NEW SCHEDULE UTP: "UNCERTAIN TAX POSITIONS IN THE AGE OF TRANSPARENCY"

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I. INTRODUCTION

A taxpayer, when signing the jurat on the tax return, swears under penalties of perjury that the tax return is true, accurate, and complete.[1] But, as a general rule, the taxpayer need not have a subjective belief that the tax position taken on the tax return is sustainable when making this sworn statement.[2] Furthermore, tax advisors need not believe that a tax position is ultimately sustainable before they advise their client to take a position on a tax return.[3]

[1] *See, e.g.*, IRS, DEP'T OF THE TREASURY, FORM 1040 (2011), *available at* http://www.irs.gov/pub/irs-pdf/f1040.pdf; IRS, DEP'T OF THE TREASURY, FORM 1120 (2011), *available at* http://www.irs.gov/pub/irs-pdf/f1120.pdf.

[2] *See* 26 U.S.C. § 6662(d)(2)(B)(i) (2006). The general rule is that if the tax position being considered is not a tax shelter item nor is it a listed transaction, then a taxpayer can claim the tax position without disclosure as long as the position has at least "substantial authority." *See id.* The Joint Committee on Taxation has stated that "substantial authority" exists for a tax position if its chances of success are at least 40%. *See, e.g.*, JOINT COMM. ON TAXATION, JCX-79-99, COMPARISON OF RECOMMENDATIONS OF THE JOINT COMMITTEE ON TAXATION STAFF AND THE TREASURY RELATING TO INTEREST AND PENALTIES 13 (1999), *available at* www.jct.gov/publications.html?func=startdown&id=2836. Current law allows taxpayers to take even more aggressive tax positions that do not possess "substantial authority" without risk of an accuracy-related penalty if the tax position has a "reasonable basis" and is disclosed on the tax return. *See* 26 U.S.C. § 6662(d)(2)(B)(ii)(I). A corporation is never treated as having a reasonable basis for its tax treatment if the underlying transaction represents a "multiple-party financing transaction." *See id.* § 6662(d)(2)(B). In all other situations, the Joint Committee on Taxation has stated that a "reasonable basis" for a tax position exists if there is at least a 20% chance of it being sustained. *See, e.g.*, JOINT COMM. ON TAXATION, *supra*, at 13. Two limited exceptions exist to the above general rule. First, if the tax position being considered were a tax shelter item, the taxpayer must demonstrate that the taxpayer reasonably believed that the tax position was more likely than not correct. *See* Treas. Reg. § 1.6664-4(f)(2)(i)(A)–(B) (as amended in 2003). Second, if the tax position in question were a "reportable transaction," the taxpayer has reasonable cause to claim the tax benefits only if the taxpayer reasonably believed at the time the return was filed that the tax treatment is likely correct and the position is adequately disclosed on the tax return. *See* 26 U.S.C. § 6662A(d)(2).

[3] The Treasury Department has been authorized to regulate tax practice and has exercised that authority by issuing proposed regulations providing that a tax advisor generally can advocate an uncertain tax position as long as claiming the uncertain tax position complies with the tax reporting standards for taking the position without penalty. *See* 31 C.F.R. § 330 (2011); Regulations Governing Practice Before the Internal Revenue Service, 75 Fed. Reg. 51,713, 51,714 (Aug. 23, 2010) (to be codified at 31 C.F.R. pt. 10).

This leniency in the nation's tax-reporting standard contributes to the nation's "tax gap."[4] For 2001, the IRS estimates that the tax gap was $345 billion.[5] The IRS estimates that 83.7% of the taxes that were required to be paid in 2001 were voluntarily paid and that this $345 billion compliance gap represents 16.3% of the amount of the total taxes that should have been paid for that year.[6] Congress has reacted strongly to the tax gap, stating that the unwillingness of some to pay their taxes in a timely manner creates an unfair burden on honest taxpayers.[7] Furthermore, Congress has called for more aggressive efforts to reduce the tax gap.[8] To achieve this objective, Congress, the U.S. Treasury Department, and tax commentators have offered numerous solutions.[9] And yet, the reality is that the tax gap has

[4] *See* Nina Olson, *Closing the Tax Gap: Minding the Gap: A Ten-Step Program for Better Tax Compliance*, 20 STAN. L. & POL'Y REV. 7, 8 (2009). The "tax gap" refers to the difference between what taxpayers owe on their return and the amount that they voluntarily pay in a timely manner. *See id.* The IRS made tax gap studies for tax years 1979, 1983, 1987, and 2001. *See* U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-88-66BR, TAX ADMINISTRATION: IRS' TAX GAP STUDIES (1988), *available at* http://archive.gao.gov/d34t11/135439.pdf. For a discussion of the slightly different definitions used to define the tax gap over the years, see *id.*

[5] IRS, DEP'T OF THE TREASURY, TAX YEAR 2001 FEDERAL TAX GAP 1 (2001), *available at* http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf; *see also* I.R.S. News Release IR-2006-28 (Feb. 14, 2006), 2006 WL 330160, *available at* http://www.irs.gov/newsroom/article/0,,id =154496,00.html; OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5 (2006), *available at* http://www.treasury.gov/press-center/press-releases/Documents/otptaxgapstrategy%20final.pdf.

[6] *See* IRS, DEP'T OF THE TREASURY, TAX YEAR 2001 FEDERAL TAX GAP (EXTENDED VERSION) 1 (2001), *available at* http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.

[7] Press Release, Sen. Max Baucus, Baucus Calls New Tax Gap Numbers "Unacceptable," Calls for Bolder IRS Action to Collect Taxes Owed (Feb. 14, 2006), *available at* http://finance.senate.gov/newsroom/ranking/release/?id=14d69969-d6a3-418e-939e-0f0da7068fa5; *see also GSA Contractors Who Cheat on Their Taxes and What Should Be Done About It: Hearing Before the Subcomm. on Investigation of the S. Comm. on Homeland Security and Governmental Affairs*, 109th Cong. 2 (2006) (statement of Sen. Carl Levin) ("[W]hen so many Americans fail to pay the taxes that they owe, it begins to undermine the fairness of our tax system, forcing honest taxpayers to make up the shortfall needed to pay for basic Federal protections.").

[8] *See, e.g.*, Stephen Joyce, *Everson Urges Fiscal 2008 Request Approval; Conrad Calls Tax Gap Proposals 'Too Modest'*, Daily Tax Rep. (BNA) No. 31, at G-2 (Feb. 15 2007), *available at* 2007 WL 466860 (stating that Sen. Kent Conrad, D-ND, sought a "far more aggressive approach" to close the tax gap); Memorandum from Sen. Charles Grassley on Tax Gap Numbers (Feb. 14, 2006), *available at* http://finance.senate.gov/newsroom/chairman/release/?id=c73ca76d-52b4-4a1b-bd0e-e620ef5c24cd.

[9] *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2008 REVENUE PROPOSALS 61–82 (2007), *available at* http://www.treasury.gov/

remained largely unchanged since 1973.[10] Most citizens prefer not to pay higher taxes,[11] but even more so they prefer not paying additional taxes when they are meeting their tax obligations and believe that others are not paying what they already owe.[12] Furthermore, a vast majority of Americans believe that it is every American's civic and moral duty to pay the taxes that they are legally obligated to pay.[13]

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resource-center/tax-policy/Documents/bluebk07.pdf; *see also* IRS, DEP'T OF THE TREASURY, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 3 (2007), *available at* http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf; Olson, *supra* note 4, at 35–36.

[10] *See* ABA Comm. on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance*, 41 TAX LAW. 329, 334 (1988); James Andreoni et al., *Tax Compliance*, 36 J. ECON. LIT. 818, 819 (1998); Eric Toder, *What Is the Tax Gap?*, 117 TAX NOTES 367, 367–69 (2007); Nina A. Olson, Testimony Before the Senate Comm. on Finance on the Tax Gap and Tax Shelters 1 n.1 (July 21, 2004), *available at* www.irs.gov/pub/irs-utl/nta_sfc_testimony_tax_gap062104.pdf; *supra* note 5 and accompanying text.

[11] *But see* RANDOLPH E. PAUL, TAXATION FOR PROSPERITY 277 (1st ed. 1947) ("I like to pay taxes. With them I buy civilization." (quoting Oliver Wendell Holmes)); Chuck O'Toole, *Tax Us More, Says Group of Wealthy Activists*, Tax Notes Today (Tax Analysts) Doc. 2009-18768 (Aug. 20, 2009), *available at* LEXIS 2009 TNT 159-2.

[12] *See* Janet Novack, *Are You a Chump?*, FORBES, Mar. 5, 2001, at 122 (suggesting that a taxpayer was a chump if they paid their taxes without using tax shelters); *see also* IRS OVERSIGHT BD., IRS, DEP'T OF THE TREASURY, IRS OVERSIGHT BOARD ANNUAL REPORT 2 (2002), *available at* http://treas.gov/irsob/reports/2001_annual_report.pdf ("The Oversight Board is concerned that the broad decline in enforcement activity increases our reliance on voluntary compliance, and fears that the public's attitude towards voluntary compliance is beginning to erode."); Steve Johnson, *The 1998 Act and the Resources Link Between Tax Compliance and Tax Simplification*, 51 U. KAN. L. REV. 1013, 1014 (2003) (noting that a loss of public confidence in the tax system will lead to a decline in self-assessments—i.e., voluntary compliance); Alison Bennett, *IRS Compliance Activity Increasing but Audit Rates Rising Slowly, Data Show*, Daily Tax Rep. (BNA) No. 55, at GG-1 (Mar. 21, 2003), *available at* 2003 WL 1384247; James M. Bickley, *CRS Updates Report on Tax Gap, Enforcement*, Tax Notes Today (Tax Analysts) Doc. 2008-3938 (Feb. 26, 2008), *available at* LEXIS 2008 TNT 38-15 ("Other motivations for reducing the tax gap include adverse effects on (1) public trust in the fairness of the tax system, which may adversely affect voluntary compliance with tax laws . . . ."); Larry Levitan, Chairman, IRS Oversight Bd., Testimony Before the Joint Committee on Taxation: Joint Hearing on the Strategic Plans and Budget of the IRS 5 (May 14, 2002), *available at* http://www.treasury.gov/irsob/testimony/2002/5-14-02.pdf.

[13] IRS OVERSIGHT BD., IRS, DEP'T OF THE TREASURY, 2010 TAXPAYER ATTITUDE SURVEY 4 (2011), *available at* http://www.treasury.gov/irsob/reports/2011/IRSOB%202010%20Taxpayer%20Attitude%20Survey.pdf (stating that in response to the statement "[i]t is every American's civic duty to pay their fair share of taxes," 94% of the individuals surveyed in the 2010 Taxpayer Attitude Survey responded that they either "Completely Agree" (70%) or "Mostly Agree" (25%)

Although the above state of affairs is not new, the IRS this year has announced a radical and far-reaching compliance initiative for certain large corporate taxpayers.[14] In this regard, certain large corporate taxpayers will now be required to complete a new disclosure schedule as part of their federal income tax return.[15] In this new disclosure schedule (called Schedule UTP), the taxpayer is required to separately disclose and describe each uncertain tax position contained in the taxpayer's income tax return.[16] Thus, after the taxpayer signs the face of the income tax return where the taxpayer swears that the information contained in the return is true, accurate, and complete, the taxpayer will be required to affirmatively disclose on the attached Schedule UTP all of the soft spots contained in the taxpayer's income tax return.[17] This new Schedule UTP disclosure requirement represents an important new chapter in the self-assessment requirements imposed on taxpayers under the country's income tax laws.[18]

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and that, similarly, 81% of the respondents identified personal integrity as providing "[a] great deal of influence" on their tax compliance).

[14] *See infra* note 61.

[15] *See infra* Part III.A.

[16] The disclosure requirements of new Schedule UTP are discussed in Part III.A.

[17] I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408 (Feb. 16, 2010); *infra* note 61.

[18] Although Schedule UTP represents a radical departure from prior tax reporting practice, the concept of having such a requirement is not new. The idea was publicly announced in a speech to the American Institute of Certified Public Accountants on May 24, 1977 by then IRS Commissioner Jerome Kurtz, as set forth in the following excerpt from that speech: "I believe taxpayers, especially sophisticated taxpayers, and their preparers should be required to report on their returns 'questionable' positions that have been taken on the return. By 'questionable' I mean essentially a position that is knowingly inconsistent with published regulations, rulings or cases. The kind of position that accountants reserve against . . . ." Jerome Kurtz, Comm'r, IRS, Remarks Before the American Institute of Certified Public Accountants, Los Angeles, California 2 (May 24, 1977), *in* I.R.S. News Release (June 21, 1977) (text of IRS News Release available with the Baylor Law Review). This proposal created a firestorm of controversy through the remainder of 1977 and into 1978. *See, e.g.*, *AICPA Representatives Talk with IRS Commissioner Jerome Kurtz*, 144 J. ACCOUNTANCY 42, 44–45 (1977); *Discussion on "Questionable Positions:" Commissioner Jerome Kurtz and Panel*, 32 TAX LAW. 13, 13 (1978). IRS Commissioner Kurtz announced his proposal at a time when the IRS sought tax accrual workpapers from accounting firms to aid in tax audits, and this effort to obtain tax accrual workpapers created its own further firestorm of controversy. *See generally* Mortimer M. Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194 (1979) [hereinafter Caplin, *Should the Service Be Permitted*]; Mortimer Caplin, *IRS Toughens Its Stance on Summoning Accountant's Tax Accrual Workpapers*, 53 J. TAX'N 130 (1980) [hereinafter Caplin, *IRS Toughens Its Stance*]; Arthur John Keefe, *I.R.S. Eyes Accountants Workpapers*, 67 A.B.A. J. 1703 (1981); Michael Riley Marget, Note, *Government Access to Corporate Documents and Auditors'*

However, before proceeding with an analysis of the implications of the new affirmative disclosure requirements contained in Schedule UTP, it is helpful to review the impetus for these new compliance requirements. In this regard, somewhat surprisingly, the catalyst for this new disclosure schedule was the transparency and corporate governance reforms that were implemented for nontax reasons. Therefore, Part II of this article reviews these corporate governance reforms in order for the reader to correctly understand the background for the changes that are being demanded in today's tax practice. After this review, Part III sets forth a detailed discussion of the new disclosure requirements implicated by new Schedule UTP. Part IV sets forth an analysis of another transparency reform involving whistleblower awards and discusses how those reforms interrelate with the new Schedule UTP disclosure requirements. Part V sets forth a prediction of what further reforms are reasonably foreseeable. And finally, Part VI sets forth some concluding thoughts about the overall impact that these recent initiatives will have on the tax community and how taxpayers should respond.

