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The IRS's Recent Uncertain Tax Positions Initiative: A Tangle of Accounting, Tax and Privilege Issues

Kathryn J. Kennedy*

Executive Summary: Given the extremely limited source of resources available to the IRS in recent years, it's not surprising that it is exploring all sorts of avenues to increase its efficiency, particularly relying on corporate taxpayers to self report questionable tax positions. Under the banner of "corporate governance" and "transparency," the Service issued a series of proposals in 2010 requiring disclosure of uncertain tax positions ("UTPs") by corporate taxpayers. The Service essentially piggybacked on the recently imposed 2006 audit requirements that reserves be posted for contingent tax liabilities (i.e., tax positions that could later not be sustained, and therefore had to be paid), by requiring such reserves to be disclosed on the financial statements for corporations.¹ Disclosure of questionable tax positions would normally be mandated by legislation under the federal Internal Revenue Code (the "Code")² or compelled through civil tax provisions that impose penalties if positions are not disclosed. However, the Service relied on neither, assuming that its authority under the "returns" provisions of the Code was sufficient. The author is extremely critical of the Service using its powers under the Code for non-tax policy measures, including corporate governance, and opines that unintended consequences usually result from such endeavors.

I. INTRODUCTION

A. *Summary of the Issues*

For tax years beginning after December 15, 2006, the accounting rules dramatically changed with the promulgation of FIN 48, such that publicly traded entities had to report income tax expenses that were

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1. FINANCIAL ACCOUNTING STANDARDS BOARD, FASB INTERPRETATION NO. 48, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES: AN INTERPRETATION OF FASB STATEMENT NO. 109 (Fin. Accounting Standards Bd. 2006), available at http://www.fasb.org/pdf/aop_FIN48.pdf [hereinafter FIN 48].

2. The Internal Revenue Code, 26 U.S.C., is referred to as the "Code" in the text and will appear abbreviated as I.R.C.

more in sync with tax expenses in the event the entity was audited and challenged by the federal and state tax authorities.³ Uncertain Tax Positions (“UTPs”), defined as those *contingent* tax liabilities that could be incurred if the tax position in question was not later sustained, had to be reported as reserves under audited financial statements prepared under generally acceptable accounting standards.⁴ In determining these contingent liabilities, taxpayers, their accountants, and their attorneys need to produce supporting workpapers, referred to as tax accrual workpapers.⁵ Such workpapers, if disclosed to the Internal Revenue Service (“IRS” or the “Service”), could provide a “road map” for the Service to question the tax positions taken by the taxpayer.⁶

At the federal level, the IRS has had a policy of restraint, stating that it would not request tax accrual workpapers except in unusual circumstances, in order to promote the integrity of the financial statements and the independence of the outside auditors.⁷ Without this protection, it was feared that taxpayers would be reluctant to disclose UTPs to their independent outside auditors, resulting in misleading financial statements. Under its summons powers, the IRS may request the workpapers in unusual situations, but there are a variety of privileges – attorney-client privilege, federally authorized tax practitioner privilege (“FATP”), and the work product doctrine – that could be asserted by the taxpayer to block such summons.⁸ In recent years, the Service has been aggressive in asserting its summons powers under the Code, thereby attempting to negate privilege on the part of the taxpayer.⁹

3. FIN 48, *supra* note 1.

4. FIN 48, *supra* note 1, at Summary, *How the Conclusions in This Interpretation Relate to the Conceptual Framework*.

5. See INTERNAL REVENUE MANUAL § 4.10.20.1 [hereinafter I.R.M.].

6. See *United States v. El Paso Co.*, 682 F.2d 530, 546 (5th Cir. 1982) (Garwood, J., dissenting) (noting that the IRS wanted disclosure of the tax accrual papers because they “focus and concentrate the Service’s energy” and “may be useful to the IRS as a ‘road map’ through a company’s tax return.” Thus, such disclosure was simply for “*the convenience of the Service*.” (emphasis added)).

7. See I.R.M., *supra* note 5, §§ 4.10.20.3(2), 4.10.20.3.1, stating that such workpapers would be requested in “unusual circumstances” (including where the taxpayer has participated in a listed transaction), that such request would not be “as a matter of standard examining procedure,” and that requests would be limited to the “portion of the workpapers that is material and relevant to the examination.”

8. I.R.C. § 7602 (2006).

9. See *United States v. Arthur Young & Co.* 465 U.S. 805, 808-09 (1984); *Regions Fin. Corp. v. United States*, No. 2:06-CV-00895-RDP, 2008 WL 2139008 (N.D. Ala. 2008); *United States v. Textron*, 577 F.3d 21, 24 (1st Cir. 2009); *United States v. Deloitte LLP*, 610 F.3d 129, 133 (D.C. Cir. 2009).

The IRS received a favorable 2009 decision from the First Circuit where the IRS issued a summons for taxpayer accrual workpapers that was initially challenged on the grounds of privilege, but later affirmed by the court.¹⁰ Spurred on by this decision, the Service announced in early 2010, using its powers under the returns provisions (and not the summons powers), that it would propose mandatory disclosure of UTPs by certain corporate taxpayers on accompanying schedules to their corporate federal returns.¹¹ The goal was to improve the Service's efficiency in audits, piggybacking on the Financial Accounting Standards Board ("FASB") audit standards that required disclosure of UTPs and the posting of reserves. Under the guise of corporate transparency and better corporate governance, the IRS's initial proposal would have required disclosure of individual UTPs on certain taxpayers' tax returns, including the analysis of the legal pros and cons of a specific tax position, the probability of litigation, and the maximum tax liability that could result if the position was not sustained.¹² Such a pervasive approach raises questions as to why the internal or outside attorneys for the taxpayer would even engage in such dialogue if such documents were then to be disclosable under the work product doctrine. As expected, the backlash from the corporate business, legal, and accounting communities was enormous.

As the IRS's initial approach to requiring disclosure of items already being reported under FIN 48 did not evaluate its implication for privilege issues, the Service considered revisions and then issued its final proposal in September 2010 and reaffirmed its policy of restraint, thereby attempting to pacify the practitioners' concerns over privilege.¹³ It also issued proposed regulations regarding its authority to promulgate such disclosure through its returns powers in September of 2010.¹⁴ However, whether its final position will sustain privilege challenges in more controversial non-restraint contexts and whether it has the power under the returns statutes are open issues for the courts to decide. Other outstanding issues consider whether the Service will seek Congress' assistance in providing penalties for failure to comply with the new requirements and whether the Service is attempting to impose higher disclosure standards under existing penalty rules. Given Congress' most recent cooperation with the Service in imple-

10. See *United States v. Textron*, 577 F.3d 21, 24 (1st Cir. 2009).

11. I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408 (Jan. 26, 2010).

12. *Id.*

13. See I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428 (Sept. 24, 2010) and I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010).

14. Prop. Treas. Reg. § 1.6012-2 (Sept. 9, 2010).

menting higher penalties for nondisclosure of positions that lack economic substance,¹⁵ it may support the Service's recent initiatives through new penalties for nondisclosure of UTPs.

This article traces the history and reasons for the Service's implementation of the new UTP reporting and disclosure requirements in 2010, addressing the tangle of issues relating to accounting, privilege, and tax disclosure, each of which has different purposes and goals. The article is divided into five parts: the financial standards required under generally applicable accounting standards, applicable to most publicly traded companies, requiring the posting of contingent tax reserves (UTPs); federal tax reporting and disclosure requirements existing under the Code and its regulations pre-2010, with resulting penalties for noncompliance; the scope of the privilege doctrines for attorneys, accountants, and taxpayers; the IRS's new UTP approaches as they have evolved during 2010; and prospects for the future. The article then critiques the long-term usefulness of the Service's position for 2011 and beyond.

Everyone agrees that 2011 will be a significant year for U.S. tax administration and enforcement initiatives.¹⁶ In the context of corporate governance initiatives and circumvention of existing privileges or the work product doctrine, the author has been critical of using the Internal Revenue Code to implement or circumvent non-tax policy concerns.¹⁷ This article will be no exception. What's for certain is that the issue of UTP reporting and disclosure marks a new battleground between corporate taxpayers and the IRS. This is unfortunate as the issue of corporate tax reform is now on the drawing board for Congress and the President, and the IRS's new initiatives have undoubtedly tainted the corporate taxpayers' expectations that very much will change.

B. *Concerns for the Service*

The U.S. federal tax system relies on a voluntary tax compliance and self-reporting process in order to collect expected taxes assessed under the federal income tax code.¹⁸ Taxpayers sign under penalties

15. Pub. L. No. 111-152, § 1409(b)(2), 124 Stat. 1029 (2010) (adding I.R.C. § 6662(i)).

16. Marie Sapirie, *Next Year to Be Significant for Tax Administration, Wilkins Says*, 129 TAX NOTES 1296, 1296 (2010).

17. See Kathryn J. Kennedy, *Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses*, 10 Hous. Bus. & Tax L.J. 196 (2010); Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans*, 35 J. MARSHALL L. REV. 487 (2002).

18. The Internal Revenue Code relies on civil delinquency penalties under I.R.C. § 6651 (2006) and criminal penalties for failure to file a return or to pay taxes under I.R.C. § 7203 (2006) to compel taxpayers to file returns and pay owed taxes. A voluntary self-assessment tax system

of perjury on their tax returns that the return is true, accurate, and complete.¹⁹ In non-tax contexts, a taxpayer wouldn't be able to swear to the accuracy of a given statement without its belief that the statement is true; yet the corporate taxpayer signs its tax return knowing that certain tax positions are not sustainable if challenged.²⁰ Due to the complexity and sometimes lack of guidance of the Code, there are a variety of different standards used by the Code, common law, and courts, in assessing a taxpayer's position.²¹ This dichotomy sets up the issue whereby a taxpayer can report and pay a given tax that could likely be later challenged and increased upon audit or litigation, along with interest and penalties for understatement. Mixed into the equation is whether disclosure of the underlying tax accrual workpapers associated with the UTPs is covered by one or more privileges that could be asserted.

Between what is actually reported versus actually taxed is referred to as the "tax gap."²² The IRS has been fighting an uphill battle in recent years in bridging that gap due to limitations on its enforcement efforts.²³ The gap is more pronounced in the corporate tax community due to its size of revenue and complexity of returns, in comparison with the individual taxpayer community. Using the popular herald of "corporate governance" and "greater transparency," the Service has attempted to promote greater disclosure in hopes of discovering what issues it should be auditing and targeting.²⁴ One should

is premised on the theory that the taxpayer has knowledge of all the relevant facts and should be responsible to determine the correct amount of tax. See Bret Wells, *Voluntary Compliance: "This Return Might Be Correct But Probably Isn't,"* 29 VA. TAX REV. 645, 671 (2010).

19. I.R.C. § 6662(d)(2)(B) (2006). See, e.g., I.R.S. Form 1040; I.R.S. Form 1120.

20. See Calvin Johnson, *'True and Correct': Standards for Tax Return Reporting*, 43 TAX NOTES 1521, 1521 (1989).

21. See *United States v. El Paso Co.*, 682 F.2d 530, 546 (5th Cir. 1982):

The income tax laws, as every citizen knows, are far from a model of clarity. Written to accommodate a multitude of competing policies and differing situations, the Internal Revenue Code is a sprawling tapestry of almost infinite complexity. Its details and intricate provisions have fostered a wealth of interpretations. To thread one's way through this maze, the business or wealthy taxpayer needs the mind of a Talmudist and the patience of Job.

