COLUMBIA JOURNAL OF TAX LAW

TAX MATTERS

2012, No. 2

IRS Announcement 2010-75 created a reporting requirement that certain corporations with audited financial statements file a Schedule UTP (Uncertain Tax Position) Form beginning with the 2010 tax year. In the Schedule UTP, a corporation must disclose all uncertain US tax positions taken in its tax return for which the corporation has recorded a tax reserve for financial accounting purposes. In addition, the corporation must rank the magnitude of the reserves reported on the form. A corporation must also disclose uncertain tax positions for which no reserve is recorded for financial reporting purposes if the corporation believes that it is more likely than not that it would need to litigate the position to sustain the benefit.

Furthermore, the First Circuit ruled in United States v. Textron (2009) that the work product doctrine does not protect tax accrual workpapers created for financial filings and auditing purposes from discovery requests by the IRS.

What effects, if any, have the UTP requirement and Textron decision had on how tax directors and clients evaluate tax planning and documentation of transactions? Although the IRS has announced a policy of restraint for both, how much have the UTP requirement and Textron decision expanded the IRS's ability to obtain tax reserve information? Do you believe that other jurisdictions will attempt to implement similar reporting regimes, and if so, how would this development affect the management of global tax controversies?

Michael J. Graetz, Columbia Alumni Professor of Tax Law, Wilbur H. Friedman Professor of Tax Law, Columbia Law School

MINIMIZING POTENTIAL PRIVILEGE IMPLICATIONS CAUSED BY SCHEDULE UTP

Yuni Yan[*]

The conflicting circuit court decisions in United States v. Textron and United States v. Deloitte & Touche USA, LLP leave the privilege status of FIN 48 workpapers significantly unclear. Schedule UTP further complicates taxpayers' preserving the privilege of tax planning materials by requiring certain corporations to disclose individual uncertain tax positions ("UTPs") as part of their tax returns starting in the 2010 tax year. Some commentators predict that in reaction, corporations may try to reduce the number of their UTPs by obtaining pre-filing agreements ("PFA") or private letter rulings ("PLR") from the IRS. Indeed, according to the IRS's published statistics, the total number of PFAs the IRS received increased by approximately 70% to 39 in 2011, from 23 in 2010. This is by far the largest year-to-year increase of PFAs since 2001, suggesting that some corporations may be seeking more certainty prior to filing their returns. On the other hand, the total number of PLRs issued dropped by approximately 25% to 2,900 in 2011, from 3,864 in 2010, suggesting that taxpayers in general are not seeking more certainty upfront. The costs associated with filing a PFA and PLR—about $50,000, and $10,000, respectively, a PFA taking more than 250 days on average to be negotiated – and, most importantly, the risk of having disclosed a potential weakness and then obtaining an adverse determination could deter many taxpayers from seeking a PFA or PLR. In the end, before the Supreme Court resolves the privilege issue arising from tax accrual

[*] Associate, Wachtell, Lipton, Rosen & Katz. The author would like to thank Simon Friedman for his helpful comments. All views expressed herein are solely those of the author.

workpapers and Schedules UTP, corporations will probably react by adopting certain approaches that would reduce the quality of their UTP disclosures.

One possible conclusion from the Deloitte court's reasoning, that material developed in anticipation of litigation can be incorporated into a document produced during an audit without ceasing to be work product, is that distancing the FIN 48 workpapers prepared to support the financial statements from the legal tax opinions and analyses created for assessing the legal risks of tax positions, and then distancing the UTP from the FIN 48 workpapers, can increase the likelihood of the legal opinions being privileged attorney work product. Thus, before the company enters into tax positions that pose significant litigation risks, its tax attorneys could draft legal opinions that evaluate the tax risks and the likelihood of litigation and settlement. Such opinions by themselves are likely privileged work product under United States v. Adlman. For purposes of preparing its financial statements at a later stage, the company could incorporate such legal opinions by reference, instead of preparing legal opinions specifically for FIN 48 purposes. The goal of the "incorporation by reference" approach would be to clearly distinguish the purposes of the legal opinions—to assess the risk of litigation—from the purpose of the FIN 48 workpapers. Certainly, this approach would not apply to all contents of FIN 48 workpapers, but it could potentially strengthen the privilege claims on the legal opinions and litigation risk assessments of certain tax positions.

Further, distancing materials used to file a Schedule UTP from the FIN 48 workpapers also may increase the likelihood of preserving privilege over the legal opinions. To that effect, the company may use an accountant, who has access to only summaries of the FIN 48 workpapers to prepare the Schedule UTP. The summaries would include a quick fact description, reserve amount, and the settlement probability,

among other things, and would be prepared by tax attorneys or accountants who prepared the FIN 48 workpapers and would not be involved in preparing the Schedule UTP.

In addition to taking the approaches above that likely will lead to more vague description of the tax positions, corporations may choose simply not to disclose some UTPs that would be difficult for the IRS to discover. For example, Schedule UTP requires the disclosure of those positions where a reserve is not recorded because (a) the corporation has determined that it is "more likely than not" to prevail on the merits in litigation, and (b) it determines the probability of settling with the IRS to be less than 50%. Since a company is not required under FIN 48 standards to assess the probability of settlement for positions that pass the "more likely than not" test, the risk of such positions being discovered and audited by the IRS is very low. Thus, taking a commercial approach, a taxpayer may simply claim that the chance of settling any position that passes the "more likely than not" test is always more than 50%.

Although the IRS has announced a policy of restraint in seeking potentially privileged documents at the examination stage, until the Supreme Court settles the issue, taxpayers will remain very cautious about whether their completion of Schedule UTP represents a waiver of privilege with respect to the subject matters affirmatively disclosed on the schedule and will likely try to keep such disclosures as limited and vague as possible.