II. CORPORATE GOVERNANCE AND TRANSPARENCY REFORMS

In the fall of 2001, Congress and regulatory agencies faced a crisis in public confidence with respect to the financial reporting of public companies. This crisis was fueled by the financial collapse of Enron, WorldCom, Adelphia, and Tyco. The common denominator for each of these high-profile corporate failures was the fact that the publicly-filed financial statements for each of these companies did not adequately disclose to the user of the financial statements the nature of the risks that were

Workpapers: Shall We Include Auditors Among the Privileged Few?, 2 J. CORP. L. 349 (1977). As will be explored further in Part II of this article, today's environment has been remarkably more conducive to current IRS Commissioner Schulman's proposal because the corporate governance reforms of the past last decade have fundamentally changed the underlying expectations of compliance and expectations of transparency for taxpayers and their tax advisors. Thus, it is an important insight to recognize that IRS Commissioner Kurtz's original proposal received a hostile reception in 1978 and was not implemented at that time whereas current IRS Commissioner Schulman's reintroduction of this same proposal at the beginning of 2010 was implemented in rapid fashion within a year. In addition to representing a testament to the tax community's acknowledgement of the heightened transparency expectations of today versus the past, this historical record also represents a testament to the rapidity in which change is being implemented in today's tax practice versus the past.

imminent nor did the internal controls for each of these companies warn management of the inadequacy of their public disclosures.[19]

In response, Congress and regulatory bodies acted aggressively to institute sweeping reforms.[20] One important early response to restore public confidence in the financial reporting of public companies was the enactment of the Sarbanes-Oxley Act of 2002 (SOX).[21] In an effort to reinforce the seriousness of the financial reporting of public companies, SOX Section 302 and Section 404 require the principal executive officer and the principal financial officer to certify under penalties of perjury that the company's financial statements are reliable and that the company's internal controls are effective.[22] In addition, the company's external auditor must give its opinion as to management's assessment of the effectiveness of the company's internal controls,[23] and this auditor attestation must be done in conjunction with the overall audit of the company's financial statements.[24]

When the principal officer states that the company's internal controls over financial reporting are effective, the principal officer is stating that no material weaknesses exist.[25] A material weakness in internal controls is a deficiency, or combination of deficiencies, that results in a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.[26] A

[19] Edward J, Janger, *Brandeis, Business Ethics, and Enron*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS, at 63, 63 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

[20] Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, *in* ENRON, *supra* note 19, at 495, 515.

[21] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 [hereinafter SOX] (codified as amended in scattered sections of the U.S.C.).

[22] *See id.* §§ 302(a), 404(a).

[23] *See id.* § 404(b); PUB. CO. ACCOUNTING OVERSIGHT BD., PCAOB RELEASE 2005-009, POLICY STATEMENT REGARDING IMPLEMENTATION OF AUDITING STANDARD NO. 2, AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS 3 (2005), *available at* http://pcaobus.org/Rules/Rulemaking/Docket008/2005-05-16_Release_2005-009.pdf.

[24] PUB. CO. ACCOUNTING OVERSIGHT BD., PCAOB RELEASE NO. 2007-005A, AUDITING STANDARD NO. 5: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS AND RELATED INDEPENDENCE RULE AND CONFORMING AMENDMENTS 5 (2007), *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20021/2007-06-12_Release_No_2007-005A.pdf.

[25] *See id.* app. ¶ 2.

[26] *Id.* app. ¶ A7. PCAOB Auditing Standard No. 5 superseded PCAOB Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Conducted in Conjunction with an Audit of Financial Statements*, effective for fiscal years ending on or after Nov. 15, 2007. *Id.* at 15.

deficiency in internal control includes both deficiencies in design and operation.[27] Thus, in order for management to make the certification required by SOX Section 302 and Section 404, the company must assess both the design of its internal controls and the operating effectiveness of those internal controls.[28] The objective of these internal control assessments is to provide management with reasonable assurance that its

PCAOB Auditing Standard No. 5's definition of "material weakness," however, is effective on issuance, June 12, 2007. *Id.* PCAOB retained the existing framework for evaluating deficiencies under which material weaknesses are identified by assessing the likelihood and magnitude of a potential misstatement, but changed the likelihood from *more than remote* to *reasonably possible*, and increased the magnitude by making a material weakness as more severe than a significant deficiency. *Compare id.* app. ¶ A11, *with* PUB. CO. ACCOUNTING OVERSIGHT BD., PCAOB RELEASE NO. 2004-001, AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS app. ¶ 10 (2004), *available at* http://pcaobus.org/Rules/Rulemaking/Docket008/2004-03-09_Release_2004-001-all.pdf. PCAOB Auditing Standard No. 2, Paragraph 10, defined a material weakness as equal to "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected." PUB. CO. ACCOUNTING OVERSIGHT BD., *supra*, app. ¶ 10 (emphasis added). PCAOB Auditing Standard No. 5, however, does not equate a significant deficiency with a material weakness. *See* PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 24, app. ¶ A11. Paragraph A11 defines significant deficiency as "a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting." *Id.* The SEC defines the term significant deficiency in the same manner as the PCAOB. *See* 17 C.F.R. § 240-12b-2 (2011); Definition of the Term Significant Deficiency, Exchange Act Release No. 33,8829, 91 SEC DOCKET 726 (Sept. 10, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8829.pdf.

[27] PCAOB Auditing Standard No. 5, Paragraph A3, states:

> A deficiency in internal control over financial reporting exits when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 24, app. ¶ A3.

[28] *See* Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 705–06 (2007); *see generally* SIMON M. LORNE ET AL., INTERNAL CONTROLS: SARBANES-OXLEY ACT § 404 AND BEYOND (2006).

internal controls operate effectively to ensure the reliability of the company's financial reporting.[29]

Furthermore, in order to demonstrate that management's assessment was reasonable, the SEC advised companies that they must maintain documentary evidence to substantiate the basis for management's conclusion that the company's internal controls are effective.[30] In order to satisfy this documentation requirement, companies have expended considerable effort to document the design of their internal controls and then have expended considerable effort to document the actual operating effectiveness of those controls.[31]

Another outgrowth of this same effort to restore public confidence came from the issuance of Financial Interpretive Statement 48 (FIN 48) by the Financial Accounting Standards Board (FASB).[32] The FASB stated that the

[29] Securities Exchange Act of 1934, 15 U.S.C. § 78m(b)(7) (2006). The SEC staff have stated:

> [W]hile "reasonableness" is an objective standard, there is a range of judgments that an issuer might make as to what is "reasonable" in implementing Section 404 and the Commission's rules. . . . Different conduct, conclusions and methodologies by different companies in a given situation do not by themselves mean that implementation by any of those companies is unreasonable.

DIV. OF CORP. FIN., OFFICE OF THE CHIEF ACCOUNTANT, SEC, STAFF STATEMENT ON MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING 5 (2005), *available at* http://www.iasplus.com/usa/0505controlssecstaff.pdf.

[30] *See* 17 C.F.R. § 240.13a-15(c); *id.* § 229.308 instruction 2; Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 33,8238, 68 Fed. Reg. 36,636, 36,642 (June 5, 2003).

[31] *See* DELOITTE & TOUCHE LLP, UNCERTAINTY IN INCOME TAXES: A ROADMAP TO APPLYING INTERPRETATION 48, at 5 (2007), *available at* http://www.iasplus.com/usa/0703fin48.pdf (discussing need for thorough review of policies, procedures, and documentation and, where necessary, revise its documentation to include a thorough description of the internal controls involved in the identification, evaluation, and reporting of all material tax positions); ERNST & YOUNG, EMERGING TRENDS IN INTERNAL CONTROL 5 (2005), *available at* http://www.sarbanes-oxley.be/aabs_emerging_trends_survey4.pdf (stating that for 70% of companies that the Section 404-related costs were over 50% higher than original estimates).

[32] *See, e.g.*, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, FASB Interpretation No. 48, summary (Fin. Accounting Standards Bd. 2006) [hereinafter FIN 48], *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820931560&blobheader=application%2Fpdf. Under the codification of accounting standards, the relevant portions of FIN 48 are now contained in Accounting Standards Codification subtopic 740-10, Income Taxes. *See* FASB Accounting Standard Codification § 740-10 (Fin. Accounting Standards Bd. 2009). Because the industry is more conversant with the

issuance of FIN 48 would result in increased relevance and comparability in financial reporting of income taxes.[33] The FASB had become concerned that a diversity of practice had developed with respect to the financial statement reporting of tax exposures related to uncertain tax positions that had been taken on a company's tax return.[34] To reduce such diversity, FIN 48 sets forth criteria for the recognition, derecognition, measurement, classification, and disclosure of the financial impact of a company's income tax positions.[35] In terms of recognition, FIN 48 prescribes the following two-step process:

> 1. Recognition: The company must determine whether a tax position is more-likely-than-not to be sustained upon examination.[36]
>
> 2. Measurement: If a tax position meets the more-likely-than-not recognition standard, then the amount of a benefit to be recognized on the company's financial statements is the largest amount of the estimated benefit that has a greater than 50% likelihood of being realized.[37]

If the company believes that it is more-likely-than-not entitled to the tax benefits of a tax position in the amount claimed on the tax return, then the company must claim a financial statement benefit for the full amount of the tax benefit and no footnote disclosure is required.[38] If the company determines under FIN 48's criteria that it has claimed tax benefits on a tax return that are not sustainable in full, then FIN 48 requires the company to not claim a financial statement benefit to this extent and must disclose the aggregate financial impact of its unsustainable tax benefits in a tabular schedule in the footnotes to its financial statements.[39] Even though the

FIN 48 nomenclature, this article continues to refer to this pronouncement as FIN 48 and not ASC 740-10.

[33] FIN 48, *supra* note 32, summary.

[34] *Id.* ¶ 1.

[35] *Id.* ¶ 2.

[36] *Id.* ¶ 6.

[37] *Id.* ¶ 8.

[38] *See id.* ¶ 6.

[39] *See id.* ¶ 21(a). For ease of discussion, this paper refers to the portion of a tax position that fails to meet the "more-likely-than-not" tests set forth in FIN 48 as unsustainable. *See id.* ¶ 6. The author believes it is appropriate to refer to these as unsustainable because they are in the company's own judgment unlikely to be sustained if all of the facts were known.

tabular disclosure required by FIN 48 is made on an aggregate basis, FIN 48 requires the company to employ a separate issue-by-issue evaluation for each of its uncertain tax positions in order to determine the aggregate financial impact of its unsustainable tax positions.[40] Thus, FIN 48 makes clear that the more-likely-than-not recognition threshold is a positive assertion that the company believes that it either is entitled, or is not entitled, to the economic benefits associated with each individual tax position.[41]

In order to demonstrate the basis for its conclusions with respect to each of its uncertain tax positions, a company will often obtain legal opinions from attorneys that evaluate the company's uncertain tax positions. These documents, inclusive of the legal opinions that address the sustainability of a company's uncertain tax positions, are generally known in the industry as a company's "FIN 48 tax accrual workpapers."[42] Although the FASB stopped short of requiring management to obtain an outside tax opinion for each uncertain tax position that the company identified, the FASB did recognize that obtaining an outside tax opinion represents evidence supporting management's conclusion and can serve to document the due-diligence efforts that management conducted in order to conclude on whether or not to recognize a tax benefit for a tax position.[43]

Furthermore, it is important to remember that FIN 48 must be complied with in the context of the rigorous certification and attestation requirements of SOX Section 302 and Section 404, and that those requirements mandate that the company create written documentation to substantiate the basis for its FIN 48 conclusions.[44] Thus, the challenge for taxpayers and their tax advisors has been to document the basis for the company's conclusion regarding whether an uncertain tax position is sustainable or whether the uncertain tax position fails to meet FIN 48's two-part more-likely-than-not

[40]*See id.* ¶¶ 4–5, app. B ¶¶ B13–B14. FIN 48 uses the term "unit of account" and states that each individual "unit of account" must be separately analyzed. *See id.* ¶ 5.

[41]*Id.* ¶ 6.

[42]CHRISTOPHER H. HANNA ET AL., CORPORATE INCOME TAX ACCOUNTING ¶ 12.03 (4th ed. 2010).

[43]FIN 48, *supra* note 32, app. B ¶ B34 (stating that FASB recommends that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law).

[44]*See* SOX, *supra* note 21, §§ 302(a), 404(a); FIN 48, *supra* note 32, ¶ 8; text accompanying *supra* note 22.

recognition and measurement standards.[45] This FIN 48 documentation is required in order to substantiate in a transparent way that the company's internal processes for making subjective tax decisions are operating effectively.[46]

The combined effect of the enactment of SOX and the issuance of FIN 48 has been to require the creation of written documentation with respect to a company's uncertain tax positions. Companies now have detailed documentation on an issue-by-issue basis for each uncertain tax position and must document why they believe their tax positions are unsustainable before they can establish a financial statement reserve.[47] Tax departments no longer have cookie jar reserves that represent a general overall reserve. The income tax reserve of today represents an issue-by-issue, bottom-up, reserve analysis. Furthermore, no income tax reserve is allowed under FIN 48 unless the taxpayer believes that the taxpayer will not sustain a tax position in full with respect to a particular issue.[48] In order to promote greater disclosure to financial statement users, the FASB decided that it was important for the company to disclose in its financial statement footnotes the aggregate financial statement impact of the company's unsustainable tax positions.[49]

The financial community and the public have quickly grasped the import of these new footnote disclosures. For example, one equity research report published in 2007 reviewed 361 companies in the S&P 500 that had adopted FIN 48.[50] In their analysis, they found that sixty-two companies had each claimed over $500 million of tax benefits from unsustainable tax positions, and thirty-six of those companies had claimed over $1 billion of tax benefits from unsustainable tax positions.[51] The top ten companies with the largest unrecognized tax benefits had claimed a combined $46 billion of tax benefits for positions that in their own self-assessment were not sustainable.[52] This report then attempted to develop a "tax risk report card" where the financial impact of each company's unrecognized tax benefits

[45] *See supra* note 44 and accompanying text.