22. See UNDERSTANDING THE TAX GAP, I.R.S. FACT SHEET (2005), available at <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>

23. See *id.*, in which the IRS notes the three components that produce the tax gap: nonfiling, underreporting, and underpayment. The underreporting of income tax, employment taxes, and other taxes represents about 80 percent of the gap. For the 2001 tax year, the Service estimated that all taxpayers paid \$1.767 trillion on time, which represented and 83 percent to 85 percent of the total amount due. The 2001 tax gap ranged from \$312 billion to \$353 billion for all types of taxes.

24. Douglas Shulman, Commissioner, Internal Revenue Service, Prepared Remarks to the American Bar Association (Sept. 24, 2010).

question whether it is good tax policy for the Service to have taxpayers self-report questionable tax positions rather than have the Service resolve such questionable positions and determine for itself what to audit. However, given its limited resources, this certainly was a strategic position for it to take.

The tax gap is partially due to the fact that U.S. corporations face considerably higher corporate tax rates nationally than their competition in the global economy. U.S. corporations are now faced with the U.S.'s high 35 percent (federal corporate rate tax) and 39 percent (average state corporate tax included) tax rates, which are expected to be the highest in the Organisation for Economic Co-operation and Development ("OECD") after Japan reduces its rate in April of 2011.²⁵ Thus, many are either deciding to shift more jobs and investment abroad with foreign affiliates or take more aggressive tax positions in order to achieve an effective tax rate more comparable to the international corporate rate of 22 percent.²⁶ Congress understands that reduced corporate rates could produce more revenue by keeping jobs in the U.S. instead of losing them to jurisdictions with lower tax rates.²⁷ Ideally, good tax policy would tax all economic activity alike, and would not rely on tax code provisions to reallocate resources. However, excessive marginal tax rates produce incentives for all taxpayers, not just corporate taxpayers, to hide, shelter, and under-report income.

While the new UTP disclosure rules promote greater transparency and efficiency, the policy is for the benefit of the IRS, not the taxpayers.²⁸ The end analysis is a hostile environment pitting attorneys against accountants and providing IRS agents with an upper hand in the audit process. While the end product improves efficiency for the IRS, the question that must be raised is at whose cost? But before solely criticizing the IRS for its position, this newest standoff between the IRS and the business community is also due in part to Congress' continued poor oversight in providing adequate policy structure and

25. See Martin Feldstein, *Want to Boost the Economy? Lower Corporate Tax Rates*, WALL ST. J., Feb. 15, 2010, at A15.

26. See Meg Shreve, *Sessions Open to Paying for Corporate Tax Cut*, 130 TAX NOTES 632, 632 (2011); Feldstein, *supra* note 25. Since 1995, twenty-four of the European Union countries have cut their corporate tax rates. See Daniel Mitchell, *Corporate Taxes: America Is Falling Behind*, CATO INST. TAX & BUDGET BULLETIN (July 2007).

27. Shreve, *supra* note 26; Feldstein, *supra* note 25; Mitchell, *supra* note 26.

28. According to Barry Shott, former deputy commissioner (international) of the then IRS Large and Mid-Size Business Division (now LB&I), the "division's case load for both corporations and partnerships has grown exponentially in the past few years," prompting the Service to rethink its use of resources. Alison Bennett, *UTP Disclosure a Continued Focus for IRS In Looking at Taxpayers*, GUIDANCE DECISIONS, DAILY TAX REPORT G-6 (Feb. 18, 2011).

specific tax guidance through the Code. Thankfully, there is a renewed dialogue in 2011 between Congress and the president to simplify the Code for corporations.

II. FINANCIAL STANDARDS REQUIRED UNDER GAAP

A. *Accounting Scandals and Financial Meltdown*

The Securities Exchange Act of 1934²⁹ ("34 Act") is known as a full-disclosure statute, requiring registered corporations to disclose a wide range of information to shareholders. Publicly traded corporations are required under the 34 Act to have independent auditors certify their financial statements in accordance with generally accepted auditing standards.³⁰ The financial meltdowns of such prominent firms as Enron, WorldCom, and Tyco led Congress to call for greater corporate governance rules, especially with respect to the reporting of the corporation's financial statements.³¹ Of late, the Securities and Exchange Commission ("SEC") has been using its power under the statute to promote greater corporate governance. In 2002, Congress passed The Sarbanes-Oxley Act of 2002 ("SOX"),³² referred to by then chairman of the SEC as "the most important securities legislation since the original federal securities laws of the 1930's."³³ The law requires the board of directors' audit committee to be fully independent and to have the ability to supervise the auditors and assess their tenure and compensation.³⁴ The auditors must report solely to the audit committee and are required to report financial weaknesses within the

29. See Securities Exchange Act of 1934, 15 U.S.C. § 78(d) (2006).

30. See Definitions of terms used in Regulation S-X, 17 C.F.R. § 210.1-02(d) (2009). "Generally accepted auditing standards" are set forth by a committee of the public accounting profession's national organization, the American Institute of Certified Public Accountants (AICPA). See also CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement of Auditing Standards No. 1, § 150.02 (Am. Inst. of Certified Pub. Accountants 1973).

31. William H. Donaldson, Chairman, Securities and Exchange Commission, Remarks to the National Press Club (July 30, 2003), available at <http://www.sec.gov/news/speech/spch073003whd.htm>.

32. See generally Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201-66 (2006)).

33. Donaldson, *supra* note 31.

34. See Sarbanes-Oxley Act of 2002 § 301(m)(2):

The audit committee of each issuer, in its capacity as committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

corporation's financial statements.³⁵ The audit committee also resolves conflicts between management and the auditors.

To make management accountable, the corporation's CEO and CFO must attest and certify that the financial statements are accurate and complete, under penalties of perjury.³⁶ Any disclosures regarding the financial statement must be certified as "fairly present in all material respects."³⁷ SOX caused auditors to truly focus on the corporation's internal controls as they relate to its financial statements, so that financial positions were documented and complete.³⁸ The result is greater transparency in the numbers that are reported.

B. FIN No. 48 "*Accounting for Uncertainty in Income Taxes*"

The goal of standards for financial statements is to provide predictable and transparent financial statements enabling investors to compare and evaluate business entities. Under federal securities law, publicly traded businesses must use Generally Accepted Accounting Principles ("GAAP") in producing their audited financial statements.³⁹ Those principles require the reporting of certain contingent liabilities, including contingent tax liabilities.⁴⁰ In 1975, the Financial Accounting Standards Board ("FASB") issued Financial Accounting Standards ("FAS") No. 5, entitled, "Accounting for Contingencies."⁴¹ That standard acknowledged a contingent tax liability on the financial statement (referred to as a "reserve") if it was probable and estimable, assuming that the taxing bodies had full knowledge of all the facts, that the corporation would lose tax benefits.⁴²

Under this standard, all tax benefits reported on the corporate tax return were assumed valid, but liabilities were reserved for the potential loss of the tax benefits upon audit. All tax positions were combined for purposes of determining a single reserve, and the auditor could consider the possibility that the IRS may not look at each individual tax issue and that issues could be appealed at the IRS level.⁴³

35. *Id.* §§ 204, 302.

36. *Id.* § 302.

37. *Id.* § 302(a)(3).

38. *Id.* § 404.

39. See 15 U.S.C. §§ 78(i), 78(m) (2006); 17 C.F.R. § 210 *et seq.* (2009).

40. FASB INTERPRETATION NO. 5, ACCOUNTING FOR CONTINGENCIES (Fin. Accounting Standards Bd. 1975) (applicable to income taxes, as well as payroll and excise taxes).

41. *Id.*

42. *Id.* ¶ 8, whereby "probable" was defined as "likely to occur" and was thought to mean a seventy-five percent or more chance of occurring.

43. FIN 48, *supra* note 1, ¶ B20.

In 1992, FASB provided additional income tax rules in FAS No. 109, entitled "Accounting for Income Taxes," but it did not speak to the issue of accounting for contingent tax liabilities.⁴⁴ Due to inconsistencies that were developing between the reporting of UTPs (which led to difficulty in comparing financials of corporations), FASB revised the issue of reserves and issued "Accounting for Uncertainty in Income Taxes" in June of 2006.⁴⁵ This interpretation, which is commonly referred to as FIN 48, revised and supplemented FAS No. 109. In a nutshell, under the new FIN 48 standard, UTPs are financially accounted reserves (i.e., reported liabilities) for tax positions taken by a corporation that are *not* "more likely than not" to be supported upon IRS examination or if litigated, supported by the courts.⁴⁶ The intent behind the contingent liability is to disclose to shareholders potential liabilities that could result if a corporation's tax return is later disputed upon audit and assessed greater taxes (hence, liabilities should be reserved for such an event).

The goals of FIN 48 were to quantify the liability for UTPs; provide more consistent standards in recognizing, derecognizing and measuring tax benefits; and to require disclosure of such positions for years open under the applicable statute of limitations.⁴⁷ It is generally applicable to C corporations, non-for-profit entities, pass-through entities such as S corporations, and combined or consolidated financial statements.⁴⁸ Only *material* tax positions are subject to FIN 48 and the reserve or determination of whether or not to reserve are based on estimates, not detailed determinations.⁴⁹ The drafters of FIN 48 rejected the idea that only tax positions characterized by (1) substantial uncertainty (e.g., tax shelters, listed transactions) or (2) nontaxable and nondeductible differences between financial statements and tax returns (referred to as permanent differences) be disclosed.⁵⁰

44. FINANCIAL ACCOUNTING STANDARDS BOARD, FASB INTERPRETATION NO. 109, ACCOUNTING FOR INCOME TAXES (1992) [hereafter FIN 109].

45. FIN 48, *supra* note 1. FIN 48 is effective for years beginning after December 15, 2006 (calendar year 2007 for calendar-year taxpayers). The effective date was delayed for private entities until years beginning after December 15, 2008. FIN 48 is applicable to not-for-profit entities, pass through entities, and entities entitled to a dividend paid deduction (e.g., REIT or RIC).

46. FIN 48, *supra* note 1, ¶ 5.

47. FIN 48, *supra* note 1, at Summary, *How the Conclusions in This Interpretation Relate to the Conceptual Framework*, and ¶ 21.

48. FIN 48, *supra* note 1, at Summary and ¶ 68; FIN 109, *supra* note 44, ¶ App. E, Glossary (see definitions of nonpublic enterprise and public enterprise).

