTAs for which a reserve is recorded appear on the Schedule at all, which for GAAP taxpayers means the taxpayer believes there is at least a 50% likelihood that some portion of the benefit will be conceded.

n29 See, e.g., Miller & Chevalier Chartered Comments on *Announcement 2010-9* and Draft Schedule UTP and Instructions (June 1, 2010) ("We also applaud the IRS'[s] decision not to invade upon the taxpayer's risk assessment of the individual issues on the schedule.").

n30 See, e.g., Vinson & Elkins LLP Comments on *Announcement 2010-9, Announcement 2010-17, Announcement 2010-30* on Reporting Uncertain Tax Positions (June 1, 2010) ("Lastly, as noted above, we believe the existence of the MTA requirement will be too tempting a target for field personnel, who will understandably be drawn to the highest dollar adjustments.").

n31 NYSBA Tax Section Comments on *Announcement 2010-9* on Reporting Uncertain Tax Positions, Draft Schedule, Implementation Date (March 29, 2010).

n32 Steptoe & Johnson LLP Comments on *Announcement 2010-9* on Reporting Requirements for Uncertain Business Tax Positions (April 7, 2010).

n33 BNA Teleconference: Disclosing Uncertain Tax Positions (June 9, 2010).

n34 Although these alternatives may at first appear to be different ways of saying the same thing, the estimated adjustment is not coterminous with the reserve. A reserve measures the portion of the tax benefit claimed on the return that the taxpayer does not expect to receive on an MLTN basis. This is different from the tax benefit a taxpayer expects to lose assuming that the tax position is not sustained. If, for example, a taxpayer believes it has a 65% chance of receiving 50% of a tax benefit and a 35% chance of receiving 0% of the tax benefit, its reserve under FIN 48 is 50% of the tax benefit. In this same scenario, the taxpayer would expect to lose 100% of the tax benefit if its position is not sustained. The latter is the "estimated adjustment."

n35 Ernst & Young LLP Comments, note 27 above; see also Steven Hannes, Transfer Pricing Discussion Group's Comments on IRS Schedule UTP, 19 Transfer Pricing Report 109 (June 3, 2010) (comments submitted to the IRS specifically addressing transfer pricing-related concerns, including the rankings approach adopted in the Draft Instructions).

n36 See also Jeremiah Coder, "Maloy Tells Tax Executives to End Skepticism of Uncertain Tax Position Reporting," 2010 Tax Notes Today 71-2 (4/14/10).

n37 There are many examples of items that, in the aggregate, are highly material, but comprise several sub-issues that would not be treated as separate units of account. For example, a basis computation may properly be treated as a single unit of account, even though several different legal issues, each of which individually creates uncertainty, are built into the return position. Moreover, in cases where various uncertain issues are interrelated, there may be no choice but to treat the entire item as a single unit of account -- because the IRS would have to examine the issue at that level and the measurement step under FIN 48 would be impossible to apply otherwise. In all of these cases, the unit of account would include portions of the tax item that the taxpayer would not expect the IRS to challenge (i.e., highly certain portions).

n38 Actually, the Draft Instructions are not even this clear, and could be interpreted to require a taxpayerto report for each position the same MTA, which would equal the maximum potential U.S. tax liability for the year as a whole. See Draft Instructions ("The MTA for a tax position taken in a tax return is an estimate of the maximum amount of the potential U.S. federal income tax liability associated with the tax year for which the position was taken."). Obviously this interpretation was not intended.

n39 This temptation would most likely exist for large taxpayers who are under perpetual audit. Such taxpayers would be concerned only with issue selection, and therefore may wish to inflate the MTA of positions that have a small amount of uncertainty attached to them. Smaller taxpayers that are more concerned with being selected for audit most likely would have the opposite incentive, desiring instead to minimize reported MTAs.

n40 Perhaps not surprisingly, the American Institute for Certified Public Accountants (AICPA) most strongly voiced this concern in its submitted comments. See AICPA Comments on *Announcement 2010-9, Announcement 2010-17, Announcement 2010-30* on Reporting Uncertain Tax Positions (June 1, 2010).

n41 See, e.g., Deloitte Tax LLP Comments on *Announcement 2010-9, Announcement 2010-17, Announcement 2010-30* on Reporting Uncertain Tax Positions (May 28, 2010) (explaining the many difficulties the IRS's MTA approach would cause taxpayers with highly granular units of account).

n42 See Tax Executives Institute Inc. Comments on *Announcement 2010-9, Announcement 2010-17, Announcement 2010-30* on Reporting Uncertain Tax Positions (May 20, 2010). TEI's buckets proposal would require taxpayers to divide positions into only two buckets, one for "significant" UTPs and the other for "insignificant" UTPs. The significance of a position would be determined with reference to the absolute size of the position relative to the size of the taxpayer. TEI also proposed to limit the total number of disclosed positions to a fixed number.

n43 Senator Carl Levin's Comments on *Announcement 2010-9, Announcement 2010-17, Announcement 2010-30* on Reporting Uncertain Tax Positions (May 21, 2010).

n44 Thus, the "expectation of litigation" label is something of a misnomer. A more appropriate label would be an "expectation that settlement is unlikely."

n45 IRS Chief Counsel William J. Wilkins has observed that "there may be ways in which companies can avoid setting up reserves on issues that may be of interest." See "Wilkins Says Uncertain Tax Positions Reporting Not Road Map for Adjustments," 78 BNA Daily Tax Report G-2 (4/26/10).

n46 See, e.g., Miller & Chevalier Chartered Comments, note 29 above ("For truly outlandish positions, taxpayers would have a high probability of prevailing, and presumably would be willing to litigate such issues if the IRS made the ill-considered decision to challenge them on such a basis.").