[46] *See supra* note 44 and accompanying text.

[47] *See supra* note 40 and accompanying text.

[48] *See* FIN 48, *supra* note 32, app. A ¶ A17; *supra* note 39 and accompanying text.

[49] *See* FIN 48, *supra* note 32, ¶ 21, app. B ¶ B63.

[50] DAVID ZION & AMIT VARSHNEY, CREDIT SUISSE, PEEKING BEHIND THE TAX CURTAIN 8 (2007).

[51] *Id.*

[52] *Id.* at 9.

was compared to the overall market capitalization of the company.[53] This report indicated that "the new disclosures in FIN 48 take the guesswork out of trying to get your arms around a company's uncertain tax positions and the tax reserves it has taken against them."[54] Now that FIN 48 has taken away the guesswork, the public sees that the largest companies and the most sophisticated taxpayers openly admit that they have claimed significant tax benefits that they do not believe are sustainable.[55] Another report, prepared with data as of June 15, 2010, found that the 500 largest US public companies claimed in combination over $200 billion of tax benefits that in their own self-assessment were unsustainable.[56] The largest claims of unsustainable tax positions were as follows:[57]

Table: FIN 48 Self Disclosures of Tax Owed But Not Paid		
	Company	Amount
1.	GE	$8.7 billion
2.	Pfizer	$7.6 billion
3.	AT&T	$7.5 billion
4.	JP Morgan	$6.6 billion
5.	General Motors	$5.4 billion
Total of Top 500		~$200 billion

And yet, after making these self-declarations that these companies believe in their own judgment that they have claimed tax positions that are

[53] *See id.* at 9–10.

[54] *Id.* at 13.

[55] *See id.* at 8.

[56] *Id.*

[57] *Ferraro 500—Uncertain Tax Positions*, THE FERRARO LAW FIRM, http://www.tax-whistleblower.com/ferraro500/ (last visited Apr. 7, 2011) (accurate as of June 15, 2010).

not sustainable, these companies continue to claim these unsustainable tax positions on their tax returns even though the company has come to a positive assertion that they are not sustainable in their own judgment.[58] When a taxpayer and its advisors take a tax return position that is not sustainable (and which the taxpayer does not reasonably believe is sustainable), the government's efforts to collect the right amount of tax in a timely manner are frustrated.[59] The adoption of FIN 48 has revealed the scope of the tax gap related to this current tax filing practice, and this transparency has in turn created the impetus for Schedule UTP. [60]

III. NEW SCHEDULE UTP: REPORTING REQUIREMENTS AND IMPLICATIONS

Through a series of announcements and proposed regulations and then final regulations,[61] the IRS established a new reporting requirement for certain large companies to affirmatively disclose their uncertain tax positions on new Schedule UTP. On January 26, 2010, the IRS first announced this new initiative to require taxpayers to affirmatively highlight the soft spots in their own tax returns through its issuance of Announcement 2010-9.[62] On April 19, 2010, the IRS issued Announcement 2010-30 which in turn set forth an initial draft Schedule UTP and accompanying instructions for completing this new disclosure schedule.[63] On September 24, 2010, after considering a number of taxpayer comments, the IRS issued Announcement 2010-75 in order to set forth the taxpayer disclosure requirements for completing final Schedule UTP.[64] For clarity, this article

[58] *See* ZION & VARSHNEY, *supra* note 50, at 9.

[59] *See* Toder, *supra* note 10, at 367.

[60] Jeremiah Coder, *UTP Reporting Grew Out of Changes in Accounting Requirements, Wilkins Said*, Tax Notes Today (Tax Analysts), Doc. 2010-24000 (November 9, 2010), *available at* LEXIS 2010 TNT 216-6. One important caveat, however, is that the tax disclosure includes US federal income, state income, and non-US income tax exposures. Thus, the financial statement disclosure may represent amounts attributable to more than just US federal income tax issues.

[61] *See* Treas. Reg. § 1.6012-2(a)(4)–(5) (as amended in 2010); Prop. Treas. Reg. § 1.6012-2, 75 Fed. Reg. 54,802, 54,804 (Sept. 9, 2010); T.D. 9510, 75 Fed. Reg. 78,160, 78,160 (Dec. 15, 2010); I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 428 (Oct. 12, 2010); I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668, 668 (May 10, 2010); I.R.S. Announcement 2010-17, 2010-13 I.R.B. 515, 515 (Mar. 29, 2010); I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408, 408 (Feb. 16, 2010).

[62] I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408, 408.

[63] I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668, 668.

[64] I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 428.

refers to the draft version of Schedule UTP and its draft instructions that were released on April 19th concurrently with Announcement 2010-30 as the draft Schedule UTP while the later final version of Schedule UTP and its final instructions that was released on September 24th concurrently with Announcement 2010-75 is referred to as the final Schedule UTP.

A. Analysis of Schedule UTP Reporting Requirements

Final Schedule UTP and its instructions generally apply to certain large companies that issue audited financial statements and make their tax filings on Form 1120, Form 1120-F, Form 1120-L, or Form 1120-PC.[65] However, in response to various public comments,[66] the IRS implemented a five-year phase-in period for final Schedule UTP for corporations with total assets of under $100 million.[67] In this regard, Announcement 2010-75 provides that corporations that have total assets equal to or exceeding $100 million must file final Schedule UTP starting with their 2010 tax year.[68] The announcement goes on to state that this total asset threshold will be reduced to $50 million starting in 2012 and then further reduced to $10 million starting in 2014.[69] Announcement 2010-75 indicates that the IRS is still considering whether and to what extent it should extend final Schedule UTP reporting requirements to other taxpayers.[70] Final Schedule UTP and its instructions do not exclude taxpayers in the Compliance Assurance Program (CAP)[71] nor does it exclude taxpayers which are under continuous

[65] IRS, DEP'T OF THE TREASURY, INSTRUCTIONS FOR SCHEDULE UTP 1–2 (2010) *available at* http://www.irs.gov/pub/newsroom/2010_instructions_for_sch_utp.pdf.

[66] *See, e.g.*, Lisa G. Workman, *CPA Firm Raises Concerns About Proposal to Require Reporting of Uncertain Tax Positions*, Tax Notes Today (Tax Analysts), Doc. 2010-12415 (May 21, 2010), *available at* LEXIS 2010 TNT 109-20.

[67] *See* I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 428.

[68] *See id.*

[69] *See id.*

[70] *See id.*

[71] *See id.*; I.R.S. Announcement 2005-87, 2005-2 C.B. 1144 (Dec. 12, 2005) ("The objective of the program is to reduce taxpayer burden and uncertainty while assuring the Service of the accuracy of tax returns prior to filing, thereby reducing or eliminating the need for post-filing examinations. . . . Participating taxpayers that resolve all material issues will be assured, prior to the filing of the tax return, that the Service will accept their tax return, if filed consistent with the resolutions . . . and that no post-filing examination will be required.").

audit.[72] But, the IRS did say in Announcement 2010-75 that further guidance for CAP taxpayers is expected to be forthcoming shortly.[73]

Announcement 2010-75 makes clear that an uncertain tax position includes all of the taxpayer's uncertain tax positions for which the taxpayer has created a tax reserve on its financial statements by reason of FIN 48.[74] The final instructions clarify that final Schedule UTP seeks the reporting of tax positions consistent with the financial statement reserve decisions made by the corporation.[75] In response to several comment letters,[76] the instructions now clarify that corporations are not required to report uncertain tax positions that are either immaterial under applicable financial accounting standards or are sufficiently certain so that no reserve is required under financial accounting standards.[77] In addition, the instructions to final Schedule UTP make clear that an uncertain tax position must be disclosed even if no financial statement reserve is created for the position when the taxpayer expects to litigate the issue with the IRS.[78]

The draft Schedule UTP originally had proposed that the taxpayer must report an estimated maximum tax adjustment amount for each uncertain tax position listed on Schedule UTP other than transfer pricing and valuation uncertainties.[79] This initial proposal received considerable comment from the public,[80] and after considering those comments the IRS in

[72] I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 428; Letter from Patricia A. Thompson, Am. Inst. of Certified Pub. Accountants, to Douglas H. Shulman, Comm'r, IRS on Uncertain Tax Position Reporting 3 (Dec. 2, 2010), *available at* http://www.aicpa.org/InterestAreas/Tax/Resources/IRSPracticeProcedure/Advocacy/DownloadableDocuments/AICPA%2012.02.2010%20UTP%20letter.pdf ("For Coordinated Industry Case (CIC) taxpayers that are under continuous audit, their returns are examined regardless of the information provided on Schedule UTP.").

[73] I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 430.

[74] *Id.*

[75] *See id.* For a discussion of several unresolved reporting questions with respect to reporting of pre-existing uncertain tax positions for affiliates that enter or leave a consolidated group, see Peter H. Blessing, N.Y. State Bar Ass'n Tax Section, *NYSBA Tax Section Report Addresses Uncertain Tax Positions in Mergers, Acquisitions, Spinoffs*, Tax Notes Today (Tax Analysts) Doc. 2010-27092 (Dec. 20, 2010), *available at* LEXIS 2010 TNT 244-17.

[76] Am. Bankers Ass'n et al., *Business Groups Take Issue With Uncertain Tax Position Proposal*, Tax Notes Today (Tax Analysts) Doc. 2010-12641 (June 1, 2010), *available at* LEXIS 2010 TNT 110-21.

[77] I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 430.

[78] IRS, *supra* note 65, at 2.

[79] I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668, 672–73 (May 10, 2010).

[80] *See, e.g.*, Ernst & Young LLP, *Ernst & Young Voices Concerns with UTP Reporting*

Announcement 2010-75 removed the requirement to report a maximum tax adjustment amount.[81] Instead, the instructions to final Schedule UTP now require a corporation to rank all of its uncertain tax positions (including transfer pricing and other valuation positions) based on the United States federal income tax reserve (including interest and penalties) recorded for the position taken in the return and requires the taxpayer to designate the tax positions for which a reserve for the particular tax position exceeds 10% of the aggregate amount of the financial statement reserves established for all of the tax positions reported on final Schedule UTP.[82] In response to several public comments[83] with respect to tax positions for which no reserve was created based on an expectation to litigate the position, the final instructions to final Schedule UTP now provide that no exposure size or ranking needs to be indicated with respect to these uncertain tax positions.[84]

In the draft Schedule UTP, the IRS had proposed that taxpayers explain why an uncertain tax position was uncertain and also proposed that taxpayers explain the nature of the uncertainty.[85] This required explanation created considerable public comment about whether this disclosure would cause the taxpayer to make party admissions or waive subject-matter privilege.[86] In response to those concerns, the instructions to final Schedule UTP eliminates this requirement and affirmatively states that a taxpayer need not assess the hazards of an uncertain tax position.[87] Instead, the instructions to final Schedule UTP now require taxpayers to only provide a concise description of the tax position that reasonably can be expected to

Proposal, Tax Notes Today (Tax Analysts) Doc. 2010-12740 (June 1, 2010), *available at* LEXIS 2010 TNT 111-30; Richard M. Lipton, Am. Coll. of Tax Counsel, *Tax Law Group Seeks Limitations Under Uncertain Tax Position Proposal*, Tax Notes Today (Tax Analysts) Doc. 2010-13688 (June 8, 2010), *available at* LEXIS 2010 TNT 119-19; Skadden, Arps, Slate, Meagher & Flom LLP, *Firm Suggests Changes, Alternatives to UTP Reporting Proposal*, Tax Notes Today (Tax Analysts) Doc. 2010-13689 (June 4, 2010), *available at* LEXIS 2010 TNT 119-20..

[81] I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 429.

[82] *See id.*

[83] Ron Dickel, Fin. Execs. Int'l, *Financial Executives Group Comments on Proposal to Require Reporting of Uncertain Tax Positions*, Tax Notes Today (Tax Analysts) Doc. 2010-12653 (June 1, 2010), *available at* LEXIS 2010 TNT 111-25.

[84] I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 431.

[85] *Id.* at 429.

[86] Walter A. Pickhardt, Minn. Bar Ass'n Tax Section, *Minnesota State Bar Association Tax Section Comments on Proposed Regs to Implement UTP Reporting*, Tax Notes Today (Tax Analysts) Doc. 2010-21031 (Sept. 17, 2010), *available at* LEXIS 2010 TNT 187–24.

[87] *See* I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 429; IRS, *supra* note 65, at 1–2.

apprise the Service of the identity of the tax position and the nature of the issue.[88]

Several commentators asked the IRS to confirm that a taxpayer's right to claim privilege would not be impacted by the taxpayer's completion of final Schedule UTP.[89] Instead of doing so, the IRS issued a separate announcement where it indicated that the government would generally extend its policy of restraint at the IRS examination level to final Schedule UTP workpapers.[90] In this regard, Announcement 2010-76 stated that the IRS would forgo seeking production of documents that relate to the completion of final Schedule UTP and stated that taxpayers may exclude from any request for taxpayer reconciliation workpapers any working drafts, revisions, or comments concerning the concise description of tax positions reported on final Schedule UTP.[91] But, this separate announcement also indicated that the IRS's restraint does not create or imply any change in the government's understanding of the application of the attorney-client privilege, the tax-advice privilege under Section 7525, or of the attorney-work-product doctrine.[92] In a public statement, the IRS Commissioner stated that disclosures made on final Schedule UTP that are consistent with the revised guidelines set forth for final Schedule UTP do not constitute a waiver of privilege over the subject matter of the uncertain

[88] *See supra* note 87.

[89] *See, e.g.*, George M. Gerachis & Christine L. Vaughn, Vinson & Elkins LLP, *Attorneys Suggest Changes to UTP Reporting Proposal*, Tax Notes Today (Tax Analysts) Doc. 2010-12674 (June 1, 2010), *available at* LEXIS 2010 TNT 111-26.