49. FIN 48, *supra* note 1, ¶ 7.

50. FIN 48, *supra* note 1, ¶ B11.

In an effort to improve uniformity and transparency, FIN 48 revised the standard for the reporting and accounting of contingent liabilities UTPs.⁵¹ The new standard was a considerable change from the pre-FIN 48 standards. FIN 48 applied its methodology on an issue-by-issue basis (referred to under FIN 48 as a “unit of account”), instead of an aggregate approach. It also adopted a two-step process in determining whether a contingent tax liability should be reserved. The first step is to determine whether the tax position taken on the financial statement had a “more likely than not” (i.e., more than 50 percent) chance of being sustained upon an IRS examination or in litigation with the IRS.⁵² If the answer is yes, no reserve needs to be recognized under FIN 48. If the tax position failed the “more likely than not” standard, the second step requires that a reserve is recognized equal to the highest amount of tax benefits *greater than* 50 percent likely to be realized upon settlement with the IRS (including interest and possible penalties), not the maximum tax that the IRS could potentially receive.⁵³ Thus, when a corporation takes a tax benefit without posting a reserve on its financial statements, it is affirming that such benefits are more likely than not to be sustained if challenged by the IRS.⁵⁴ Conversely, if a tax position fails the more likely than not standard, a related reserve generally must be posted for the UTP.⁵⁵

Under the first criterion, referred to as the “recognition” threshold, the taxpayer determines the likelihood that the tax position will be upheld upon examination, including related appeals and litigation, “based on the technical merits of the position.”⁵⁶ It assumes the IRS has full knowledge of the law and applicable facts, and does not consider issue trading.⁵⁷ It is also assumed that the IRS will examine the

51. FIN 48, *supra* note 1, ¶ B73.

52. This is referred to as the “recognition” threshold. See FIN 48, *supra* note 1, ¶ 6. The test is based on the tax law in effect as of the GAAP reporting date and assumes that the IRS has full knowledge of all the facts used in taking the tax position on the return. FIN 48, *supra* note 1, ¶ 8. There is a very narrow exception for certain administrative practices and precedents. FIN 48, *supra* note 1, ¶ B35. The recognition threshold also must presume the issue would be challenged upon audit; therefore the probability of an audit cannot be factored into this stage. FIN 48 does not presume that legal tax opinions are necessary to justify the “more likely than not” recognition threshold; such opinions can be external evidence to justify management’s decision. FIN 48, *supra* note 1, ¶ B34.

53. FIN 48, *supra* note 1, ¶¶ 6-8.

54. FIN 48, *supra* note 1, ¶ 6.

55. FIN 48, *supra* note 1, at Summary, *How the Conclusions in This Interpretation Relate to the Conceptual Framework*.

56. FIN 48, *supra* note 1, ¶ 7.

57. FIN 48, *supra* note 1, ¶ 7. There is a possible exception permitting for “administrative practices and precedents.” See FIN 48, *supra* note 1, ¶ A13 (applying the administrative practice exception for de minimis amounts).

position; thus, one does not factor in the probability of an audit. If the tax position satisfies the more likely than not standard, no reserve needs to be posted. Under the second criterion, referred to as the “measurement” threshold, there needs to be an estimated reserve, not a precise determination, as to the greatest amount of the benefit *more than* 50 percent that is likely to be realized upon settlement with the IRS (not what could be realized upon litigation).⁵⁸ Thus, the corporation reports the tax benefit “at the largest amount of benefit that is greater than a 50 percent likelihood of being realized upon ultimate settlement.”⁵⁹

Using the example in FIN 48, if the corporation had a tax position resulting in a benefit of \$100, it would examine the amounts and probabilities of possible outcomes as follows:⁶⁰

| Possible Outcome | Individual Probability of Occurring (%) | Cumulative Probability of Occurring (%) |
|-----------------------------------|---|---|
| \$100 Best settlement | 5% | 5% |
| \$80 Likely negotiated settlement | 25% | 30% |
| \$60 Probable IRS settlement | 25% | 55% ⁶¹ |

Thus, for a tax position of \$100, the corporation would record a reserve of \$60, as it has a cumulative probability of 55 percent, which is a “more than 50%” chance of recognition of a tax benefit of \$60.⁶²

There are two important exceptions to consider in avoiding disclosure of a UTP reserve. The first arises in those situations where the taxpayer “expects to litigate” and assesses that it will be more likely than not to prevail on the merits, even though it has determined that the probability of settling with the IRS is less than 50 percent.⁶³ Thus, there needs to be evidence that the taxpayer intended to litigate,

58. FIN 48, *supra* note 1, ¶ 8.

59. FIN 48, *supra* note 1, ¶ 8.

60. FIN 48, *supra* note 1, ¶ A21.

61. 55 percent represents the percentage that is the largest amount of tax benefit that is greater than 50 percent likely of being realized on settlement.

62. FIN 48, *supra* note 1, ¶ A23.

63. See FIN 48, *supra* note 1, ¶¶ A2-A3 (stating that “the measurement of the tax position is based on management’s best judgment of the amount the taxpayer would ultimately accept in a settlement with taxing authorities.”) (emphasis added). Corporations and auditors state that this provides an expectation for positions that the taxpayer is expected to litigate and there is a more likely than not chance of winning on the merits). See also PRICEWATERHOUSECOOPER, 2010 GUIDE TO ACCOUNTING FOR INCOME TAXES § 16.4.1.5 (2010). As FIN 48, *supra* note 1, ¶ 8, refers to the taxpayer’s ability to settle with the taxing authorities, taxpayers have argued that should the tax position be litigated and there is a greater than 50 percent chance of success, no reserve is needed.

which in the context of many large corporations is not an issue. Second, if the taxpayer has taken a tax position without sufficient support, it can avoid recording a reserve if the IRS has had an administrative practice of not examining or challenging that position.⁶⁴

In preparing financial statements, tax-related workpapers are produced in three types: audit workpapers, tax accrual workpapers,⁶⁵ and reconciliation workpapers.⁶⁶ Audit workpapers are usually prepared by or for the taxpayer's outside auditors, indicating how the audit was conducted (e.g., tests done, information requests, procedures used to document) to attest that the financial statements were performed in accordance with GAAP.⁶⁷ According to the Internal Revenue Manual, taxpayer accrual workpapers "relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. They reflect an estimate of the company's tax liabilities."⁶⁸ Such workpapers may reside with the taxpayer, the taxpayer's auditor, or the taxpayer's third party advisor (e.g., attorney). Lastly, there are tax reconciliation workpapers, which represent the data used in assembling the tax return. These will include schedules that reconcile net income with taxable income using book or financial statements.⁶⁹

In ascertaining the recognition and measurement of the reserve used in the tax accrual workpapers, documentation is necessary. This includes identifying the position; factual information to determine amounts; technical merits of the position, which may involve a legal opinion weighing the pros and cons of the position; the taxing authority's past administrative practices in pursuing such positions; the probability of prevailing on the merits; and factors used in ascertain-

64. See FIN 48, *supra* note 1, ¶¶ A12, B35.

65. These documents are referred to by other names, such as noncurrent tax accounts and tax pool analysis. See *United States v. El Paso Co.*, 682 F.2d 530, 533 (5th Cir. 1982).

66. I.R.M., *supra* note 5, § 4.10.20.

67. According to I.R.M., *supra* note 5, § 4.10.20.2(1), "audit workpapers may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor."

68. I.R.M., *supra* note 5, § 4.10.20.2(2). Such workpapers may show "an audit trail and/or complete explanation of the transactions," whether positions were dependent upon legal advice or information "describing or evaluating the tax strategies." I.R.M., *supra* note 5, § 4.10.20.2(2)(A).

69. Note that large corporate taxpayers provide such reconciliation of book-tax income differences on Schedule M-3.

ing settlement estimates.⁷⁰ In determining the “more likely than not” standard, the taxpayer generally makes an assessment using attorney opinion letters and spreadsheets with relevant data in determining whether the economic benefit of the tax position can be realized, assuming that the tax authorities know all the relevant facts.⁷¹ Taxpayers and their advisors may have to exercise considerable judgment in applying FIN 48’s standards. For example, legal research, legal opinions, risk assessments, alternative IRS approaches, and similar work product may be derived by internal and external CPAs and attorneys. Depending on the level of detail in these tax accrual workpapers, the workpapers could provide the Service with a roadmap in ascertaining the taxpayer’s tax “soft spots.”⁷²

The Service regards the documentation used to identify the reserves under FIN 48 as tax accrual workpapers.⁷³ As the taxpayer normally shares this information with independent outside auditors in order to secure an unqualified audit opinion, the issue arose as to whether such information continued to be privileged. This subject will be discussed in full in Part IV of this article.

If there are changes in subsequent periods, prior UTPs must be reviewed for open tax years to discover if new recognition or de-recognition is called for and whether there is a change in the measurement.⁷⁴ FIN 48 also prescribes disclosure requirements in the corporation’s annual financial statements, with tabular reconciliations for public companies, the effective tax rate utilized, and penalties and interest.⁷⁵ Due to the recent changes in tax disclosures of UTPs, the

70. FIN 48, *supra* note 1, ¶ B34. Included in such documentation would be materials used to ascertain any risk assessment for the tax position, its size and scope, the technical issues involving the tax issue, identification of the position, its description, analysis of authority and conclusion. Large corporations may have an outside attorney’s or accountant’s opinion letter to support its decision. This requirement is consistent with Sarbanes-Oxley §§ 302 and 404’s requirements that written documentation is required for taxpayers to justify its FIN 48 conclusions. See FIN 48, *supra* note 1, ¶ 8.

71. FIN 48, *supra* note 1, at Summary, *How This Interpretation Will Improve Financial Reporting*.

72. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 813 (1984).

73. See I.R.S. LMSB Comm’r Mem., 04-0507-044 (May 10, 2007) and I.R.S. Tech. Adv. Mem. 2007-0012 (Mar. 22, 2007), *Documentation for FIN 48 Compliance Considered Tax Accrual Workpapers*, 2007 TAX NOTES TODAY 112-15 (2007).

74. FIN 48, *supra* note 1, ¶ 10.

75. See FIN 48, *supra* note 1, ¶ 21 (requiring disclosure of positions taken on the tax return but not currently disclosed on the financial statements). Disclosure requires (1) a tabular reconciliation of unrecognized tax benefits at the beginning and end of the year, (2) projection regarding any change in unrecognized tax benefits in the next year, (3) the effective of the tax rate on the unrecognized tax benefits, (4) a list of all open tax years under the affected statute of limitations, and (5) any tax-related penalties and interest recognized on the financial statements. Thus, all uncertain tax positions impact the financial statements.

Service looked to such accounting disclosures in attempting to more efficiently administer the Code.

Prior to the issuance of FIN 48, FASB received 118 comment letters on its exposure draft and subsequently held public discussions.⁷⁶ Some commentators objected to the tabular reconciliation that FIN 48 required, suggesting that it would provide a “roadmap” for the taxing authorities.⁷⁷ FASB rejected these objections for several reasons: it did not equate the taxing authorities with a counterpart in litigation, disclosure at the aggregate level did not provide information about individual UTP, and the IRS had recently adopted a detailed reconciliation requirement noting differences between amounts reported for tax versus financial purposes.⁷⁸

C. *Use of FIN 48's Standard by Other Authorities*

The FIN 48 “more likely than not” standard has been used by other regulators as well. Under the U.S. Department of Treasury Circular 230 regulations, the “more likely than not” standard must be satisfied by accountants, attorneys, enrolled agents, and enrolled actuaries who practice before the IRS in order for taxpayers to rely on their written tax advice for penalty protection.⁷⁹

The Public Company Accounting Oversight Board (“PCAOB”) issued Rule 3522 in June 2006, which prohibits a registered public accounting firm from providing services to an audit client that relies on the marketing, planning, or rendering an opinion on an “aggressive tax position.”⁸⁰ In defining an “aggressive tax position,” Rule 3522 states that it is a position “that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.”⁸¹ Failure to adhere to the PCAOB’s Rule could result in the compromise of the accounting firm’s independence.