n47 See PricewaterhouseCoopers LLP Comments on *Announcement 2010-9, Announcement 2010-17*, *Announcement 2010-30* on Reporting Uncertain Tax Positions (June 1, 2010); Plante & Moran PLLC Comments on *Announcement 2010-9* on Reporting Uncertain Tax Positions (June 1, 2010) ("In order to complete Schedule UTP, a taxpayer must evaluate all tax positions, including tax positions beyond the financial statement reserve where general administrative practices and the expectation of litigation are involved.").

n48 See "Wilkins Says Uncertain Tax Positions Reporting Not Road Map for Adjustments," 78 BNA Daily Tax Report G-2 (4/26/10).

n49 See, e.g., KPMG LLP Comments on *Announcement 2010-9, Announcement 2010-17, Announcement 2010-30* on Reporting Uncertain Tax Positions Para. III.B. (June 1, 2010) ("[W]e are concerned that the definition of what constitutes a 'concise statement' may implicitly involve the disclosure of a taxpayer's risk assessment of the reportable TP and is therefore inconsistent with the IRS's articulated continuance of the policy of restraint.").

n50 BNA Teleconference: Disclosing Uncertain Tax Positions (June 9, 2010).

n51 Id. When asked specifically about this issue, Wilkins said:I don't have the 8275 in front of me so I am not exactly sure, but I do recall that some comments . . . have said there is language in, I believe, it's the 8275 that says 'in sufficient detail to identify the issue,' so something like that. And we take that under consideration if that's language people feel that solves the nervousness about asking for the taxpayer's legal reasoning, but still identifies the issue; that is worthy of consideration.

n52 See, e.g., PricewaterhouseCoopers LLP Comments, note 47 above ("We believe a more appropriate approach would be to consider the reporting requirements under Form 8275."). It should also be noted that, while some of the comments take the position that the concise description formulation in Form 8275 is better than the formulation in the Draft Instructions, concern remains about requiring a concise description at all. Unlike Schedule UTP, Form 8275 is voluntary, and, as a result, does not have the same impact as Schedule UTP. See Skadden, Arps, Slate, Meagher & Flom LLP Comments on *Announcement 2010-9, Announcement 2010-30* on Reporting Uncertain Tax Positions, fn. 23 (June 4, 2010) ("Furthermore, completion of Form 8275 is voluntary, for those taxpayers who wish to supply disclosure adequate to avoid the imposition of certain penalties, whereas it has not been proposed that the Proposed Disclosure Regime would be optional.").

n53 Alison Bennett, "IRS Not Planning to Use Uncertain Tax Positions as Exam Starting Point," 77 BNA Daily Tax Report G-2 (4/23/10).

n54 See Jaclyn Jaeger, IRS Brass Explains Reporting of Uncertain Tax Positions, available at http://www.complianceweek.com/article/5926.

n55 Sections 6721 and 6723 impose penalties on failures to file correct information returns and failures to comply with a specified information reporting requirement. Section 6724(d)(1) and (3), which defines the relevant terms, makes clear that these penalties do not apply to failures with respect to Schedule UTP.

n56 See *Patronik-Holder v. Comr., 100 T.C. 374 (1993).*

n57 *Beard v. Comr., 82 T.C. 766, 777 (1984),* aff'd, *793 F.2d 139 (6th Cir. 1986)* (citing three Supreme Court decisions dealing with statutes of limitations -- *Florsheim Bros. Drygoods Co. v. U.S., 280 U.S. 453 (1930); Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934);* and *Badaracco, Sr. v. Comr., 464 U.S. 386 (1984)).*

n58 *86 T.C. 383 (1986),* acq. in result in part, *1986-2 C.B. 1.*

n59 *86 T.C. at 387.*

n60 In a letter to IRS Commissioner Shulman dated May 21, 2010, Senator Carl Levin cited *GCM 38057* (Aug. 22, 1979) as a "precedent" in support of his suggestion that the IRS rely on the §6651 failure-to-file penalty in order to enforce compliance with Schedule UTP. In GCM 38057, the IRS's Office of Chief Counsel argued that the instructions to corporate tax returns for insurance companies be amended to state that the §6651(a)(1) penalty would apply to failures to attach a copy of the insurance company's annual statement, as required by Regs. §1.6012-2(c). We note, however, that: (1) the argument in *GCM 38057* was premised on the lack of clear guidance from the case law ("Our view is that the decided cases do not clearly establish . . . We believe, therefore, that a court might hold . . ."); and (2) *GCM 38057* was written well before the Beard and Blount decisions.

n61 Regs. §301.7701-15 (Dec. 15, 2008).

n62 While failing to disclose a transaction does not per se invoke a penalty under §6694, a taxpayer's disclosure of the type provided for under the §6662 accuracy-related penalty (i.e., on a Form 8275 or Form 8275-R, as the case may be) does have an impact on a return preparer's liability under §6694 for unreasonable positions relating to transactions that are neither tax shelters or reportable transactions. See Regs. §1.6694-2(a)(1)(iii). As mentioned above, Schedule UTP may be filed in lieu of a Form 8275 or Form 8275-R.

n63 See, e.g., *Pappas v. U.S., 216 F.2d 515, 517 (10th Cir. 1954)* ("Repeated efforts on the part of internal revenue agents to obtain this information were unavailing"). In addition, even if informed of the obligation to supply information by the IRS, taxpayers can assert as a defense that it acted in good faith on the belief that the refusal was justified. *U.S. v. Murdock, 290 U.S. 389 (1933).*

n64 Regs. §1.6664-4(d).

n65 H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. (2004).