[90] I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432, 432 (Oct. 12, 2010). The IRS "policy of restraint" was first developed in the 1980s. After prevailing in its right to seek tax accrual workpapers in the *Arthur Young* case, *see* United States v. Arthur Young, 465 U.S. 805, 814–18 (1984), the IRS became concerned that there would be a legislative response that might curtail the scope of the IRS victory in that judicial decision. To forestall a potential legislative response, the IRS announced that it would generally not seek tax accrual workpapers from taxpayers. For the initial guidance setting forth the initial formulation of the IRS "policy of restraint," see I.R.S. News Release IR-81-49 (May 5, 1981); *see also* I.R.S. Announcement 84-46, 1984-18 I.R.B. 18 (Apr. 30, 1984) (announcing that, in response to the *Arthur Young* decision, the Service would not alter its current procedures for requesting tax accrual workpapers relating to the evaluation of a corporation's reserves for contingent tax liabilities). However, the legislative environment today is not favorable for further protections from discover because the Congressional mood from both political parties supports efforts to reduce the nation's tax gap. *See, e.g.*, sources cited *supra* note 8.

[91] I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432, 432.

[92] *Id.*

tax position,[93] but this legal conclusion is not found in the text of Announcement 2010-76 and in fact the preamble to final Treasury regulations explicitly refused to provide any such concession.[94] As a result, taxpayers are likely to remain concerned about whether their completion of final Schedule UTP represents a waiver of privilege with respect to the matters affirmatively disclosed on final Schedule UTP.[95] The issues surrounding privilege are considered more fully as a discrete subtopic in this article in Part V.C.

The instructions to final Schedule UTP clarify that corporations need only report their own tax positions and need not report the tax positions of a related party.[96] The instructions to final Schedule UTP also clarify that tax positions taken in years before 2010 need not be reported on final Schedule UTP even if a reserve is recorded in audited financial statements issued in 2010 or later.[97]

At least one comment letter indicated that a liberal disclosure of final Schedule UTP to non-US tax officials could create extraterritorial waiver issues in non-U.S. jurisdictions.[98] Perhaps due to this comment letter, the IRS stated that it intends to generally refrain from providing final Schedule UTP information to other governments except in those circumstances in which there is a reciprocal exchange of information agreement.[99] In addition, even if reciprocity did exist, the Service would consider other factors in determining whether to disclose the information, including the relevance of the information to the foreign government.[100]

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[93] Douglas Shulman, IRS, *Shulman Announces Release of Final UTP Reporting Schedule and Instructions and Guidance*, Tax Notes Today (Tax Analysts) Doc. 2010-20927 (Sept. 24, 2010), *available at* LEXIS 2010 TNT 186-30.

[94] *See* T.D. 9510, 75 Fed. Reg. 78,160, 78,160 (Dec. 15, 2010).

[95] *See* I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 430–31 (Oct. 12, 2010); *see also* sources cited in note 90.

[96] *See* IRS, *supra* note 65, at 1–2.

[97] *See id.*; *see also* IRS, Dep't of the Treasury, *Frequently Asked Questions on Schedule UTP*, IRS.GOV, http://www.irs.gov/businesses/article/0,,id=237538,00.html (discussing this issue in Q&A set #3).

[98] Paul Seraganian, Osler, Hoskin & Harcourt LLP, *Canadian Company Asks Congress to Implement Uncertain Tax Position Proposal*, Tax Notes Today (Tax Analysts) Doc. 2010-12201 (May 28, 2010), *available at* LEXIS 2010 TNT 107-23.

[99] *See* I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 431.

[100] *See id.*

B. Analysis of Why Taxpayers Should Fully Complete Schedule UTP

The requirement to complete final Schedule UTP brings several potential reactions, but an analysis of each of these reactions leads one to believe that in the end taxpayers are likely to believe that their safest (and really only practical) course of conduct will be to fully complete final Schedule UTP, to disclose all uncertain tax positions for which the company has taken a financial statement reserve, and to disclose uncertain tax positions that the IRS has issued guidance to the tax community that it intends to litigate. A current treatise provides the following wise practical advice:

> In our view, the traditional tax planning and dispute resolution model of adopting aggressive positions, sitting back to see if the tax authorities raise any serious issues, and then proceeding to IRS Appeals and litigation if such issues arise is outdated and unworkable in today's world of transparency. The reality today is that tax positions will be examined by the company's auditor, and possibly disclosed in its financial statements, which, in turn, will result in a much higher likelihood that these matters will be reviewed by the IRS. As such, companies are better served to assume that their tax positions, aggressive or routine, will be reviewed by the IRS, including all associated workpapers and opinion materials. In our view, the overall policy of the company should be one of open disclosure which will, in turn, create a collaborative work environment with the IRS.[101]

As the following discussion indicates, the IRS has sufficient enforcement mechanisms to ensure that taxpayers fully complete Schedule UTP and conduct their tax reporting in a transparent manner.[102] Furthermore, it is reasonable to expect that further reforms could well be in place before the audit of the 2010 tax returns, and the risk of these reforms should cause taxpayers to avoid noncompliance. The thought process for reaching the conclusion that taxpayers should decide to fully complete Schedule UTP and avoid hiding the ball is set forth below.

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[101] HANNA ET AL., *supra* note 42, ¶ 12.03.

[102] *See id.*

1. Not Disclosing All Uncertain Tax Positions Creates Unacceptable Risk

From a tax perspective, taxpayers may have an initial desire to not record financial statement reserves in order to avoid making affirmative disclosures on final Schedule UTP, but actually following through on this initial desire is fraught with risk. The failure to have appropriate internal controls in place to assure that a company has appropriately assessed and evaluated the firm's subjective risks can represent a material weakness in the company's internal controls.[103] An intentional failure in internal controls implicates a range of potential sanctions that can create personal exposure to the Chief Financial Officer and to the Chief Executive Officer.[104] The public disclosure obligations with respect to reporting material weakness to shareholders and the corrective actions to remediate those weaknesses make this possible response unpalatable to most companies and to their board of directors. Furthermore, the company's external financial auditor will have its own motivation to ensure that its audit clients do not understate or misstate their financial statement reserves because the external auditor must give its own opinion with respect to the operating effectiveness of the company's internal controls over subjective tax decisions.[105] In addition, if a person were to attempt this course, then that person must set forth the substantive basis for reaching this decision in written form, and in today's SOX environment this person would need to obtain multiple sign-offs within the company and from the company's external financial auditors.[106] Thus, the corporate governance and transparency reforms that have occurred over the last decade will make this response a risky and unsatisfactory response, and so this author believes that it is unlikely that companies subject to SOX would actually follow through on this course of action.

A second potential response is that a taxpayer would simply not complete final Schedule UTP. In this event, Section 7203 of the Internal Revenue Code theoretically could impose criminal penalties for failure to properly complete final Schedule UTP, but as has been pointed out by another commentator, it is often difficult for the IRS to prove "willful

[103] *See supra* notes 25–29 and accompanying text.

[104] *See* 18 U.S.C. § 1350(c)(1) (2006) (imposing a prison sentence of up to ten years for knowingly filing false certifications).

[105] *See infra* Part V.C.

[106] *See* 18 U.S.C. § 1350(a).

failure."[107] But with this said, another effective remedy available to the IRS in this situation would be for it to further rescind its policy of restraint with respect to taxpayers that report tax reserves on their financial statements but fail to provide an adequate disclosure of them on final Schedule UTP.[108]

A precedent for this sort of a governmental response exists with the evolution of the administrative practice related to listed transactions. In Notice 2000-15 the IRS gave its initial administrative guidance with respect to the types of transactions that must be disclosed in the tax return as listed transactions.[109] In 2002, two years after giving guidance as to the types of transactions that should affirmatively be disclosed on the tax return, the IRS announced that it would modify its policy of restraint and request tax accrual workpapers if the IRS became aware that the taxpayer had engaged in listed transactions.[110] Announcement 2002-63 went on to state that if the taxpayer affirmatively had disclosed the listed transaction on their tax return as required by Temporary Treasury Regulation Section 1.6011-4T, then the IRS would routinely request the tax accrual workpapers of the taxpayer that pertained only to the listed transaction.[111] However, Announcement 2002-63 then stated that if the taxpayer had not disclosed the listed transaction on the taxpayer's tax return, then the IRS would routinely request all tax accrual workpapers of the taxpayer for all issues.[112] Finally, Announcement 2002-63 stated that if the IRS determined that the taxpayer had engaged in multiple listed transactions, then regardless of whether the listed transactions were disclosed the IRS may request all of the taxpayer's tax accrual workpapers for all tax issues.[113]

Given this prior precedent, it is foreseeable that taxpayers will find that the IRS audit practice at the time of the audit of their 2010 tax return will

[107] *See* J. Richard Harvey, Jr., *Schedule UTP: Views of a Former Tax Advisor and Administrator*, 128 TAX NOTES 1259, 1260 n.9 (2010).

[108] *See* I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408, 408 (Jan. 26, 2010) ("The proposal does not require the taxpayer to disclose the taxpayer's risk assessment or tax reserve amounts, even though the Service can compel the production of this information through a summons."); *see also infra* Part V.A.

[109] The IRS has subsequently updated this list of transactions of interest and the current list of such transactions is set forth in I.R.S. Notice 2009-59. *See generally* I.R.S. Notice 2009-59, 2009-31 I.R.B. 170 (Aug. 3, 2009).

[110] *See* I.R.S. Announcement 2002-63, 2002-2 C.B. 72, 72 (July 8, 2002).

[111] *Id.*

[112] *Id.*

[113] *Id.*

no longer provide restraint from seeking FIN 48 workpapers if the taxpayer did not provide adequate information on final Schedule UTP. Said differently, if the IRS cannot get the tax reserve information in the detail that it needs from final Schedule UTP, then it is foreseeable that the IRS will not show restraint with respect to requesting FIN 48 tax accrual workpapers from such taxpayers. Given the strong probability that the IRS audit process will be changed in this way in time for the IRS audit of the 2010 tax year,[114] taxpayers are likely to avoid the risk of this scenario by completing final Schedule UTP.[115]

As an intermediate course, a taxpayer might instead choose to limit their disclosures of uncertain tax positions on final Schedule UTP to only those issues that the IRS has already identified as rollover issues in prior audits. This tactical alternative is also fraught with risk.[116] Similar to the situation where final Schedule UTP is not completed at all, if the IRS suspects that a taxpayer's completion of final Schedule UTP is incomplete, it is foreseeable that the IRS audit practice at the time of the audit of the taxpayer's 2010 tax return will provide the IRS examination team with authority to request the taxpayer's FIN 48 tax accrual workpapers.[117] Given this obvious and predictable scenario, taxpayers are likely to want to fully complete final Schedule UTP so that the taxpayer can assert that the FIN 48 workpapers would not identify any additional tax reserve positions that were not disclosed on final Schedule UTP.

Thus, after reviewing each of the above distasteful outcomes associated with an incomplete disclosure of tax reserves on final Schedule UTP, the likely response from most taxpayers will be that they will disclose all of their uncertain tax positions for which they have established a financial statement reserve. If this is the likely response, then a likely further outcome is that the company's tax department will have substantial internal

[114] *See infra* Part V.

[115] *See* I.R.S. Announcement 2002-63, 2002-2 C.B. 72, 72 ("If the Listed Transaction was disclosed under Temp. Treas. Reg. § 1.6011-4T, the Service will routinely request the Tax Accrual Workpapers pertaining only to the Listed Transaction.").

[116] *See* IRS, *supra* note 65, at 1 ("Schedule UTP requires the reporting of each U.S. federal income tax position taken by an applicable corporation . . . for which . . . either the corporation or a related party has recorded a reserve with respect to that tax position for U.S. federal income tax in audited financial statements . . . ."); *see also* I.R.S. Announcement 2002-63, 2002-2 C.B. 72, 72 ("In addition, if the Service determines that tax benefits from multiple investments in Listed Transactions are claimed on a return, regardless of whether the Listed Transactions were disclosed, the Service, as a discretionary matter, will request all Tax Accrual Workpapers.").

[117] *See* Harvey, *supra* note 107, at 1261.

discussions with senior management about tax positions that require disclosure on final Schedule UTP, and in fact the company's board of directors may also become more interested in being briefed on the uncertain tax positions that require disclosure on final Schedule UTP.[118] This further internal rigor along with the added disclosure of the soft spots in the taxpayer's tax return may (in combination) cause taxpayers to become more conservative with respect to the tax positions taken on their tax return. It would be a benefit to the country if taxpayers minimized the instances in which they claimed tax positions that in their own judgment are unsustainable.

Another line of inquiry that taxpayers must now go through involves identification of tax positions where the taxpayer expects to prevail through litigation.[119] Again, the IRS has requested disclosure of sustainable tax positions when the taxpayer expects to litigate the matter.[120] Thus, the question becomes what criteria the taxpayer should use to determine whether a tax position would require litigation.

In this regard, as a general rule, the Internal Revenue Manual makes it clear that the IRS mission is to collect the right amount of tax, not the maximum amount of tax.[121] Given that the IRS has a stated goal of collecting the right amount of tax, one would expect taxpayers to argue that it is reasonable for them to expect the IRS to not litigate a case where the taxpayer believes there is more than a 50% likelihood of taxpayer success.

An exception to this general approach would exist when the IRS has issued administrative guidance that makes it clear that the government is

[118] In an unusual action, the Commissioner of the IRS in several public speeches last year called upon the board of directors to enhance their governance oversight of the company's tax function. *See* Douglas H. Shulman, Comm'r, IRS, Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman Before the 2009 National Association of Corporate Directors Corporate Governance Conference 1 (October 19, 2009) *in* I.R.S. News Release IR-2009-95 (Oct. 19, 2009); Douglas H. Shulman, Comm'r, IRS, Prepared Remarks of Douglas H. Shulman at the George Washington University Law School 22nd Annual Institute on Current Issues on International Taxation (Dec. 10, 2009) *in* I.R.S. News Release IR 2009-116 (December 10, 2009). The adoption of final Schedule UTP is likely to trigger the outcome that the Commissioner publicly requested.