The 2007 Small Business Tax Act altered the standard under I.R.C. § 6694(a), which is a penalty provision for tax preparers who do not meet the “realistic possibility of being sustained on the merits” or “reasonable belief that the position is more likely than not to be sus-

76. FIN 48, *supra* note 1, ¶ B3.

77. FIN 48, *supra* note 1, ¶ B64.

78. FIN 48, *supra* note 1, ¶ B64.

79. Dep’t of Treasury Circular No. 230, 31 C.F.R. § 10.35 (2010).

80. PROFESSIONAL STANDARDS § 3, Rule 3522 (Pub. Co. Acct. Oversight Board 2006), *available at* http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx.

81. *Id.*

tained” standards.⁸² Thus, tax positions that are not adequately disclosed must meet such standard to avoid penalty.

III. REPORTING AND DISCLOSURE REQUIREMENTS UNDER THE CODE BEGINNING IN 2010

A. IRS's Operating Divisions

The Service administers the Code through four main operating divisions, one of which is known as the Large Business and International Division (“LB&I”).⁸³ Heather Maloy is the commissioner of LB&I and was recently nominated by Tax Notes as the 2010 Person of the Year.⁸⁴ The renaming and reconfiguration of this unit came about when the Service realized that international tax issues were not being adequately served in a single unit within the IRS.⁸⁵

Initially in October 2009, IRS Commissioner Douglas Shulman piqued the public's interest during the National Association of Corporate Directors Governance conference, indicating that corporate risk and transparency could best be served through the reporting of UTPs, making the administration of the tax system more efficient.⁸⁶ The notion was that if the accountants needed UTPs to be ascertained and disclosed for generally acceptable accounting standards, why shouldn't the IRS ask for a list of these positions and their amounts to better ascertain whom to audit, what issues to audit, and the magnitude of the problem? Given that the accountants already had these positions and their reserves, not much additional work would be required of taxpayers. It was in Maloy's first six months on the job that the IRS issued Announcement 2010-9, proposing the development of a new tax return schedule for large businesses under the jurisdiction of LB&I to annually disclose UTPs to the Service.⁸⁷

At a George Washington University Internal Tax Conference (co-hosted by the IRS), Commissioner Shulman again reiterated his goal of reaching out to corporate boards in order “to promote good corpo-

82. Pub. L. No. 110-28, § 8246, 121 Stat. 190 (2007) (amending I.R.C. § 6694(a)).

83. The LB&I division was formerly the Large and Midsize Business division, renamed after the passage of the Foreign Account Tax Compliance Act (FATCA) that adopted new reporting and withholding requirements.

84. Tax Analyst, *The 2010 Person of the Year*, 130 TAX NOTES TODAY 7 (2011).

85. See I.R.S., 2009 ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT) REPORT OF RECOMMENDATIONS (June 9, 2010), available at http://www.irs.gov/pub/irs-tege/tege_act_rpt9.pdf.

86. Douglas Shulman, IRS Comm'r, Prepared Remarks to the National Association of Corporate Directors Governance Conference in Washington D.C. (Oct. 19, 2009), available at <http://www.irs.gov/newsroom/article/0,,id=214451,00.html>.

87. 2010-9 I.R.B. 408.

rate governance on tax issues and to engage the corporate community in discussing the appropriate role for the board of directors in addressing tax risk oversight.”⁸⁸

B. *Returns and Penalties for Noncompliance*

In order to better understand the Service’s initial proposal for UTPs, it is helpful to first understand the level of tax disclosure required, the penalties for understating taxes, and the Service’s policy of restraint regarding the required disclosure of information that existed before 2010. The Service has two powerful tools in its tax arsenal: returns and related schedules, and the power to summons books and records.

The Internal Revenue Code requires corporations subject to tax under Subtitle A to make a return with respect to their income.⁸⁹ Persons or entities required to make a return or statement to the IRS must conform to the forms and regulations prescribed by the Secretary, including information required by such forms or regulations.⁹⁰ The IRS uses tax returns and associated schedules so that taxpayers recognize questionable and abusive tax schedules. The IRS’s procedural regulations rely on taxpayers to self-assess the amount of tax due and to file returns based on facts that can determine and assess the taxes due.⁹¹

Typically corporations are required to make and to file federal corporate tax returns using Form 1120, U.S. Corporation Income Tax Return.⁹² The return must be “sufficient” in order to begin the running of the statute of limitations and to avoid penalties for failure to file a return. As such, the return must use the proper form, provide information necessary for the IRS to compute the tax, and be signed under penalties of perjury. Using the proper form is sufficient if it contains information “on which the substantial correctness of the self-assessment may be judged.”⁹³ Corporations with reported total assets of \$10 million or more on Schedule L of Form 1120 are also required to

88. See DELOITTE, PROPOSED U.S. TAX REPORTING REQUIREMENTS FOR UNCERTAIN TAX POSITIONS: THE LATEST STEP IN A JOURNEY TOWARD ENHANCED TAX GOVERNANCE AND TRANSPARENCY 5 (2010), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_UTP_042010.pdf.

89. I.R.C. § 6012 (West, Westlaw through P.L. 111-383).

90. I.R.C. § 6011 (West, Westlaw through P.L. 111-383).

91. Summary of General Tax Procedure, 26 C.F.R. § 601.103 (2010).

92. Alternate forms and schedules are filed by life insurance companies (Form 1120L); by property and casualty insurance companies (Form 1120PC); by foreign corporations (Form 1120F); by personal holding companies (Schedule PH with Form 1120); and by mutual insurance companies (Form 1120M).

93. I.R.C. § 6702(a)(1)(A) (2006).

complete and file Schedule M-3, which reconciles book-tax income differences.⁹⁴ While FIN 48 requires certain reserves for accounting purposes, these reserves have not been generally disclosed on the taxpayer's tax return.

Under the Code, the only disclosures required are the disclosure of reportable transactions and the disclosure of positions inconsistent with Treasury regulations.⁹⁵ Prior to 2010, existing corporate tax returns did not require identification and explanation of UTPs that were uncovered during the process of complying with generally accepted financial accounting principles. Thus, the IRS had to identify and assess for itself the UTPs that could be associated with a given corporate tax return. However, the Service cannot through form or regulation require disclosure of information that is otherwise protected by privilege – an issue that will be discussed in Part IV of this article.

In order to have complete and accurate disclosure on a taxpayer's return, the Code uses sanctions and civil penalties for understatement of taxes, which foster voluntary disclosure.⁹⁶ In the context of UTPs, two of these penalties become relevant: (1) negligence or disregard of rules and regulations, and (2) substantial understatement of tax.⁹⁷ Negligence exists if the taxpayer fails to take reasonable steps to comply with the tax law. In the context of tax return reporting positions, negligence exists if no reasonable basis exists for the position (which is interpreted as a standard higher than "not frivolous" or "merely arguable").⁹⁸ This generally means that the taxpayer must have a 15 percent to 20 percent chance of success on the merits if the position were litigated.⁹⁹ For purposes of negligence or disregard of rules and regulations, the regulations provide that there is no penalty if the position is disclosed, or in the case of a position that is contrary to the regulations, represents a good faith challenge to the validity of the regulations. Only with respect to the penalty relating to disregard of rules

94. SCHEDULE M-3 FOR LARGE AND MID-SIZE BUSINESSES (2010), IRS.GOV, <http://www.irs.gov/businesses/corporations/article/0,,id=119992,00.html>.

95. I.R.C. § 6707A (West, Westlaw through P.L. 111-383); Treas. Reg. § 1.6662-3(c)(1) (as amended in 2003).

96. I.R.C. § 6662 (West, Westlaw through P.L. 111-383), triggering a sanction of 20 percent for one of five different violations including: negligence and disregard of rules and regulations; understatement of income; valuation overstatement; overstatement of pension liabilities; and estate or gift tax valuation understatement.

97. There is no accuracy-related penalty tax if the taxpayer shows reasonable cause for the underpayment and acted in good faith. See I.R.C. § 6664(c) (2006).

98. Treas. Reg. § 1.6662-3(b)(3) (as amended in 2003).

99. See Burgess W. Raby & William L. Raby, *'Reasonable Basis' v. Other Tax Opinion Standards*, 73 TAX NOTES 1209 (1996).

and regulations (and not for negligence), is there no penalty if the taxpayer disclosed the position and had a reasonable basis.

The second penalty type – an accuracy-related penalty for substantial understatement of tax – was established to prevent taxpayers from taking aggressive tax positions in the face of the IRS's low audit rate. Thus, this penalty is imposed if the position is not supported by significant authority and is not disclosed.¹⁰⁰ Accordingly, the amount of the understated tax liability will be reduced either because there exists substantial authority or because it was disclosed. The substantial authority criterion generally means that the taxpayer has a one in three chance of success on the merits of the position.¹⁰¹ However, if the position is attributable to a tax shelter, the understatement is reduced only if the taxpayer had a more likely than not (i.e., 51 percent) chance of success.¹⁰² Disclosure does not affect the amount of understatement in the context of tax shelters. There are comparable penalties for tax preparers who do not disclose questionable positions on the return.¹⁰³

Thus, under the current statutory requirements, there is no disclosure required to avoid a penalty (except in the context of tax shelters) if the taxpayer reasonably believes that the position taken on the return is more likely to be sustained than not, regardless of whether the position ultimately prevails.¹⁰⁴ Therefore, the Service has generally used reporting to identify positions that are of extreme importance to it, including reportable transactions, tax shelters, and positions for which the taxpayer does not have substantial authority. The Service's proposed and final positions now compel disclosure of UTPs irrespective of whether a penalty could have been assessed against the taxpayer's position. Still, concern as to whether the IRS has the authority to compel such disclosure remains.¹⁰⁵

100. There is a similar 20 percent accuracy-related penalty with respect to any understatement resulting from an adequately disclosed *listed* transaction or reportable *avoidance* transaction (i.e., reportable transaction that involves a sizable tax avoidance purpose). See I.R.C. § 6662A (West, Westlaw through P.L. 111-383). Such penalty increases to 30 percent for an understatement resulting from an *undisclosed* listed transaction or an *undisclosed* reportable avoidance transaction. *Id.*

101. See Treas. Reg. § 1.6694-2(b)(1) (as amended in 2009), which uses a one in three, or greater, likelihood of being sustained on the merits as the standard for "realistic possibility" used in determining signature of taxpayer on the return.

102. I.R.C. § 6662(d)(2)(C)(i)(II) (West, Westlaw through P.L. 111-383).

103. I.R.C. § 6694 (West, Westlaw through P.L. 111-383).

104. See Richard M. Lipton, *Reporting "Uncertain Tax Positions" Under Ann. 2010-9: Transparency or Overkill?*, 112 J. TAX'N 260 (2010).