[119] *See* IRS, *supra* note 65, at 1.

[120] *Id.*

[121] IRS, Dep't of the Treasury, *The Agency, Its Mission and Statutory Authority*, IRS.GOV, http://www.irs.gov/irs/article/0,,id=98141,00.html ("The IRS's role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.").

unwilling to settle a particular tax position.[122] In this event, the taxpayer has notice that the government would expect to litigate this particular tax position, and so the taxpayer should disclose such positions on final Schedule UTP whether or not the taxpayer believes the tax position is sustainable.[123] If the taxpayer did not disclose these areas of particular IRS interest, then it is reasonable to believe that the IRS would view this omission as a failure to adequately complete final Schedule UTP and may in turn seek the taxpayer's FIN 48 workpapers for all other transactions. Given that this is a foreseeable and predictable governmental response, one would expect that taxpayers would disclose sustainable tax positions that the IRS has designated as positions that it will not settle administratively, but the taxpayer's disclosures may well be limited to these expressed areas of non-settlement. If the IRS wanted a more robust disclosure of sustainable tax positions, then the IRS is likely to need more guidance to elicit a further disclosure.

2. Concise Description of Issues Should Be Forthright

Once a taxpayer identifies the list of uncertain tax positions that will be disclosed on final Schedule UTP, the next decision point for the taxpayer will be to decide on the actual language for setting forth the "concise description of the tax position . . . that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue."[124] Taxpayers need to ensure that their disclosures do open the door to understanding the nature of the tax issue and do ensure that the IRS has sufficient information to know how to further develop the issue in their audit. There are at least three variables that will enter into this disclosure statement.

Variable 1: If the taxpayer does not provide sufficient information for the IRS to understand what further information requests are needed in order to develop the issue in audit, then it is foreseeable that the IRS audit practice at the time of the audit of the taxpayer's 2010 tax return will

[122] *See* Treas. Reg. § 1.6011-4(b) (as amended in 2007) (setting forth a list of transactions that are of particular interest to the IRS and that therefore require specific disclosure); *see also* I.R.S. Actions Relating to Court Decisions, 1999-2 C.B. 314 (August 30, 1999) (explaining the IRS policy for its "Action on Decision," i.e., acquiescence and non-acquiescence to decided court cases).

[123] *See* Treas. Reg. § 1.6011-4(b).

[124] IRS, *supra* note 65, at 4.

provide the IRS examination team with authority to request the taxpayer's FIN 48 tax accrual workpapers whenever the concise description is insufficient to allow the IRS to pursue the issue. To avoid this risk, taxpayers need to give the IRS a sufficiently adequate disclosure to allow the IRS to understand the nature of the issue.

Variable 2: If the concise description allows the IRS to quickly conclude that the tax position raises a coordinated issue, then development of the issue may be controlled by functional experts outside of the local examination team. The IRS has indicated that the Large Business and International Division (LB&I) is establishing a centralized processing team to collect and review filed Schedules UTP to aid in the audit selection and to aid in coordination of similar issues.[125] Taxpayers have expressed concern that grouping the individual taxpayer's issue with a host of other similarly situated taxpayers will take authority for case management out of the local examination team and make it harder for any of these taxpayers to have their individual case developed and evaluated on its particular facts and merits.[126]

Variable 3: If the concise description substantively evaluates the position, then this could create a party admission or subject-matter waiver over the particular issue.[127]

What is not a variable, at least in this author's mind, is the thought of crafting a final Schedule UTP disclosure statement that would avoid opening the door to the potential tax exposure item. In the author's view, an attempt to pursue that objective would cause the disclosure to be inadequate such that the IRS would then pursue production of the taxpayer's FIN 48 workpapers. The logical consequence of this scenario would be that the exposure item will be fully understood anyway, and the taxpayer may be in a worse position if the FIN 48 workpapers contain opinion statements that could be viewed as party admissions. Thus, in any scenario, this author believes that taxpayers will come to expect that the IRS will obtain the taxpayer's list of material uncertain tax positions and that the least risky approach for providing this information to the IRS is to fully complete Schedule UTP. The days of hiding the ball are gone, and the

[125] *See* Amy Elliott, *Pretty Good Guidance Should Be Good Enough for IRS, Official Says*, Tax Notes Today (Tax Analysts) Doc. 2010-25851 (Dec. 6, 2010), *available at* LEXIS 2010 TNT 233-4.

[126] *Id.*

[127] *See* Pickhardt, *supra* note 86.

best tax practice will be for the taxpayer to expect that all information about a tax position that is taken on a tax return will be available for inspection and reviewed by the IRS. The implications for tax practice are real and significant. Taxpayers more than ever should take tax positions with the expectation that they will be fully disclosed to the IRS and will be fully understood by the government. Thus, tax planning should be done with the assumption of transparency. Tax planning that cannot survive the rigors of this transparency should be avoided. Business practices that create significant tax risk need to be revisited and modified.

IV. HOW WHISTLEBLOWER AWARDS IMPACT THE ANALYSIS

The whistleblower provisions of Section 7623 significantly alter the equation with respect to a company's expectation of confidentiality of its internal documents.[128] The practical reality is that Section 7623 creates a significant motivation for companies to deal with uncertain tax positions in a fully transparent manner with the IRS.[129]

In 2006, in an effort to reduce the tax gap, Congress increased the potential amount for whistleblower awards to 30% of any tax recovery when a whistleblower provides significant information that leads to the collection of a tax underpayment.[130] If the information provided by a whistleblower contributed to the collection of an underpayment but it was determined to be a nonsignificant factor, then the whistleblower would be entitled to a reduced award.[131] Congress has called on the IRS to accelerate its use of this whistleblower program and to commence paying bounties to whistleblowers in order to spur further whistleblower filings.[132] The IRS recently issued regulations that clarified that an eligible whistleblower award includes situations where information is provided that results in a denial of a taxpayer's claim for refund,[133] and this clarifying definition of an

[128] *See* 26 U.S.C. § 7623(a) (2006).

[129] *See id.*

[130] *See id.*

[131] *Id.* § 7623(b).

[132] Sen. Chuck Grassley, *Grassley Calls on IRS to Improve Whistle-Blower Program*, Tax Notes Today (Tax Analysts) Doc. 2009-22247 (Oct. 7, 2009), *available at* LEXIS 2009 TNT 193-33; *see also* Jeremiah Coder, *IRS Pays First Enhanced Whistleblower Award*, Tax Notes Today (Tax Analysts) Doc. 2011-7587 (April 11, 2011), *available at* LEXIS 2011 TNT 69-4 (announcing a whistleblower award of $4.5 million to an in-house accountant for information about the accountant's employer).

[133] *See* Prop. Treas. Reg. § 301.7623-1(a)(2), 76 Fed. Reg. 2852, 2853 (Jan. 18, 2011).

eligible award has been met with approval by legislators and members of the tax bar that represent whistleblower claimants.[134]

Plaintiff firms, through advertisements in various tax publications and via their websites, have urged individuals to contact them for assistance in filing whistleblower claims based on the information contained in their employer's FIN 48 tax accrual workpapers.[135] In fact, one plaintiff's firm has asserted that it has filed a $4.4 billion whistleblower submission and that its client may be entitled to a whistleblower award for 30% of that amount.[136]

The ability of employees to use a company's FIN 48 tax accrual workpapers as a basis for submitting whistleblower claims raises several unresolved issues. First, should the IRS accept this information? It appears that the IRS is receptive to whistleblower claims filed on the basis of a company's FIN 48 tax accrual workpapers.[137] In Chief Counsel Memorandum CC-2010-004, the IRS Chief Counsel laid out a process for follow-up interviews with whistleblowers.[138] The IRS stated that "there is a long-standing line of cases that support the ability of the government to use information received from a private party, even if the private party obtained

[134] *See* Sen. Chuck Grassley, *Proposed Regs Are 'Good News' for Whistleblowers, Grassley Says*, Tax Notes Today (Tax Analysts) Doc. 2011-1020 (Jan. 14, 2011), *available at* LEXIS 2011 TNT 11-106; Jeremiah Coder, *IRS Proposes Expanded Definition of Proceeds for Whistleblower Awards*, Tax Notes Today (Tax Analysts) Doc. 2011-883 (Jan. 18, 2011), *available at* LEXIS 2011 TNT 11-3.

[135] *See Law Firm Analyzes Unrecognized Tax Benefit Reserves Among Fortune 500*, Tax Notes Today (Tax Analysts) Doc. 2010-19374 (Sept. 2, 2010), *available at* LEXIS 2010 TNT 170-36 ("The details in the tax accrual work papers often make for valuable tax whistleblower submissions."); *Welcome to The Ferraro Law Firm—Tax Whistleblower Attorneys*, THE FERRARO LAW FIRM, www.tax-whistleblower.com (last visited Apr. 7, 2011).

[136] *See* Ferraro Law Firm, *Ferraro Law Firm Files $4.4 Billion Whistle-Blower Submission with IRS*, Tax Notes Today (Tax Analysts) Doc. 2008-13182 (June 13, 2008), *available at* LEXIS 2008 TNT 116-61; *see also* Press Release, Ferraro Law Firm, Fiscal Year 2009 Annual Report to Congress Signals Opportunities for New Tax Whistleblowers 1 (December 13, 2010), *available at* http://taxprof.typepad.com/files/ferraro-press-release.pdf ("[T]here is approximately $200 billion of uncertain tax positions for [the Fortune 500 companies alone]. 'Those who come forward now with information regarding significant tax underpayments are more likely to receive awards than those who wait because awards are given to the informant who first provides the information to the IRS,' . . . .").

[137] *See* Jeremiah Coder, *Chief Counsel Approves More Interaction With Whistleblowers*, Tax Notes Today (Tax Analysts) Doc. 2010-3872 (Feb. 24, 2010), *available at* LEXIS 2010 TNT 36-3.

[138] I.R.S. Chief Counsel Notice CC-2010-004 (February 17, 2010).

the information in an illicit or illegal manner, as long as the government is a passive recipient of the information."[139] The memorandum goes on to state that follow-up consultations will not cause the IRS to jeopardize its status as a passive recipient for this purpose.[140] At some level, it seems inconsistent to this author for the IRS not to request a taxpayer's FIN 48 tax accrual workpapers as a matter of administrative restraint but then at the same time to provide whistleblower awards to informants for providing their employer's FIN 48 tax accrual workpapers to the government. If the FIN 48 tax accrual workpapers are helpful and useful to the IRS, then the IRS should make a regular practice of obtaining this information itself through the IRS audit process and should not provide whistleblower awards to informants for FIN 48 information except when that information is not made readily available to the government by the taxpayer.

Another important question is whether and to what extent a company's affirmative disclosure of an uncertain tax position on final Schedule UTP will impact the ability for a whistleblower to claim an award based on the whistleblower's production of the company's FIN 48 tax accrual workpapers.[141] If the company disclosed its uncertain tax position on final Schedule UTP, an argument can be made that the production of the company's FIN 48 tax accrual workpapers under the whistleblower program does not provide any meaningful new information to the government.[142] However, the taxpayer's FIN 48 tax accrual workpapers may provide insights that aid the IRS in "detecting and bringing to trial . . . persons guilty of violating the internal revenue laws" and thus may fulfill the literal requirements for a whistleblower award under Section 7623(a).[143] Thus, it would be helpful if the IRS would provide guidance in this situation.

Nevertheless, regardless of the course of future IRS guidance on these questions, this discussion reinforces the need for taxpayers to fully and adequately complete Schedule UTP. The company's tax officer does not want to have a situation where a company employee has filed a whistleblower claim that asserts the company failed to adequately disclose

[139] *Id.*

[140] *Id.*

[141] Jeremiah Coder, *Practitioners Disagree Over Effect of UTP Reporting on Whistleblower Claims*, Tax Notes Today (Tax Analysts) Doc. 2010-19323, (Sept. 2, 2010), *available at* LEXIS 2010 TNT 170-1.

[142] *See id.*

[143] *See* 26 U.S.C. § 7623(a) (2006).

its tax obligations.[144] Recent press reports speculate that significant whistleblower awards may soon be awarded, and there are firms actively soliciting clients to submit claims.[145] In today's world, too many people touch the company's FIN 48 tax accrual workpapers for a tax officer to believe that such information will remain confidential. A company's tax officer will want to avoid a scenario where a whistleblower files a claim that a company has underreported its taxes and the basis for this whistleblower claim was not adequately disclosed on Schedule UTP. If such a scenario were to arise, it is foreseeable that the tax officer will find it difficult to explain to the company's general counsel and to the company's board of directors why the company failed to act transparently with the IRS and created whistleblower exposures. The corporate governance reforms adopted by SOX will make this potential scenario untenable for any reasonable tax officer,[146] and so again this author concludes that the only practical course of conduct in this age of transparency is to fully and accurately disclose a company's uncertain tax positions in a transparent manner on Schedule UTP.

V. POTENTIAL FUTURE REFORMS ARE ON THE HORIZON

The pace of change is accelerating, and in these changing times it is advisable to have a prediction of where the law is heading in order to plan accordingly. The following section sets forth three areas where further change is likely to occur, and in combination these further predictable reforms augur for taxpayers to reexamine their tax-planning and tax-compliance processes to ensure that they will be able to withstand the added transparency that is likely to exist at the time these processes are reviewed by the government.

[144] *See* David Cay Johnston, *Can Loopholes Blow the Whistle on Whistleblowers?*, Tax Notes Today (Tax Analysts) Doc. 2010-25562 (Dec. 6, 2010), *available at* LEXIS 2010 TNT 233-11; *see also* Kelley Semrau, *SC Johnson Official Refutes Johnston's Recent Column*, Tax Notes Today (Tax Analysts) Doc. 2010-26204 (Dec. 13, 2010), *available at* LEXIS 2010 TNT 238-14.

[145] Jeremiah Coder, *IRS Whistleblower Office Reports High Submissions, Omits Controversial Issues*, Tax Notes Today (Tax Analysts) Doc. 2010-26590 (Dec. 15, 2010), *available at* LEXIS 2010 TNT 240-4.

[146] *See* SOX, *supra* note 21, § 906(a)(c)(1).

A. Reform of Tax-Reporting Standards

Taxpayers that now have an obligation to complete Schedule UTP are likely to conclude that they should minimize the instances where the taxpayer claims unsustainable tax positions that require a reserve on the company's financial statements. To achieve this end, tax functions should immediately discuss with their business units how to minimize the areas of tax risk associated with their business model.

In a broader sense, Schedule UTP is a natural outgrowth of the apparent inability of the IRS to collect through the audit process the full amount of taxes that taxpayers believe in their own self-assessment should have been collected.[147] A common practice in today's environment is for a public company to assert to the IRS that it owes a lower tax liability when it files its tax return but then to assert that it has a higher, but as yet unpaid, tax liability when it files its financial statements with the SEC.[148] Thus, different government agencies are being told different things. When a company swears that the correct amount of tax is one amount on its tax return but then simultaneously swears on its financial statements that its tax obligation is something else, the result is that the company is making inconsistent assertions. Before FIN 48, the outright inconsistency could have been explained away because prior GAAP guidance allowed taxpayers to keep more nebulous and more generalized tax reserves.[149] FIN 48 takes away that argument because a FIN 48 reserve can only be established after a company positively identifies its unsustainable tax positions through a separate issue-by-issue analysis.[150]

This raises an obvious question: if a company believes that its tax liability is higher than the amount shown on its tax return due to unsustainable tax positions taken in the tax return, then why can the company knowingly file its tax return with such unsustainable tax positions in the return without risk of penalty? This state of affairs leads to high public cynicism about noncompliance.[151] Public cynicism is harmful to the

[147] *See supra* Part I; *see also* sources cited *supra* note 12.

[148] *See* Bret Wells, *Voluntary Compliance: "This Return* Might Be *Correct, But* Probably *Isn't,"* 29 VA. TAX REV. 645, 664 (2010).

[149] *Id.*

[150] *See* FIN 48, *supra* note 32, ¶¶ 4-5, app. B ¶¶ B13-B14.

[151] *See* I.R.S. News Release IR-2008-137 (Dec. 8, 2008) (stating that 80% of respondents believe that it is very important that IRS ensure that large corporations are reporting and paying their taxes honestly); Lee Sheppard, *Tax Schemes Are Proliferating, Official Tells NYU Conference*, Tax Notes Today (Tax Analysts) Doc. 2009-23080 (Oct. 20, 2009), *available at*

country and creates a perception that the existing U.S. tax burden is not being fairly borne by sophisticated corporate taxpayers.[152] The logical conclusion to this line of inquiry is that the nation's tax laws should no longer allow a taxpayer to take a tax return position that the taxpayer has positively concluded is unsustainable in the company's own view.[153]

In Section 563 of the Affordable Health Care for America Act, Congress had proposed to increase the standards for tax reporting for certain large publicly-traded corporations to require those taxpayers to take tax positions only where they reasonably believe that the tax treatment is more likely than not the proper treatment.[154] Congress did not enact this proposal. Given the systemic problems created by the tax gap and the public's desire for greater voluntary tax compliance, this author has stated elsewhere that the law should (and likely will) be changed so that taxpayers, tax-return preparers, and tax advisors could only advocate an uncertain tax position without a risk of an understatement penalty or sanction, as the case may be, if the taxpayer, tax-return preparer, or tax advisor, as the case may be, reasonably believed that the uncertain tax position is likely to be sustained.[155]

The added transparency required by the SOX Section 302 and Section 404 along with FIN 48's added disclosure requirements has brought so much transparency that it is foreseeable that Congress would seek to force financial statement and tax return reporting conformity by requiring companies to only take tax positions on their tax return that are sustainable in the amounts believed to be sustainable by them.[156] Given this likely legislative response, taxpayers should take corrective actions now to minimize and eliminate their reliance on tax positions that are unsustainable in the taxpayer's own view. Where reducing these tax risks can be achieved only by changing the manner in which business is conducted, the tax

LEXIS 2009 TNT 200-1 ("Never in history has the American public been more aware of noncompliance. . . .").

[152] I.R.S. News Release IR-2009-95 (Oct. 19, 2009) ("In today's business climate, the general public has little tolerance for overly aggressive tax planning that can be viewed as corporations playing tax games.").

[153] *See* Wells, *supra* note 148, at 668–72 (setting forth a recommendation for how current law should be changed to address this concern).

[154] *See* Affordable Health Care for America Act, H.R. 3962, 111th Cong. § 563 (2009).

[155] *See* Wells, *supra* note 148, at 668.

[156] *See* SOX, *supra* note 21, §§ 302, 404; *see also* FIN 48, *supra* note 32, ¶ 21.

functions should immediately re-engage with their business units to make the necessary corrective changes.

B. Further Changes Forthcoming to the Policy of Restraint

In 1981, the IRS announced a policy of restraint, stating that it would generally not seek production of a taxpayer's tax accrual workpapers.[157] This policy of restraint continued until 2002 when the IRS abruptly modified its longstanding policy of restraint.[158] In Announcement 2002-63 the IRS stated that it would request a taxpayer's tax accrual workpapers if a taxpayer failed to disclose its participation in a listed transaction.[159] In 2003, the IRS further modified and clarified its revised policy of restraint, stating that it would request all tax accrual workpapers if the taxpayer failed to disclose listed transactions on returns filed after July 1, 2002, if the taxpayer claimed benefits from multiple listed transactions on returns filed after July 1, 2001, or if other financial irregularities existed.[160] In 2004, the IRS clarified the distinction between "tax accrual workpapers" (which are subject to the IRS's policy of restraint) and "tax reconciliation workpapers" (which can be routinely requested).[161]

In announcing its development of this Schedule UTP for large taxpayers, the IRS asserted that the taxpayer's FIN 48 information is highly relevant to understanding the taxpayer's tax positions and assessing how

[157] *See* I.R.S. Announcement 84-46, 1984-18 I.R.B. 18 (Apr. 30, 1984) (announcing that in response to the Arthur Young decision, the Service would not alter its current procedures for requesting tax accrual workpapers relating to the evaluation of a corporation's reserves for contingent tax liabilities); I.R.S. News Release IR-81-49 (May 5, 1981) (original statement by Commissioner Egger announcing the policy to the California CPA Tax Section); *see also* Ad Hoc Subcomm. of the Comm. on Law & Accounting, *A Qualified Privilege for Tax Accrual Workpapers*, 39 BUS. LAW. 247, 285–87 (1983).

[158] I.R.S. Announcement 2002-63, 2002-2 C.B. 72 (July 8, 2002). The current formulation of the IRS policy of restraint can be found in Internal Revenue Manual Section 4.10.20, *see* IRM §§ 4.10.20.1–.4 (July 12, 2004), and I.R.S. Announcement 2010-76, *see* I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010); *see also* I.R.S. Gen. Couns. Mem. AM2007-0012 (Mar. 22, 2007); IRS, *supra* note 97 (stating in Q&A set #5 and #6 that the policy of restraint applies to IRS Appellate Officers and generally is followed by IRS counsel but that further guidance on the impact of the policy of restraint on IRS counsel will be the subject of further guidance).

[159] I.R.S. Announcement 2002-63, 2002-2 C.B. 72.

[160] *See* I.R.S. Chief Counsel Notice CC-2003-012 (Apr. 9, 2003); *see also* IRM §§ 4.10.20.1.4.

[161] *See* I.R.S. Chief Counsel Notice CC-2004-010 (Jan. 22, 2004).

those positions affect the taxpayer's tax liability.[162] The IRS also stated that a taxpayer's FIN 48 information would aid the government in focusing its examination resources on returns that contain specific uncertain tax positions that are of particular interest or of sufficient magnitude to warrant further inquiry as well as allowing examination teams to identify all of the issues underlying the tax returns more quickly and efficiently.[163] After making these statements about the probative value of a taxpayer's FIN 48 workpapers, the IRS reiterated that it does not intend to request the taxpayer's FIN 48 workpapers and will continue its existing policy of restraint during the course of examinations.[164] However, the IRS indicated that it would continue to review its existing policy of restraint and may consider additional modifications to ensure it obtains complete and accurate information regarding a taxpayer's uncertain tax positions on a timely basis.[165]

As indicated in the earlier discussion, if the taxpayer fails to adequately disclose its uncertain tax positions on final Schedule UTP, one would expect that the IRS will modify its policy of restraint as an appropriate response to deal with taxpayer noncompliance with respect to adequately completing final Schedule UTP. In this author's view, this change is the minimum change that could be expected. In fact, some officials in the IRS and Treasury have raised the question of whether the IRS should entirely eliminate its policy of restraint.[166]

Given that it is foreseeable that the IRS will continue to modify its policy of restraint, taxpayers should now ensure that its existing tax-planning and tax-compliance processes are done with the assumption that all tax positions and all tax opinions are likely to be reviewed by the IRS

[162] I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408, 408 (Jan. 26, 2010); *see also* I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668, 668 (Apr. 19, 2010).

[163] *See supra* note 162.

[164] *See supra* note 162.

[165] *See supra* note 162.

[166] *See* Stephen Joyce, *IRS Mulling Change to 'Policy of Restraint' Concerning Accrual Papers, IRS Official Says*, Daily Tax Rep. (BNA) No. 27, at G-1 (Feb. 9, 2007), *available at* 2007 WL 417940; Stephen Joyce, *IRS Not Amending 'Policy of Restraint' on Taxpayer Tax Accrual Workpapers*, Daily Tax Rep. (BNA) No. 197, at G-6 (Oct. 12, 2007), *available at* 2007 WL 2956882; Stephen Joyce, *Nolan Discusses Efforts to Create Efficiencies While Providing Taxpayers Certainty Sooner*, Daily Tax Rep. (BNA) No. 71, at G-2 (Apr. 13, 2007), *available at* 2007 WL 1089097; Dustin Stamper, *No Plans to Change Restraint Policy for Workpapers, Stiff Says*, Tax Notes Today (Tax Analysts) Doc. 2007-23554 (Oct. 23, 2007), *available at* LEXIS 2007 TNT 205-1.

and that the tax positions will be fully disclosed and fully understood on audit. In today's age of transparency, it is no longer reasonable for a taxpayer to believe that its written documentation on tax return positions will be confidential.

C. Privilege Implications

One would expect that the issue of privilege with respect to FIN 48 tax accrual workpapers will likely be an area of significant continuing controversy between taxpayers and IRS examination agents. However, even though controversy is likely to continue in this area, taxpayers have sufficient reason to believe that they are not going to be successful in forestalling the IRS's access to the company's FIN 48 tax accrual workpapers or documentation related to the uncertain tax positions that appear on Schedule UTP.[167] Accordingly, taxpayer's should engage in current tax planning under the assumption that no privilege will exist with respect to the tax positions that are taken on a tax return and that are incorporated into a company's FIN 48 tax accrual workpapers.[168] A review of the relevant case law and the basis for this legal conclusion is set forth below.

As an initial matter, it is clear that FIN 48 workpapers are relevant business records that would be of potential interest to the IRS.[169] In *Powell v. United States*, the Supreme Court held that the IRS could enforce a summons to obtain relevant business records as long as: (i) the IRS investigation has a legitimate purpose; (ii) the IRS inquiry may be relevant to its legitimate investigation; (iii) the information sought is not already within the IRS's possession; and (iv) the administrative steps required to issue a summons have been followed.[170] The Supreme Court has analogized the IRS's investigatory power to that of a grand jury.[171] The summons power afforded the IRS under Section 7602 reflects a congressional policy in favor of disclosure of all information relevant to a

[167] *See* I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408, 408; I.R.S. Announcement 2002-63, 2002-2 C.B. 72, 72 (July 8, 2002); I.R.S. Chief Counsel Notice CC-2003-012 (Apr. 9, 2003); IRM §§ 4.10.20.1–.4 (July 12, 2004); *see also* I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668, 668.

[168] *See supra* note 166.

[169] I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408, 408.

[170] *See* Powell v. United States, 379 U.S. 48, 57–58 (1964).

[171] *See* United States v. Morton Salt Co., 338 U.S. 632, 642 (1950).

legitimate IRS inquiry and courts have been reluctant to restrict the IRS's power to summons information absent unambiguous directions from Congress.[172] The Supreme Court articulated the broad investigatory authority granted to the IRS in the following statement:

> We begin examination of these sections against the familiar background that our tax structure is based on a system of self-reporting. There is legal compulsion to be sure, but basically the Government depends upon the good faith and integrity of each potential taxpayer to disclose honestly all information relevant to tax liability. Nonetheless, it would be naive to ignore the reality that some persons attempt to outwit the system, and tax evaders are not readily identifiable. Thus, § 7601 gives the Internal Revenue Service a broad mandate to investigate and audit "persons who *may* be liable" for taxes and § 7602 provides the power to "examine any books, papers, records or other data which may be relevant . . . and to summon . . . any person having possession . . . of books of account . . . relevant or material to such inquiry."[173]

Although FIN 48 tax accrual workpapers are highly relevant business records, the IRS has a policy of not asking for these documents at the IRS examination level but has left the door open for the government to request this information at other procedural points in a tax dispute.[174] As a result, the question then becomes whether FIN 48 tax accrual workpapers are protected from potential discovery, and these issues are discussed more fully in the following two sections.

1. Attorney-Client Privilege

If the FIN 48 tax accrual workpapers included tax advice from an attorney or from a federally authorized tax practitioner, then the tax advice may be entitled to privilege under both the common law attorney-client privilege and/or under the statutory privilege set forth in Section 7525(a).[175]

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[172] *See* United States v. Bisceglia, 420 U.S. 141, 145–46 (1975).

[173] *Id.*

[174] *See* I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432, 432 (Sept. 24, 2010); T.D. 9510, 75 Fed. Reg. 78,160, 78,160 (Dec. 15, 2010).