105. *Id.*

The American Jobs Creation Act modified the accuracy-related penalties for substantial understatement of income tax for corporations so that it applied only if the understatement exceeded (1) the lesser of the amount required on the return, or (2) \$10 million.¹⁰⁶ In addition, a new 20 percent penalty applies for understatements resulting from reportable transactions.¹⁰⁷ In those contexts, the reasonable cause exception has been altered so that all relevant facts must be disclosed, there is substantial authority for the position, and the taxpayer “reasonably believes” the position was correct.¹⁰⁸ Last year, Congress increased the accuracy penalty to 40 percent if the underpayment is due to a disallowance of claimed tax benefits by reason of a transaction that lacked economic substance.¹⁰⁹ Similar penalties apply to tax preparers for the understatement of taxes.¹¹⁰

The Small Business and Work Opportunity Act of 2007 attempted to raise the standard to avoid penalties for nondisclosure of certain tax positions by tax return preparers from the realistic possibility of success to a more likely than not standard.¹¹¹ This standard was later changed by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which aligned the tax return preparer penalties with that of the taxpayer penalties and required disclosure if the position was reasonable but not supported by substantial authority.¹¹² Thus, to avoid penalties, taxpayers and tax return preparers must disclose tax positions on a tax return (other than tax shelters and reportable transactions) for which there is a reasonable basis for the position, but not substantial authority. Because the IRS disclosure standard of “reasonableness” for tax returns and the FASB disclosure standard of “more likely than not” for financial statements are not consistent with one another, it appears that the Service’s new rules are attempting to

106. I.R.C. § 6662(d)(1)(B) (West, Westlaw through P.L. 111-383).

107. I.R.C. § 6662A (West, Westlaw through P.L. 111-383) imposes a 20 percent penalty on the amount of any reportable transaction understatement. The penalty increases to 30 percent if such reportable transaction was not disclosed under I.R.C. § 6664(d)(2)(A). See I.R.C. § 6707A(c) for the meanings of “reportable transactions” and “listed transactions.” Form 8866, Reportable Transaction Disclosure Statement, is used to identify the type of reportable transaction, to state whether it was purchased through a corporation or pass-through entity, and set forth the name and address of any person that was paid in connection with the promotion, solicitation or recommendation of the reportable transaction or provided tax advice with respect to such transaction.

108. I.R.C. § 6664(d)(2)(A)–(C) (West, Westlaw through P.L. 111-383).

109. Pub. L. No. 111-152, § 1409(b)(2), 124 Stat. 1029 (2010) (adding I.R.C. § 6662(i)).

110. I.R.C. § 6694 (2006).

111. Effective for tax returns and claims for refunds prepared after May 25, 2007.

112. Pub. L. No. 110-343, § 506, 122 Stat. 3765 (2008).

impose the Small Business and Work Opportunity Act standards which were rejected by Congress in 2008.¹¹³

C. IRS Summons' Power

In addition to its powers to impose returns and schedules, the IRS also has broad powers of summons under I.R.C. § 7602, subject to two requirements: (1) the IRS's broad powers extend to determining the correctness of the return or assessing the tax liability of the taxpayer, which if met, provides it with the ability "to examine any books, papers, records, or other data which may be relevant or material to such inquiry," as well as summoning the taxpayer, its employees, or any person having "possession, custody, or care of books of account containing entries" relating to the business of the taxpayer; and (2) if such powers apply, whether applicable privileges apply to block such disclosure.¹¹⁴ With regard to whether tax accrual workpapers satisfy the first "relevance" requirement, most courts have supported the standard that if such documents "might have thrown light upon" the correctives of the return, there is support for the IRS's summons.¹¹⁵ In the seminal case of *United States v. Powell*,¹¹⁶ the Court reaffirmed the notion that the IRS did not need to show probable cause in order to obtain judicial enforcement of its summons.¹¹⁷ Instead, the Service need only show "that the investigation will be conducted *pursuant to a legitimate purpose*, that the inquiry may be relevant to that purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed."¹¹⁸ Thus, the Service need only produce a showing of potential relevance without necessitating its ability to admit such evidence at trial.¹¹⁹ In *United States v. Arthur Young & Co.*, the

113. *Id.*

114. I.R.C. § 7602(a)(1)-(2) (2006). While the Service has broad powers to examine books, records, and witnesses, there are concerns that an examination that is too broad in scope may result in an unreasonable search and seizure or violate the privilege. *See, e.g., United States v. Wyatt*, 637 F.2d 273, 300 (5th Cir. 1981); *United States v. Turner*, 480 F.2d 272, 279 (7th Cir. 1973); *United States v. Ryan*, 455 F.2d 728, 733 (9th Cir. 1972); *United States v. Egenberg*, 443 F.2d 512, 515-16 (3d Cir. 1971); *Foster v. United States*, 265 F.2d 183, 186-87 (2d Cir. 1959), *cert. denied*, 360 U.S. 912 (1959); *United States v. Arthur Young & Co.*, 465 U.S. 805, 815 (1984).

115. *See, e.g., Wyatt*, 637 F.2d at 300; *Turner*, 480 F.2d at 279; *Ryan*, 455 F.2d at 733; *Egenberg*, 443 F.2d at 515-16; *Foster*, 265 F.2d at 187.

116. *United States v. Powell*, 379 U.S. 48 (1964).

117. *Id.* at 57-58.

118. *Id.* (emphasis added).

119. *Id.* This relevance standard described by the Second Circuit as a standard as to whether the documents in question "might have thrown light upon the correctness of the return" was accepted by most lower courts. *See, e.g., Wyatt*, 637 F.2d at 300; *Turner*, 480 F.2d at 279; *Ryan*, 455 F.2d at 733; *Egenberg*, 443 F.2d at 515-516; *Foster*, 265 F.2d at 187.

Supreme Court further concluded that the Service's powers under I.R.C. § 7602 extended to certain documents not actually used in the preparation of the federal tax return, such as tax accrual workpapers, as such workpapers were "a logical predicate to the question whether such workpapers should be protected by some form of work-product immunity."¹²⁰ This decision was pre-FIN 48 when disclosure was not addressed issue-by-issue (instead aggregate), and was subject to a different standard for review.

It is the Service's position that it has the authority to request and to examine tax accrual workpapers under its summons powers.¹²¹ As noted by Justice Garwood in *United States v. El Paso Co.*, the congressional intent in drafting a broad summons power was "to promote effective and efficient tax determination and collection," not to facilitate its examination process.¹²² Immediately after the *United States v. Arthur Young & Co.* decision, the Service self-imposed a policy of restraint, whereby it would not generally request the taxpayer's tax accrual workpapers except in "unusual circumstances," due to the adverse consequences that would result if disclosure was routinely permitted.¹²³ In 2002, the IRS expanded its policy of restraint in two ways: (1) if the taxpayer disclosed two or more "listed transactions," it would routinely request tax accrual workpapers but only as they related to the listed transactions for the year under exam and (2) if the taxpayer failed to disclose any "listed transactions" or claimed tax benefits due to multiple "listed transactions," the Service had discretion to issue an information document request ("IDR") for *all* items acknowledged in the workpapers.¹²⁴ Failure to comply with this re-

120. *United States v. Arthur Young & Co.*, 465 U.S. 805, 815 (1984).

121. I.R.M., *supra* note 5, § 4.10.20.4.1.

122. *See United States v. El Paso Co.*, 682 F.2d 530, 547 (5th Cir. 1982) (Garwood, J., dissenting).

123. I.R.S. Announcement 84-46, 1984-18 I.R.B. 18 (Apr. 30, 1984); I.R.M., *supra* note 5, § 4.10.20.4. Unusual circumstances exist if the agent needs additional facts with respect to an issue; the agent "has sought from the taxpayer all facts known to the taxpayer relating to the identified issue(s)"; and the agent "has sought from the taxpayer's accountant supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue(s)." *See* I.R.M., *supra* note 5, § 34.12.3.13.1. If unusual circumstances exist, the tax agent is still limited to those workpapers "material and relevant" to the exam.

124. *See* I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72 (July 8, 2002); I.R.M., *supra* note 5, § 4.10.20, whereby tax accrual workpapers are those that the taxpayer, its accountant, or auditor prepare to establish under FIN 48 any tax reserves for current, deferred, and contingent tax liabilities, as well as footnotes relating to such reserves on the financial statements. A "listed transaction" is one that the Service has identified as a tax avoidance transaction. *See* 26 C.F.R. § 1.6011-4(b)(2) (2009). For the list of listed transactions, *see* I.R.S., LISTED TRANSACTIONS – LB&I TIER I ISSUES, available at <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html> (last visited Mar. 27, 2011). *See also* John K. Cook, Jr., *IRS Tax Accrual Workpapers Requests: An (Un)limited Expansion?*, 76 PRAC. TAX STRATEGIES 260 (2006).

quest would result in a summons. The Service exercises its new policy of restraint in exchange for disclosure by the taxpayer of the listed transaction – meaning nondisclosure results in the penalty of subjecting the tax accrual workpapers to disclosure.

With the advent of FIN 48 in 2006, there was concern as to whether the Service would request tax accrual workpapers, how it would use the disclosures, and what impact FIN 48 would have on its policy of restraint. In May of 2007, the Commissioner of the then Large and Mid-Size Business Division issued a memorandum, which analyzed the affect of FIN 48 on the Service's policy of restraint in the content of tax accrual workpapers.¹²⁵ The memorandum affirmed that the documentation used in FIN 48 analysis was tax accrual workpapers for purposes of the Service's policy of restraint, but that the Division was reconsidering its opinion to "ensure that it is still appropriate in today's environment."¹²⁶ In addition, there would be a "TAW Cadre" formed and a publication written, entitled "LMSB Field Examiner's Guide, FIN 48 Implications," to aid examiners in the context of requests for tax accrual workpapers in response to an Information Document Request.¹²⁷

IV. THE SCOPE OF PRIVILEGES

In the face of the IRS's vast summons powers, taxpayers and third parties may decline to produce IRS-summoned tax accrual workpapers by claiming protection under the Fifth Amendment privilege against self-incrimination, the attorney-client privilege, the Federally Authorized Tax Practitioner ("FATP") codified in I.R.C. § 7525, or the work product immunity embodied in Federal Rule of Civil Procedure 26(b)(3).¹²⁸ Each privilege has different functions and arises under different laws/case law. The Fifth Amendment provides that "no person . . . shall be compelled in any criminal case to be a witness against himself" but applies to any civil or criminal proceeding, both administrative and judicial.¹²⁹ However, the privilege only extends to individuals, as opposed to corporations, partnerships, or other entities.¹³⁰

125. See I.R.S. Office of Chief Counsel Mem. AM 2007-0012 (Mar. 22, 2007).

126. *Id.*

127. *Id.*

128. The American Bar Association had an Attorney-Client Privilege Task Force that issued a report in 2006, recommending protection of the attorney-client and work product privileges in the audit situation. See *ABA Task Force Examines Attorney-Client Privilege and Audit Disclosures*, 2006 TAX NOTES TODAY 214-84 (2006).