[175] *See* Upjohn Co. v. United States, 449 U.S. 383, 386 (1981) (refusing to enforce IRS

However, the attorney-client privilege (and the statutory privilege provided to federally authorized tax practitioners)[176] can be waived if the tax advice is disclosed to a third party.[177] In particular, the company's disclosure of its legal opinions to its external financial auditors has historically been understood to constitute a waiver of the attorney-client privilege and thus would represent a waiver of the statutory privilege afforded by Section 7525 as well.[178] Given that the external auditors now routinely require a full disclosure of all tax opinions and tax advice received by a company to substantiate their FIN 48 analysis,[179] the attorney-client privilege that may have existed as a prima facie matter is always waived as a practical matter.[180] Thus, neither the attorney-client privilege nor the statutory

summons because documents sought contained communications protected by the attorney-client privilege and attorney-work-product doctrine). For the statutory privilege that applies to communications between a tax practitioner and her client, see 26 U.S.C. § 7525(a) (2006).

[176] *See* Treas. Dep't Circular 230, 31 C.F.R. § 10.3 (2011). Non-attorney federally authorized tax practitioners includes certified public accountants and authorized enrolled agents. *See id.*

[177] *See* United States v. Davis, 636 F.2d 1028, 1043 n.18 (5th Cir. Unit A Feb. 1981).

[178] *See* United States v. El Paso Corp., 682 F.2d 530, 540–41 (5th Cir. 1982); First Fed. Sav. Bank of Hegewisch v. United States, 55 Fed. Cl. 263, 268–69 (Fed. Cl. 2003) (finding waiver of attorney-client privilege when board minutes containing confidential communications between board members and outside counsel were disclosed to outside auditors who were auditing company's financial statements).

[179] Robert H. Aland et al., *The Corporate Tax Director: Responsibilities in the New Era of Increased Corporate Accountability*, 83 TAXES 91, 98 (2005) (reporting a comment of Joel V. Williamson, partner in the Chicago office of the law firm of Mayer, Brown, Rowe & Maw and head of the firm's Tax Controversy and Transfer Pricing Department). The American Institute of Certified Public Accountants (the AICPA) has made it clear that a company desiring an unqualified financial audit opinion cannot refuse to disclose to its outside auditor any tax advice the company may have received from its attorneys about material financial statement items, even if such disclosure waives privilege. *See* CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU § 9326 ¶ 2.22 (Am. Inst. of Certified Pub. Accountants 2003) ("If the client's support for the tax accrual or matters affecting it, including tax contingencies, is based upon an opinion issued by an outside adviser with respect to a potentially material matter, the auditor should obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege."). Furthermore, officials with the SEC have stated on several different occasions that the company needs to provide its written documentation that demonstrates its issue-by-issue evaluation under FIN 48 to the company's external auditors before the external auditor can be in a position to opine on the company's internal controls as required by SOX. *See* Neil D. Traubenberg et al., *Session 6: Making the "Final Judgments" on Implementing the New Standard on Accounting for Uncertainty in Income Taxes*, 85 TAXES 95, 96 (2007); Jane D. Poulin, SEC, Remarks Before the 2004 AICPA National Conference on SEC and PCAOB Developments (Dec. 6, 2004), *available at* http://www.sec.gov/news/speech/spch120604jdp.htm.

[180] *See supra* note 174 and accompanying text.

privilege set forth in Section 7525(a) would apply after this information has been shared with external auditors.[181]

2. Attorney-Work-Product Protection

The core of the attorney-work-product doctrine relates to opinion work product, and this protection prevents discovery of the mental processes of the attorney so that the attorney can analyze and prepare a client's case for trial.[182] 1n 1970, the attorney-work-product doctrine that was originally enunciated in *Hickman v. Taylor* was partially codified with respect to materials and tangible things prepared in anticipation of litigation or for trial in Rule 26b(b)(3) of the Federal Rules of Civil Procedure.[183] However, the notes of the Advisory Committee on the 1970 amendments provided an important limitation on the work-product privilege, namely that it did not extend to "[m]aterials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not under the qualified immunity provided by this subdivision."[184] Thus, the attorney-work-product doctrine does not apply to ordinary business records that would have been created in the ordinary course of business regardless of the prospect of future litigation.[185] As will be discussed further below, the better view is that FIN 48 tax accrual workpapers are business records that serve a regulatory requirement and as such any attorney opinions that are incorporated into these documents takes those opinion materials out of the attorney work-product protection.

The focal point for the question about whether the attorney-work-product doctrine protects attorney opinions that are incorporated into the taxpayer's FIN 48 tax accrual workpapers begins with Supreme Court's decision in *United States v. Arthur Young & Co*.[186] In the *Arthur Young* case, the IRS sought discovery of Arthur Young's files related to its audit of

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[181] *See supra* note 174, 179 and accompanying text.

[182] *See* United States v. ChevronTexaco Corp., 241 F. Supp. 2d 1065, 1090 (N.D. Cal. 2002).

[183] FED. R. CIV. P. 26 advisory committee's note (1970 amendments); Hickman v. Taylor, 329 U.S. 495, 508–14 (1947).

[184] FED. R. CIV. P. 26 advisory committee's note (1970 amendments).

[185] *See* Shapiro v. United States, 335 U.S. 1, 55–56 (1948) (stating that in order to determine whether records are required public records, a court must consider "their custody, their subject matter, and the use sought to be made of them"); *see also* United States v. Adlman, 134 F.3d 1194, 1202 (2d Cir. 1998).

[186] *See* 465 U.S. 805, 807 (1984).

Amerada Hess as part of a criminal tax investigation of Amerada Hess.[187] The files held by Arthur Young included tax accrual workpapers of Amerada Hess.[188] These workpapers included documents and memoranda relating to Arthur Young's evaluation of Amerada Hess's reserves for contingent tax liabilities and included interview notes of Amerada Hess personnel.[189] Amerada Hess instructed Arthur Young not to comply with the IRS summons that sought discovery of these sensitive tax documents, and litigation to compel production ensued.[190] The district court held that the tax accrual workpapers were both relevant and discoverable and ordered Arthur Young to produce the documents.[191] The Second Circuit reversed the district court,[192] and in so doing attempted to fashion an accountant-work-product doctrine patterned after the attorney work-product doctrine that was announced in *Hickman*.[193] The Second Circuit's attempt to create a brand new accountant-work-product privilege was motivated by a concern that production of tax accrual workpapers gave the IRS a roadmap that would be an unfair adversarial advantage and by a concern that regular production of these documents would cause taxpayers to withhold this information from their external auditors, thus jeopardizing the quality of the financial audit and the reliability of the company's public filings.[194]

It was in this context that the Supreme Court granted certiorari and reversed the Second Circuit's decision.[195] The Supreme Court rejected the Second Circuit's expansion of the attorney-work-product doctrine to accountant's tax accrual workpapers.[196] The Supreme Court then dismantled the Second Circuit's policy concerns that motivated it to articulate a possible expansion of the work-product doctrine to encompass accounting records.[197] The Supreme Court rejected out-of-hand the idea

[187] *Id.* at 808–09.

[188] *Id.* at 809.

[189] *Id.* at 808, 812.

[190] *Id.* at 809.

[191] United States v. Arthur Young, 496 F. Supp. 1152, 1160 (S.D.N.Y. 1980), *aff'd in part, rev'd in part*, 677 F.2d 211 (2d Cir. 1982).

[192] *See* United States v. Arthur Young, 677 F.2d 211, 214 (2d Cir. 1982), *aff'd in part, rev'd in part*, 465 U.S. 805 (1984).

[193] *See Arthur Young*, 465 U.S. at 810.

[194] *Arthur Young*, 677 F.2d at 220–21.

[195] *Arthur Young*, 465 U.S. at 820–21.

[196] *Id.*

[197] *Id.* at 818–20.

that the integrity of the financial audit would be called into question if tax accrual workpapers were regularly disclosed to the IRS.[198] The Supreme Court then asserted that the auditor's analysis of a taxpayer's financial statement tax reserves represented ordinary business records.[199] The Supreme Court concluded its opinion by stating that Congress could provide additional protections from disclosure, but the Court would leave it to Congress to craft any additional protection.[200] Thus, the Supreme Court did not restrict the scope of the IRS's right to inspect relevant business records including tax accrual workpapers and did not expand the scope of any existing privilege.[201]

Subsequent to the *Arthur Young* case, the First Circuit in *Textron*[202] and the Fifth Circuit in *El Paso*[203]have concluded that tax accrual workpapers represent ordinary business records that are not entitled to attorney-work-product protection even if these documents contain opinions from counsel about a company's uncertain tax positions. These cases stand for the proposition that FIN 48 tax accrual workpapers represent normal business records. Regardless of whether litigation was expected, a public company must create written documentation that sets forth its analysis of why it is entitled (or is not entitled) to claim a financial statement benefit for all sorts of financial matters including tax matters. If FIN 48 tax accrual workpapers were protected from discovery when prepared by an attorney, then attorneys would be given greater deference for creating ordinary business records

[198] *See id.* at 819.

[199] *Id.* at 820.

[200] *Id.* at 821. Congress eventually did respond to the *Arthur Young* decision by providing a narrowly tailored statutory privilege that is set forth in Section 7525. *See* 26 U.S.C. § 7525(a) (2006). It is important to note that Congress declined to enact an accountant-work-product privilege for tax accrual workpapers. *See* United States v. KPMG LLP, 316 F. Supp. 2d 30, 35 (D.D.C. 2004). Instead, Congress decided to give the same privilege protection to tax advice given by a federally authorized tax practitioner to a client that exists under the attorney-client privilege, choosing not to expand the scope of the existing attorney-client privilege beyond its historical understanding. *See* 26 U.S.C. § 7525(a). Although Section 7525 gives the same privilege protection to tax advice given by a federally authorized tax practitioner as exists under the attorney-client privilege, the statutory privilege afforded by Section 7525(a) is narrower in that Section 7525(b) denies the right to this statutory privilege for tax advice that is given with respect to a tax shelter. *See id.* § 7525(a)–(b).

[201] *See Arthur Young*, 465 U.S. at 820–21.

[202] *See* United States v. Textron Inc., 577 F.3d 21, 31–32 (1st Cir. 2009).

[203] United States v. El Paso Corp., 682 F.2d 530, 543–44 (5th Cir. 1982) (similarly holding that tax accrual workpapers are not entitled to work product protection). *But see* United States v. Deloitte LLP, 610 F.3d 129, 143 (D.C. Cir. 2010).

than accountants. It is one thing to provide a privilege for attorney's who are preparing for trial. It is another thing to extend that privilege to cover an attorney who is creating ordinary business records that serve an accounting and regulatory-compliance function.[204] Thus, consistent with the notes of the Advisory Committee on the 1970 amendments to Federal Rule of Civil Procedure 26(b)(3), these cases hold that the attorney-work-product protection does not protect ordinary business records that are created to meet accounting or regulatory requirements.[205] Again, as the Supreme Court stated in the *Arthur Young* decision, Congress can restrict the liberal access rights that it has given the IRS if it so desires.[206] And thus far, Congress has not expressed any desire to protect FIN 48 workpapers from discovery.

However, the D.C. Circuit in *United States v. Deloitte LLP* has held that memoranda prepared by Deloitte as part of its financial audit of Dow Chemical Company were entitled to the attorney work-product protection because the memoranda included interview statements made by Dow's legal counsel about potential tax litigation exposures.[207] The D.C. Circuit was convinced that the identity of the person that created the memoranda (namely, an accountant) is not critical.[208] Instead, according to the D.C. Circuit, what was critical was whether the memoranda contained the mental impressions and legal opinions of counsel who was anticipating litigation.[209] The D.C. Circuit went on to state that the Deloitte memoranda represented dual use documents that were created because of the risk of litigation and would not have been created if litigation had not been contemplated.[210] Based on this reasoning, the D.C. Circuit held that the attorney-work-product protection could apply to tax accrual workpapers to

[204] For a scholarly and detailed analysis of the work-product doctrine that is consistent with the author's view, see Claudine Pease-Wingenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of* United States v. Textron, 8 HOUS. BUS. & TAX L.J. 337, 345–46 (2008); Dennis J. Ventry, *A Primer on Tax Work Product for Federal Courts*, Tax Notes Today (Tax Analysts) Doc. 2009-10691 (May 18, 2009), *available at* LEXIS 2009 TNT 94-8; Dennis J. Ventry, *Protecting Abusive Tax Avoidance*, Tax Notes Today (Tax Analysts) Doc. 2008-18132 (Sept. 1, 2008), *available at* LEXIS 2008 TNT 171-26.

[205] *See* FED. R. CIV. P. 26 advisory committee's note (1970 amendments).

[206] 465 U.S. at 821.

[207] 610 F.3d 129, 138–39 (D.C. Cir. 2010).

[208] *Id.* at 136.

[209] *Id.* at 139.

[210] *Id.* at 138–39.

the extent that these documents contained opinions of counsel.[211] This case openly disagrees with the reasoning in *Textron* and *El Paso*, and the court simply rejects those cases as wrongly decided.[212] Finally, the D.C. Circuit did not discuss or reconcile its opinion with the limitation to the attorney-work-product doctrine set forth in the notes to the Advisory Committee on the 1970 amendments to the Federal Rule of Civil Procedure 26(b)(3) with respect to opinion documents that are used to serve a regulatory-compliance purpose.[213]

Prior cases have held that tax-planning memoranda may be entitled to attorney-work-product protection when prepared by attorneys, but those cases explicitly limited their holdings to tax-planning materials that were not used for a routine regulatory-compliance process or for a tax–return-preparation purpose.[214] In fact, the courts in *Adlman* and *Roxworthy* specifically cited favorably the notes to the Advisory Committee on the 1970 amendments to Federal Rule of Civil Procedure 26(b)(3) and both state in the course of their opinions that the attorney-work-product protection would not apply to situations where an attorney's opinion documents are created for a regulatory-compliance process.[215] The attorney-opinion documents in the *Deloitte* case did get incorporated into routine regulatory-compliance documents (i.e., into the company's FIN 48 tax accrual workpapers) and therefore do seem to run afoul of the limitation to the attorney-work-product protection discussed in the notes to the Advisory Committee on the 1970 amendments to the Federal Rule of Civil Procedure 26(b)(3).[216] Thus, although *Adlman* and *Roxworthy* adopted a less stringent standard of review for determining whether an attorney-opinion document was created "in anticipation of litigation,"[217] the

[211] *Id.* at 139.

[212] *Id.* at 138.

[213] *See id.* at 135–36.

[214] *See, e.g.*, United States v. Roxworthy, 457 F.3d 590, 592 (6th Cir. 2006) (holding that memoranda was entitled to attorney-work-product protection even though the sought legal advice aided in the business decision about whether to proceed with a captive insurance company); United States v. Adlman, 134 F.3d 1194, 1205 (2d Cir. 1998) (holding that memorandum given to in-house legal counsel that analyzed tax risk associated with a proposed merger was entitled to attorney-work-product protection).

[215] *See Roxworthy*, 457 F.3d at 593–94; *Adlman*, 134 F.3d at 1202.

[216] *Deloitte*, 610 F.3d at 138.

[217] Nine circuits have generally provided attorney-work-product protection when a document was prepared "because of" the prospect of litigation. *See, e.g.*, *Roxworthy*, 457 F.3d at 593; *In re* Grand Jury Subpoena, 357 F.3d 900, 907 (9th Cir. 2004); Maine v. U.S. Dep't of Interior, 298

decisions in *Adlman* and *Roxworthy* are consistent with the decisions in *El Paso* and *Textron* in stating that attorney-opinion documents created for a regulatory-compliance purpose are not entitled to protection under the attorney-work-product doctrine. Furthermore, the restrictive language used in *Adlman* and *Roxworthy* contradict the DC Circuit's holding in *Deloitte* that attorney-opinion documents are entitled to work-product protection when they are incorporated into regulatory-compliance documents.[218] Thus, given prior precedent and the weight of existing authorities that have addressed tax-opinion materials, taxpayers and their advisors should view the decision in the *Deloitte* case as a distinct minority view and place limited reliance on that decision.

Furthermore, an interesting question to now consider is whether the obligation to complete final Schedule UTP will cause a taxpayer's expectation of confidentiality to further erode. In this regard, the completion of final Schedule UTP represents a "tax return preparation process." To this point, a significant line of case law has held that the attorney-work-product protection does not extend to documents that are part of the tax return preparation process because that process represents

F.3d 60, 70 (1st Cir. 2002); *In re* Sealed Case, 146 F.3d 881, 884 (D.C. Cir. 1998); *Adlman*, 134 F.3d at 1202–03; Martin v. Bally's Park Place Hotel & Casino, 983 F.2d 1252, 1260 (3d Cir. 1993); Nat'l Union Fire Ins. Co. v. Murray Sheet Metal Co., 967 F.2d 980, 984 (4th Cir. 1992); Simon v. G.D. Searle & Co., 816 F.2d 397, 401 (8th Cir. 1987); Binks Mfg. Co. v. Nat'l Presto Indus., Inc., 709 F.2d 1109, 1118–19 (7th Cir. 1983). The Fifth Circuit employs a more stringent standard of review that affords attorney-work-product protection only when the "primary motivating purpose" for creating a document was "in anticipation of litigation." United States v. El Paso Co., 682 F.2d 530, 542–43 (5th Cir. 1982). As has been pointed out by another commentator, regardless of whether the "because of" standard or the "primary motivating purpose" standard were used, FIN 48 tax accrual workpapers suffer from the same fatal characteristic regardless of which standard of review is employed in that they are routine business records that are created to meet a regulatory-compliance purpose whether or not litigation may ensue. *See* Ventry, *supra* note 204, at 878 n.44.

[218] *See Deloitte*, 610 F.3d at 138. Given that the Supreme Court specifically refused to create an accountant-work-product protection for tax accrual workpapers in the *Arthur Young* case, the D.C. Circuit's decision in the *Deloitte* case creates an incentive for taxpayers to use attorneys in lieu of accountants to create the FIN 48 tax accrual workpapers. *See id.*; United States v. Arthur Young, 465 U.S. 805, 820–21 (1984). Because this application of the attorney-work-product protection extends the scope beyond the limits placed by cases such as *Adlman* and *Roxoworthy* by providing privilege to work that serves an accounting function and because this result directly contradicts the holdings in *El Paso* and *Textron*, the D.C. Circuit's decision in *Deloitte* should be viewed with suspicion. *See Deloitte*, 610 F.3d at 138.

accounting work even when it is prepared by an attorney.[219] For example, in *Frederick*, documents were submitted to the attorney/accountant that served a dual purpose.[220] One purpose was to allow the advisor to prepare for possible litigation.[221] Another purpose was to allow the tax advisor to know how to report the transaction on the tax return.[222] The court in *Frederick* held that dual-purpose documents were not entitled to protection under the attorney-work-product protection because to provide a privilege in this instance would allow a taxpayer "to invoke, in effect, an accountant's privilege, provided that they used their lawyer to fill out their tax returns."[223] The *Frederick* court reached this conclusion even though a document was in fact prepared in anticipation of litigation because the document was also used for the non-privileged purpose of tax return preparation.[224] In other words, if the taxpayer transmitted the attorney work product to the tax-return preparer so that it could be used to complete the tax return, then such a use destroys "any expectation of confidentiality" which might otherwise have existed for its potential privileged use.[225] Other circuits have held that subjective decisions and advice related to how the tax return is prepared are simply not considered legal advice but instead accounting advice.[226] The privilege is not waived, however, when the

[219] United States v. Frederick, 182 F.3d 496, 500 (7th Cir. 1999); *see also* United States v. BDO Seidman, 337 F.3d 802, 810 (7th Cir. 2003) (tax advice does not include communications regarding tax return preparation); H.R. Rep. No. 105-599, at 267 (1998) (Conf. Rep.) ("The privilege of confidentiality . . . does not apply where the communication is made for further communication to third parties. For example, information that is communicated for inclusion in a tax return is not privileged because it is communicated for the purpose of disclosure."). For a good discussion of the authorities in this area, see generally Martin J. McMahon, Jr. & Ira B. Shepard, *Privilege and the Work Product Doctrine in Tax Cases*, 58 TAX LAW. 405 (2005).

[220] *Frederick*, 182 F.3d at 500.

[221] *Id.*

[222] *Id.*

[223] *Id.* at 501.

[224] *Id.*; MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 13.11 (2d rev. ed. 2003).

[225] United States v. Lawless, 709 F.2d 485, 487–88 (7th Cir. 1983); *see also* Dorokee Co. v. United States, 697 F.2d 277, 280 (10th Cir. 1983); United States v. Cote, 456 F.2d 142, 145 (8th Cir. 1972). *But see* United States v. Schmidt, 360 F. Supp. 339, 347 (M.D. Pa. 1973) (holding contra to the main line of cases).

[226] *In re* Grand Jury Investigation, 842 F.2d 1223, 1224 (11th Cir. 1987); United States v. Gurtner, 474 F.2d 297, 299 (9th Cir. 1973).

taxpayer instructs the attorney to not use the information in preparing the tax return or where its use is left solely to the advisor's discretion.[227]

To what extent does the above case law control with respect to the preparation of final Schedule UTP? If attorney work product is used to evaluate uncertain tax positions on final Schedule UTP, does this use destroy any expectation of confidentiality with respect to these opinion documents? If this were the case, then the IRS through the implementation of this new filing requirement contained in final Schedule UTP will have unilaterally changed the contours of when the taxpayer can have an expectation of confidentiality. Until further guidance is given in this area, this additional line of inquiry is almost certainly going to be another area of potential controversy in future litigation, and the decided cases are markedly against the taxpayer when the materials sought by the IRS were used to prepare and complete the tax return. Consequently, until clarified, taxpayers should consider the following practical questions as it designs processes to complete final Schedule UTP:

> 1. Should the person who prepares final Schedule UTP be a different person or the same person who prepares the tax disclosures for the financial statements?
>
> 2. Should the tax-return preparer (even if that person is a company employee) be denied access to the company's FIN 48 workpapers and instead be given only summary information to use for the tax return preparation?
>
> 3. Should the person who prepares final Schedule UTP be the same person who prepared the attorney work product or should the tax-return preparer be a different person?

Under existing case law on tax preparation materials, one would believe that the taxpayer may create additional risk if the tax-return preparer is involved in the preparation of the attorney work product, has access to the company's FIN 48 tax accrual workpapers, or is the same person who prepared the attorney-work-product materials.

However, even with these precautions, in the end taxpayers should expect that the additional regulatory requirements that are now required by SOX and the additional tax-return-compliance requirements required by

[227] United States v. Baucus, 377 F. Supp. 468, 472 (D. Mont. 1974); United States v. Threlkeld, 241 F. Supp. 324, 326 (W.D. Tenn. 1965).

new Schedule UTP are going to significantly inhibit the availability of the attorney-work-product protection with respect to documents that are incorporated into those two compliance functions. As a result, taxpayers should again reach the same logical conclusion with respect to their tax-planning and tax-compliance processes, namely that these processes should be conducted under the belief that all tax positions will be fully understood and fully disclosed to the IRS. Thus, taxpayers and their advisors would be well advised to take corrective actions with respect to any areas in these processes that would not be able to withstand this level of transparency.

D. Enhanced Penalties for Failure to Adequately Disclose on Schedule UTP Are on the Horizon

Congress has implemented significant legislation to raise the risk and the costs for taxpayers that fail to report a "listed transaction."[228] If a taxpayer fails to disclose a "listed transaction," then the period for assessment for this issue does not end until one year after the earlier of the time that the taxpayer files the information with the government or a material advisor provides the information about the particular taxpayer to the IRS.[229] Congress also instituted specific penalties that apply to taxpayers that have an understatement with respect to an unreported listed transaction and indicated that the imposition of such penalties must be disclosed in a public company's filings with the U.S. Securities and Exchange Commission.[230] It is foreseeable that Congress would revisit these provisions and through future legislation would seek to extend their application to cover the failure to report uncertain tax position on final Schedule UTP.

VI. CONCLUDING THOUGHTS

The voluntary tax-compliance system employed by the United States relies on the self-assessment of taxpayers of their own tax return.[231] And yet, at least historically, the nation's tax-reporting standards generally have provided a lenient approach towards a taxpayer's self-assessment of its own tax liability such that a taxpayer need not believe in the sustainability of

[228] 26 U.S.C. § 6707A(c) (2006) (defining a listed transaction).

[229] *Id.* § 6501(c)(10).

[230] *Id.* §§ 6662A(a), 6707A.

[231] Comm'r v. Lane Wells Co., 321 U.S. 219, 223 (1944) (recognizing that taxpayer self-assessment is the bedrock principle of the U.S. tax system).

their own tax positions. Large taxpayers and sophisticated tax advisors have used this leniency to create significant underpayments versus the amount that these companies believe in their own judgment are due. The added transparency as a result of the issuance of FIN 48 and the adoption of SOX requirements has made it clear that the size of the tax underreporting with respect to unsustainable tax positions is significant. This situation is harmful to the public's perception about the voluntary self-assessment of large companies,[232] and yet the normal audit process has not allowed the IRS to effectively identify these areas of noncompliance.

The publication of final Schedule UTP is an interesting new chapter in tax compliance and the nation's efforts to reduce the tax gap. After the taxpayer signs the face of the tax return where the taxpayer swears under penalty of perjury that the information contained in the return is true, accurate, and complete, the taxpayer is now required to disclose on final Schedule UTP each of the unsustainable tax positions contained in the tax return. If a taxpayer fails to adequately disclose its uncertain tax positions on final Schedule UTP, one would expect that the IRS would request all of the taxpayer's FIN 48 tax accrual workpapers. Furthermore, one would expect Congress to further enhance penalties for failure to adequately complete final Schedule UTP, and Congress may also require taxpayers to only claim tax positions on their tax return that the taxpayer believes are sustainable.

As the nation struggles to address its budget deficit shortfalls, one would expect that efforts to reduce the tax gap will remain front and center in the nation's discourse. The wave of change is moving in a consistent direction: taxpayers must provide relevant information in a transparent manner to the IRS so that the IRS can quickly and efficiently determine the level of taxpayer compliance. Schedule UTP is a step in this direction and provides a signal that the intensity of change is accelerating.

Instead of resisting these transparency initiatives, large corporate taxpayers should embrace this change and implement tax practices that ensure that they are good corporate citizens that comply with their disclosure requirements in a transparent manner. Tax officers and their tax advisors should also seek to minimize the risk that their conduct opens up their client to potential tax whistleblower claims. To that end, taxpayers

[232] I.R.S. News Release IR-08-137 (Dec. 8, 2008) (stating that 80% of respondents believe that it is very important that IRS ensure that large corporations are reporting and paying their taxes honestly).

should conduct tax planning and tax compliance with the expectation that all tax positions will be fully understood and fully disclosed to the IRS. Tax planning and tax compliance that cannot withstand this rigorous level of transparency should be avoided immediately. Furthermore, tax officers and their tax advisors should encourage a culture of openness and transparency with respect to uncertain tax positions vis-à-vis the IRS and should take corrective actions immediately to eliminate areas where the taxpayer relies on unsustainable tax positions. Where reducing reliance on unsustainable tax positions requires the company to change the manner in which it conducts business, the tax function needs to immediately engage the company to make those changes. If business-unit leaders cannot (or will not) change their business model to become less risky from a tax perspective, then the company should now recognize that in this age of transparency that it should not expect to reduce its overall tax cost by claiming unsustainable tax positions.

Once large corporate taxpayers adopt the above internal reforms, these taxpayers should then argue that all taxpayers, big or small, should be subject to the same standards of conduct when self-assessing and self-reporting their tax obligations. Tax-reporting standards that promote full tax compliance serve the public good at a time when the country sorely needs to collect all the taxes that are legally due. Tax laws that do not promote this level of civic response should be changed, and in this age of transparency this author believes that further reforms that require taxpayers to fully pay the taxes that they themselves believe are due will be forthcoming. The least risky course of conduct, given the direction of change, is for taxpayers to immediately limit the amount of tax benefits claimed on a tax return to only those amounts that are sustainable in the taxpayer's own judgment. In this age of increasing transparency, any lesser standard of tax reporting is likely to subject the taxpayer to an increasingly unacceptable level of criticism and risk.