129. *Maness v. Meyers*, 419 U.S. 449 (1975).

130. See *Curcio v. United States*, 354 U.S. 118, 122 (1957).

A. Attorney-Client Privilege

The attorney-client privilege arises out of common law doctrine and is used to protect confidential communications between client and attorney relating to legal advice.¹³¹ The public policy supporting this privilege is to enhance frank and complete dialogue between clients and their attorneys regarding legal advice. When the communication involves dual purposes (e.g., factual or accounting information versus legal communication), one part of the communications may be protected while the other may not.¹³² The privilege belongs to the client, not the attorney; therefore, the client can waive the privilege. Moreover, the privilege does not extend to information given to the attorney used in tax return preparation, as that communication is considered an accounting service.¹³³ The privilege also does not extend to communications pertaining to business advice, which includes the information contained in financial statements.¹³⁴ The presence of in-house attorneys in making business decisions also does not give rise to the privilege.¹³⁵

In the context of tax accrual workpapers, the issue arose as to whether FIN 48 workpapers prepared by attorneys could qualify for the attorney-client privilege. The answer may depend upon whether the workpapers looked more like accounting workpapers than legal workpapers, the latter of which would contain legal opinions, research, mental impressions and legal advice between the attorney and the taxpayer. It is the IRS's position that tax accrual workpapers do not constitute legal or tax advice, as they are prepared solely to pro-

131. See generally *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002). In *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981), the Supreme Court explained that the purpose of the attorney-client privilege is "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administrative of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer being fully informed by the client."

132. See *United States v. Frederick*, 182 F.3d 496, 500-01 (7th Cir. 1999), *cert. denied*, 528 U.S. 1154 (2000).

133. See *United States v. Lawless*, 709 F.2d 485 (7th Cir. 1983); *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981); *Bernardo v. Comm'r*, 104 T.C. 677 (1995). But see *Colton v. United States*, 306 F.2d 633 (2d Cir. 1962) (extending the privilege to information that was provided in securing tax advice and tax return preparation); Nancy I. Kenerdine, *The Internal Revenue Service Summons to Produce Documents: Powers, Procedures & Taxpayer Defenses*, 64 MINN. L. REV. 73, 100-01 (1979) (noting that the line between accounting work and legal work may be difficult to draw).

134. See *United States v. Horvath*, 731 F.2d 557 (8th Cir. 1984).

135. See *United States v. Adlman*, 68 F.3d 1495 (2d Cir. 1995); *United States v. Chevron Corp.*, No. C-94-1885 SBA, 1996 U.S. Dist. LEXIS 4154, at *1 (N.D. Cal. Mar. 13, 1996); *United States v. Ackert*, 84 A.F.T.R. 2d 99-7527 (D. Conn. 1999).

duce the reserves required under FIN 48.¹³⁶ If the tax accrual workpapers are regarded as “legal” by the courts and therefore privileged, a subsequent issue arose as to whether the privilege was waived when the taxpayer disclosed such documents to the outside and independent auditors. As will be discussed later, tax accrual workpapers produced internally by the client generally have greater protection under this privilege than those disclosed to the outside accountants, as the latter have no expectation of confidentiality.

B. *Tax Codified Practitioner-Client Privilege*

The Code codifies the common law protection of confidentiality between an attorney and client in the context of tax advice communications between a FATP (which could include an attorney, an accountant, an enrolled agent, and an enrolled retirement plan agent)¹³⁷ and client provided the communication would have been privileged under the similar parameters used under the attorney-client privilege.¹³⁸ The privilege extends only to communications, and not to work product, and in the case of non-attorneys, the privilege does not extend when the practitioners are doing other than an attorney’s work.¹³⁹ Thus, the privilege does not protect communications for the preparation of tax returns, nor does it protect accounting advice.¹⁴⁰ Similarly, as noted above, tax accrual workpapers produced internally by the client generally have greater protection under this privilege than those disclosed to the outside accountants, because the latter have no expectation of confidentiality.

C. *Work Product Immunity*

The work product immunity has been the most protective in resisting IRS summons for tax accrual workpapers in the context of disclosure to outside auditors as this immunity is not waivable, but instead requires a showing of “substantial need” by the opposing side to overcome the privilege.¹⁴¹ Unlike the attorney-client privilege,

136. See *United States v. El Paso Co.*, 682 F.2d 530, 539 (5th Cir. 1982).

137. See *Treas. Circ. No. 230*, § 10.2(a)(5) (2008) (entitled “Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraiser Before the Internal Revenue Service”). The term “FATP” includes attorneys, CPAs, enrolled agents, enrolled actuaries, and enrolled retirement plan agents.

138. I.R.C. § 7525 (2006).

139. See *United States v. Frederick*, 182 F.3d 496, 502 (7th Cir. 1999); *United States v. KPMG LLP*, 237 F. Supp. 2d 35 (D.D.C. 2003).

140. See *Frederick*, 182 F.3d at 500.

141. The work product doctrine embodied in Federal Rule of Civil Procedure 26(b)(3) provides as follows:

which protects confidential legal communications between client and attorney, the work product protection protects the litigation process by keeping an attorney's litigation preparation out of discovery.¹⁴² The latter may involve questions of law and fact. Voluntary disclosure of the work product should not automatically waive the immunity as it may not necessarily undermine the adversarial process.¹⁴³

The attorney work product doctrine was first established by the Supreme Court in *Hickman v. Taylor*,¹⁴⁴ and was later partially embodied in Rule 26(b)(3) of the Federal Rules of Civil Procedure. In *Hickman*, the plaintiff's attorney requested notes from the defendant's attorney regarding interviews of prospective witnesses taken to prepare for trial.¹⁴⁵ The Court rejected the attorney's discovery attempt without a showing of need or hardship.¹⁴⁶ Thus, the Court created an immunity against discovery for "documents and tangible things that are prepared in anticipation of litigation or for trial" by or

TRIAL PREPARATION: MATERIALS. Subject to the provisions of subdivision (b)(4) of this rule, a party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the parties seeking discovery have substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

FED. R. CIV. P. 26(b)(3).

142. See Henry J. Lischer, *Work Product Immunity for Attorney-Created Tax Accrual Workpapers?: The Aftermath of United States v. Textron*, 10 FLA. TAX REV. 503, 532 (2011) (quoting I.R.S. News Release IR-81-49 (May 5, 1981), which states that "[p]roper preparation of a client's case demands that [the lawyer] assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference.").

143. See *United States v. M.I.T.*, 129 F.3d 681 (1st Cir. 1997); *United States v. Deloitte LLP*, 610 F.3d 129, 140 (D.C. Cir. 2010).

144. *Hickman v. Taylor*, 329 U.S. 495 (1947). The public policy behind such immunity involved several factors: attorneys need a certain amount of privacy in preparing a case; the unfavorable impact that permitted discovery would have on the legal profession; promotion of an orderly legal system; compelling an attorney to testify as witnesses at trial would result in the attorney being less an officer of the court and more like a witness. According to the Court, providing opposing counsel with work product would undermine the legal system:

[M]uch of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate, would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served.

Id. at 511.

145. *Id.* at 498-500.

146. *Id.* at 510-12.

for another party or that party's representative (which includes an attorney or other representative such as a CPA).¹⁴⁷ Such documents include the attorney's legal analysis, research, legal theories and mental impressions.¹⁴⁸ However, the protection is not absolute, as a showing of necessity may result in the disclosure of the materials (e.g., production of facts are essential to the other side's case) or a showing of an "inability to obtain the substantial equivalent of the information from other sources without undue hardship."¹⁴⁹ A highly litigated discovery issue involves whether the documents in question were prepared "in anticipation of litigation or for trial."¹⁵⁰

The issue then arises as to whether tax accrual workpapers used to ascertain UTPs are protected under one or more privileges. Such workpapers could include: (1) a listing of individual UTPs deemed to be material and the dollar amount reserved if the taxpayer did not prevail in litigation; (2) the probability of prevailing in litigation for each reported UTP; (3) memorandums of in-house attorneys or opinions from outside counsel indicating their opinions as to prevailing on the merits; and (4) memorandums of in-house accountants or notes from outside accountants used in making a determination that involved UTPs. Taxpayers obviously argue that disclosure of these workpapers is protected under one of the above privileges; otherwise, the IRS may have a clear "roadmap" to identify issues for audit which in turn would provide it with an unfair advantage in litigating or settling the case.

If the taxpayer/client is a corporation, the use of the Fifth Amendment privilege is unavailable. With respect to the attorney/client privilege, neither the common law nor I.R.C. § 7525 extends the privilege to tax return preparation, and if the information is shared with outside

147. FED. R. CIV. P. 26(b)(3). *But see Hickman*, 329 U.S. at 511, which would have used the work product immunity to protect from discovery other non-tangible information such as the attorney's mental impressions, conclusions, opinions or legal theories.

148. *Hickman*, 329 U.S. at 510-12.

149. *See In re Sealed Case*, 124 F.3d 230, 235-36 (D.C. Cir. 1997).

150. In footnote nine of the *Hickman* decision, the Court made mention of an English rule that extended the privilege to all documents prepared by or for counsel with a view to litigation. Documents were created for the purpose – but not necessarily the sole purpose – of actual or expected litigation. This includes documents or "reports by a company's servant, if made in the ordinary course of routine, are not privileged, even though it is desirable that the solicitor should have them and they are subsequently sent to him." *See Hickman*, 329 U.S. at 510 n.9. *See also* *United States v. Adlman*, 134 F.3d 1194, 1195 (2d Cir. 1998) (protecting a study prepared by an accountant/attorney "because of" anticipated litigation); *United States v. Davis*, 636 F.2d 1028, 1043 (5th Cir. 1981) (not protecting workpapers used in tax return preparation as they were not created for actual litigation regarding such returns); *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006), *nonacq.*, AOD 2007-40 (requiring the attorney to show that workpapers were prepared in anticipation of litigation and not within the ordinary course of business).

auditors, there is no expectation of confidentiality, which is required under the privilege. Thus, many cases hinge on the work product immunity to protect tax accrual workpapers, regardless of whether they are produced internally by the taxpayer or prepared by outside counsel and accountants.

D. *United States v. Arthur Young & Co.*

In the case of *United States v. Arthur Young & Co.*, the Supreme Court answered the question as to whether an independent certified public accountant's tax accrual workpapers (including those used in evaluating the corporate taxpayer's reserve for contingent tax liabilities) were protected under the work product immunity.¹⁵¹ During a routine audit of the corporation's tax return, the Service used its authority under I.R.C. § 7602 to summon Arthur Young & Co., the independent auditor to the corporate client, Amerada Hess Corp., to produce its tax accrual workpapers.¹⁵² Amerada Hess instructed the independent auditor not to comply with the summons, thus prompting the IRS to pursue an enforcement action. The district court ordered that the summons be enforced.¹⁵³ The Second Circuit affirmed in part and reversed in part, holding that the tax accrual workpapers fell within the work product immunity.¹⁵⁴ While such papers were relevant to the Service's audit, the Second Circuit held that the Service had not rebutted the work product immunity for the papers of independent auditors, nor had it sought fraud on the part of the taxpayer.¹⁵⁵ It is highly relevant that the case involved the production of tax accrual workpapers by an outside auditor or CPA firm, as no such privilege could be invoked if the workpapers were produced internally by the taxpayer's auditors.

The Supreme Court reversed.¹⁵⁶ The Court acknowledged that the tax accrual workpapers tracked the auditor's "process of examination and analysis" used to ascertaining the client's tax treatments, including UTPs, including item-by-item review of the client's potential tax exposure.¹⁵⁷ According to the Court, "the tax accrual workpapers pinpoint the 'soft spots' on a corporation's tax return by highlighting

151. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

152. *Id.* at 808-09.

153. *United States v. Arthur Young & Co.*, 496 F. Supp. 1152, 1160 (S.D.N.Y. 1980), *rev'd*, 677 F.2d 211 (2d Cir. 1982), *rev'd*, 465 U.S. 805 (1984).

154. *United States v. Arthur Young & Co.*, 677 F.2d 211, 221 (2d Cir. 1982), *rev'd*, 465 U.S. 805 (1984).

155. *Id.*

156. *United States v. Arthur Young & Co.*, 465 U.S. 805, 820 (1984).

157. *Id.* at 812.

those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes.”¹⁵⁸ However, the Service’s summons power under § 7602 was sufficiently broad to favor disclosure of all information “relevant to a legitimate IRS inquiry.”¹⁵⁹ And while § 7602 was “subject to the traditional privileges and limitations,” there was no confidential *accountant*-client privilege under federal law and thus the tax accrual workpapers prepared by an outside accounting firm were subject to disclosure.¹⁶⁰

The Court contrasted the relationship between an attorney and client and the relationship between an outside accountant and client as the accountant in the latter relationship had a responsibility to the public and the corporation’s creditors and shareholders to maintain its independence from the client and to disclose its interpretations of the client’s financial statements to assure the integrity of the financial securities markets.¹⁶¹ While there was the potential for management to fail to disclose potential problems, thereby compromising the audit, the auditor would simply issue a qualified, adverse, or disclaimed opinion.¹⁶² Thus, the decision did not address whether an attorney’s thought processes used to determine FIN 48 reserves would be protected work product.

Following the decision in *United States v. Arthur Young & Co.*, the Service issued Announcement 84-46, in which it affirmed that its policy of restraint – that it would not routinely request tax accrual workpapers in all audits.¹⁶³ The Announcement affirmed that the Service would show administrative sensitivity to the accounting profession and thus not exercise its summons powers except in unusual cases. In the wake of Enron and other corporate scandals, the IRS modified its policy of restraint and began requesting tax accrual workpapers when the taxpayer had engaged in certain listed transactions “that [are] the same as or substantially similar to ones of the types of transactions that the [IRS] has determined to be a tax avoidance transaction.”¹⁶⁴

158. *Id.* at 813.

159. *Id.* at 817.

160. *Id.*

161. *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984).

162. *Id.* at 818.

163. I.R.S. Announcement 84-46, 1984-18 I.R.B. 18 (Apr. 30, 1984). See I.R.M., *supra* note 5, § 4.10.20.3.1(2) (requesting tax accrual papers in “unusual circumstances” or if the taxpayer was engaged in a listed transaction). The Service realized that without such a policy of restraint, taxpayers would be reticent in sharing information with outside auditors.

164. See 26 C.F.R. § 1.6011-4(b)(2) (2009). For a current list of such transaction types, refer to I.R.S., RECOGNIZED ABUSIVE AND LISTED TRANSACTIONS – LB&I TIER I ISSUES, *available at*

E. *Split Among the Circuits*

Early on, companies struggled to determine what documents (specifically tax accrual workpapers) were protected by the work product immunity, especially those documents initially prepared for non-litigation purposes.¹⁶⁵ Under the criteria that the documents protected be prepared “in anticipation of litigation,” and thus within the purview of Rule 26(b)(3), it must be that “in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation.”¹⁶⁶ The majority of courts adopted a “because of” standard whereby a document created due to the prospect of litigation would not lose its protection simply because it was created to foster other business decisions.¹⁶⁷

In *United States v. El Paso Co.*, the Fifth Circuit rejected the premise that tax accrual workpapers were prepared “in anticipation of litigation” unless the “primary motivating force” behind their creation was to prepare the taxpayer’s tax return.¹⁶⁸ In that case, the corporate taxpayer refused to disclose tax accrual workpapers pursuant to an IRS summons conducted in a routine audit of the taxpayer.¹⁶⁹ Since no single tax item was under scrutiny by the IRS at the time the papers were created, routine business processes called for the creation of the workpapers, not the “press of litigation.”¹⁷⁰ The Third Circuit later applied the “primary motivating force” rationale in *United States v. Rockwell International*.¹⁷¹

After those decisions, the Second Circuit had occasion to decide whether the work product doctrine extended backwards in time before trial preparation. In the case of *United States v. Adlman*, an attorney was hired by the taxpayer to evaluate the tax results of a proposed restructuring.¹⁷² The attorney conducted a study to assess the likelihood of litigation and drafted a memo with his legal analysis

<http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html> (last visited Mar. 27, 2011).

165. See *United States v. Adlman*, 134 F.3d 1194, 1197 (2d Cir. 1998).

166. See *In re Grand Jury Proceedings*, 604 F.2d 798, 803 (3d Cir. 1979).

167. See *id.*; *Nat’l Union Fire Ins. Co. v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992); *Binks Mfg. Co., v. Nat’l Presto Indus., Inc.*, 709 F.2d 1109, 1118-19 (7th Cir. 1983); *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987), *cert. denied*, 484 U.S. 917 (1987); *Senate of Puerto Rico v. United States Dep’t of Justice*, 823 F.2d 574, 586 n.42 (D.C. Cir. 1987).

168. *United States v. El Paso Co.*, 682 F.2d 530, 543 (5th Cir. 1982).

169. *Id.* at 533. There, the court noted that tax accrual workpapers are also referred to a noncurrent tax account and tax pool analysis.

170. *Id.* at 543.

171. 897 F.2d 1255 (3d Cir. 1990).

172. *United States v. Adlman*, 134 F.3d 1194, 1195 (2d Cir. 1998).

as to the likelihood the IRS would challenge the restructuring and the taxes that would result if it did.¹⁷³ In response to an IRS summons for the memo, the taxpayer cited work product privilege and declined to produce it.¹⁷⁴ The issue before the court was whether documents prepared “because of expected litigation” in the context of making business decisions was nevertheless protected under the work product privilege.¹⁷⁵ The court affirmed protection under the work product doctrine as the taxpayer would have been left with an “untenable choice” between the taxpayer asking for advice that would later prejudice them in subsequent litigation or engaging in a business transaction without adequate legal advice.¹⁷⁶ Hence, the protected document did not have to be prepared “primarily or exclusively” for litigation.¹⁷⁷ Likewise, the First Circuit followed the Second Circuit’s holding and held that documents created for dual purposes – for litigation and for business reasons – nevertheless could be protected by the work product doctrine if they had been prepared “because of” expected litigation.¹⁷⁸ The Sixth Circuit also affirmed this approach in *United States v. Roxworthy*.¹⁷⁹

F. *United States v. Textron, Inc.*

The battle over work product immunity for tax accrual workpapers culminated in the First Circuit’s *United States v. Textron, Inc.* decision.¹⁸⁰ In response to an IRS summons requesting *all* tax accrual workpapers relating to disclosed listed transactions, the taxpayer asserted the work product privilege. The First Circuit had previously addressed the scope of the work product immunity in a case that did not involve tax accrual workpapers and affirmed the use of the “because of” standard, which had been followed by several other circuits.¹⁸¹

173. *Id.*

174. *Id.* at 1195-96.

175. *Id.* at 1197-98.

176. *Id.* at 1200.

177. *Adlman*, 134 F.3d at 1198.

178. *See Maine v. United States Dep’t of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002).

179. 457 F.3d 590, 598 (6th Cir. 2006).

180. *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009), *cert. denied*, 130 S. Ct. 3320 (2010). *See also* I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72 (July 8, 2002), where the IRS expanded its policy of restraint with respect to any returns filed on or after July 1, 2002, to situations where the taxpayer claimed a tax benefit from a Treas. Reg. § 1.6011-4T(b)(2) “listed transaction.”

181. *See Maine*, 298 F.3d 60. Other courts of appeals have adopted this standard in the following cases: *National 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); *Senate of Puerto Rico v. United States Dep’t of Justice*, 262 U.S. App. D.C. 166, 823 F.2d 574, 586 n.42 (D.C. Cir. 1987);

Textron was a publicly traded corporation and was thus required under federal securities law to have its public financial statements certified as accurate by an independent auditor.¹⁸² As noted earlier, those financial statements must disclose and account for contingent tax liabilities. To assure that the outside accountants could determine the “adequacy and reasonableness of the corporation’s reserve account for contingent tax liabilities,” Textron’s internal tax attorneys prepared spreadsheets identifying each debatable tax position, the dollar amount subject to dispute, and the percentage estimate of the IRS’s success upon the merits. The results from these spreadsheets could be used to fix the reserve.¹⁸³ The information provided was pursuant to pre-FIN 48 requirements.¹⁸⁴ The spreadsheets also provided backup with notes from internal attorneys and outside counsel retained to advise the corporation regarding the reserve requirements.¹⁸⁵ Textron had shared the spreadsheets with its outside accountants, Ernst & Young, but refused to disclose them pursuant to an IRS administrative summons.¹⁸⁶

Textron argued at the district court level that that the opinions of counsel and accountants as to what tax positions could be challenged, the probability of litigation, and the calculation of the tax reserves had all been prepared “but for” the fact that the taxpayer anticipated the possibility of litigation with the IRS.¹⁸⁷ The district court held that the internal tax accrual workpapers were protected work product as they consisted of “lists of items on Textron’s tax returns, which, in the opinion of Textron’s counsel, involve issues on which the tax laws are unclear, and therefore, may be challenged by the IRS.”¹⁸⁸ The court used the “because of” standard and held that the workpapers were prepared with the prospect of litigation, thereby denying the IRS’s petition for enforcement of its summons.¹⁸⁹ A divided panel of the

Binks Mfg. Co. v. National Presto Indus., Inc., 709 F.2d 1109, 1118-19 (7th Cir. 1983); *In re Grand Jury Proceedings*, 604 F.2d 798, 803 (3d Cir. 1979). For a full discussion of *United States v. Textron*, see Lischer, Jr., *supra* note 142.

182. See 15 U.S.C. §§ 78i, 78m (2006); 17 C.F.R. § 210 *et seq.* (2010).

183. *Textron*, 577 F.3d at 23.

184. *Id.*

185. *Id.* at 24.

186. *Id.*

187. See *United States v. Textron, Inc.* 507 F. Supp. 2d 138, 150 (D.R.I. 2007), *rev’d*, 577 F.3d 21 (1st Cir. 2009).

188. *Id.* at 142. The work papers included estimates, in percentage terms, of the taxpayer’s chances of prevailing (the “hazards of litigation percentages”) and “the dollar amounts reserved to reflect the possibility that Textron might not prevail in such litigation (the ‘tax reserved amounts’).” *Id.* at 142-43.

189. *Id.* at 150 (discussing *United States v. El Paso Co.*, 682 F.2d 530, 543 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984)).

First Circuit upheld that ruling and the appellate court granted rehearing en banc.¹⁹⁰

The First Circuit held that the only purpose of Textron's tax accrual workpapers was to fix the amount of the tax reserve on its book so as to obtain a financial opinion from its auditors.¹⁹¹ Reading the literal language of Rule 26(b)(3), which requires documents to be "prepared in anticipation of litigation or for trial," the court held that the phrase "in anticipation of litigation" did not extend to documents prepared for some purpose other than litigation.¹⁹² The First Circuit focused on the "function" of the workpapers – to assess tax reserves under the accounting rules – and not the "content" of the workpapers, which could include legal analysis of "soft spots" on the corporate tax return.¹⁹³

Not surprisingly, there was a vigorous dissent, stating that the Circuit's prior "because of" standard was now being replaced with a "prepared for" standard, asking if the document was "prepared for use in possible litigation."¹⁹⁴ Thus, the documents must be "for use" in litigation in order to be protected.¹⁹⁵ While the dissent noted the right of the majority to create a new rule for the Circuit, it chastised the majority, stating that the new rule is "not even a good rule."¹⁹⁶ As noted in *Hickman*, the result allows the IRS to identify "weak spots" and to "know exactly how much Textron should be willing to spend to settle each item."¹⁹⁷ It also goes beyond the numbers used to calculate the reserves and discloses the legal rationale for Textron's view of success in litigation.¹⁹⁸ In fact, the IRS explicitly admitted that this was the purpose of its inquiry.¹⁹⁹ The Supreme Court denied the petition for writ of certiorari of the *Textron* decision in May of 2010, which will perpetuate litigation as the circuits are split.²⁰⁰

Two subsequent cases are worth noting, as they protected tax accrual workpapers. In *Regions Financial Corp. v. United States*,²⁰¹ the IRS used its summons power to compel disclosure of records of the taxpayer and its auditor. Portions of the records were either withheld

190. See *Textron*, 577 F.3d at 21.

191. *Id.* at 30.

192. *Id.* at 29.

193. *Id.* at 31-32.

194. *Id.* at 32.

195. *Textron*, 577 F.3d at 33.

196. *Id.* at 35.

197. *Id.* at 36.

198. *Id.* at 37.

199. *Id.* at 36.

200. *Textron, Inc. v. United States*, 130 S. Ct. 3320 (2010).

201. No. 2:06-CV-00895-RDP, 2008 WL 2139008 (N.D. Ala. May 8, 2008).

or redacted on the basis that they were either “core documents” (relating to legal opinions, legal analysis, and possible strategies with the IRS) and “derivative documents” (follow up communication between the taxpayer and the advisors relating to the core documents).²⁰² The district court held that the documents were protected through the work product doctrine under the “primary” purpose test, as the taxpayer solicited such documents because of the possibility of litigation.²⁰³ The fact that such workpapers were used for accounting purposes did not exclude them from the work product doctrine.²⁰⁴

Similarly, in *United States v. Deloitte & Touche USA, LLP*,²⁰⁵ the IRS sought to disclose from the taxpayer’s independent auditor three documents – a flow chart prepared by the taxpayer’s employees, memorandum prepared by outside auditors, and a tax opinion prepared by outside counsel – used by the taxpayer in connection with ongoing tax litigation between the taxpayer and the government.²⁰⁶ As the district court protected the documents from discovery under the work product doctrine, on appeal the IRS argued that one of the documents was prepared internally and thus was not protected under the doctrine, whereas the taxpayer waived the privilege for the other two documents by disclosing to the outside auditor.²⁰⁷ As the first document was prepared internally by the taxpayer, the court did not limit its analysis solely to Rule 26(b)(3) which protects “documents and tangible things that are prepared . . . by or for another party or its representative.”²⁰⁸ Instead, the court went beyond Rule 26(b)(3) to the Supreme Court’s ruling in *Hickman* to protect the attorney’s “mental impressions,” that is intangible work products, independent of Rule 26(b)(3).²⁰⁹ As to the other two documents prepared as part of the taxpayer’s routine audit process, the court affirmed the “because of” test used by the Second Circuit in *Adlman*, thus affirming the use of the work product immunity for documents developed in anticipation of litigation even though they had been incorporated into documents used for audit purposes.²¹⁰ Thus, the court rejected the Service’s argument that the function of the document, not its content,

202. *Id.* at *1.

203. *Id.* at *7.

204. *Id.* at *7-8 n.11.

205. 610 F.3d 129 (D.C. Cir. 2010).

206. *Id.* at 133.

207. *Id.*

208. *Id.* at 135.

209. *Id.* at 136.

210. *Deloitte*, 610 F.3d at 138.

was critical in determining work product.²¹¹ Thus, a document is protected under the work product immunity even though it serves dual purposes, provided it was prepared because of the prospect of litigation.²¹²

V. SERVICE'S NEW INITIATIVE WITH REPORTING OF UTPs

Given the success that the IRS had in the *Textron* decision, it issued Announcement 2010-9²¹³ and Announcement 2010-17,²¹⁴ noting that it had broad authority to specify the form and content of the returns through regulations and thus, it had the authority to require certain corporations to provide disclosure of UTPs concurrent with the filing of a return.²¹⁵ In effect, the Service wanted to rely on the internal controls necessitated by the financial accounting standards to better administer its tax system. By requiring reporting of UTPs on the tax return, the taxpayer would be forced to use the "more likely than not" financial accounting standard for tax purposes. This standard has not been normally used in the accuracy-related penalty provisions to compel disclosure. For most of the tax, auditing, and corporate communities, this was viewed as an expansion by the IRS, requiring tax accrual workpapers that violated the taxpayer's privilege and circumvented existing penalty requirements.

A. *Announcement 2010-9*

In Announcement 2010-9, the IRS stated that it was considering changes to the reporting requirements concerning UTPs "in order to improve tax compliance and administration," and thus would be developing a schedule for taxpayers and related entities (with total assets in excess of \$10 million) to report their UTPs.²¹⁶ As the U.S. tax system relies on self-assessment of taxes and returns that set forth the facts on which tax liability can be assessed and determined, the Service noted that it needs to be able to quickly and efficiently judge significant issues, which include UTPs.²¹⁷ Due to the fact that FIN 48

211. *Id.* at 137.

212. *Id.* at 138.

213. 2010-7 I.R.B. 408 (Jan. 26, 2010).

214. 2010-13 I.R.B. 515 (Mar. 29, 2010).

215. I.R.C. § 6011 (West, Westlaw through P.L. 111-383) requires persons or entities liable for taxes under Title 26 of the United States Code to file a return in accordance with regulations prescribed by the Secretary of Treasury according to the forms and regulations prescribed by the Secretary. I.R.C. § 6012 (West, Westlaw through P.L. 111-383) specifically requires corporations to file returns, using the forms prescribed by the Secretary of the Treasury.

216. See I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408 (Jan. 26, 2010).

217. *Id.*

already requires identification and quantification of UTPs for accounting purposes, the Service wished to use such information in understanding the taxpayer's position and how such positions affect their tax liability. More specifically, the Service stated "[t]hat information also would aid the Service in focusing its examination resources on returns that contain specific uncertain tax positions that are of particular interest or of sufficient magnitude to warrant Service inquiry, as well as allowing examination teams to identify all of the issues underlying the tax returns more quickly and efficiently."²¹⁸ Thus, the Service's new position was clearly based on its needs and efficiencies.

The initial proposal was extremely broad and would have required the following disclosure for corporations that file Form 1120, U.S. Corporation Income Tax Return provided its total assets were in excess of \$10 million:

- A concise description of *each* UTP for which the taxpayer has posted a reserve on its financial statement in accordance with FIN 48, which included facts sufficient for the IRS to ascertain the nature of the issue, the rationale for the taxpayer's position, and the reasons it used in determining whether it was a UTP. The Service noted the following six elements necessary for the description: the applicable Code sections; the tax years to which the position related; whether the position involved an item of income, gain, loss, deduction, or credit against tax; whether it involved a permanent inclusion or exclusion of any item, the timing of that item, or both; whether it involved the determination of the value of property or right; and whether the position involved a computation of basis.
- For tax positions for which no tax reserve need be established pursuant to FIN 48, disclosure of any tax position which the taxpayer expects to litigate or the taxpayer has determined that the Service has a general administrative practice not to audit such position.
- For the above reportable UTPs, the maximum amount of potential federal tax liability attributable to each UTP, ascertained without regard to risk analysis as to the likelihood of prevailing on the merits.²¹⁹ Hence, disclosure was to be the maximum tax amount the IRS would receive if the position was disallowed upon audit.

For those taxpayers not complying with the considered changes, the Service noted that it was assessing options for penalties or sanctions,

218. *Id.*

219. *Id.* According to LB&I Commissioner Maloy, the use of the maximum tax adjustment represented a balance to prevent the IRS from ascertaining the taxpayer's risk assessment. See DELOITTE, UNCERTAIN TAX POSITIONS AND THE IRS TRANSPARENCY INITIATIVE: NO HOLDS BARRED 2 (2010), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_UTP2_072710.pdf.

including those that could be imposed legislatively.²²⁰ Except as provided in the Announcement, the Service reiterated its intention to adhere to its existing policy of restraint for requesting tax accrual workpapers during an audit.²²¹ The Service asked for comments on eight particular issues by March 29, 2010.²²² The reaction from the business, legal, and accounting communities was enormous which prompted the Service to issue Announcement 2010-17,²²³ which (1) confirmed that the new schedule would relate to the 2010 tax years and fiscal years beginning in the 2010 tax years; (2) summarized the comments received thus far; (3) extended the initial comment period to June 1, 2010; and (4) invited comments on three new matters.²²⁴

B. *Announcement 2010-30*

In May of 2010, the Service issued Announcement 2010-30, which explicitly addressed the types of taxpayers subject to the UTP disclosure rules, and issued draft Schedule UTP and related draft instructions.²²⁵ Under the draft schedule and instructions, beginning with the 2010 tax year, taxpayers with audited financial statements²²⁶ having

220. See I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408 (Jan. 26, 2010).

221. *Id.* The IRS's policy of restraint is set forth in I.R.M., *supra* note 5, § 4.10.20.

222. I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408 (Jan. 26, 2010). The issues for which the IRS wanted comments included the best way to quantify each UTP (e.g., exact dollar amounts or dollar ranges); alternative methods of disclosure that the Service could use to determine the relative value of the UTPs; whether the calculation of the maximum tax liability should relate to the tax year for which it is disclosed or all tax years for which it relates and whether net operating losses or excess credits should be reflected; the treatment of related entities; the breadth of the information required to be disclosed; whether transitional rules should be considered; the reporting of UTPs for which no reserve is presently required, but a subsequent reserve is later recorded; and whether disclosure should be different during examination as opposed to tax returns.

223. 2010-13 I.R.B. 515 (Mar. 29, 2010).

224. *Id.* The Service requested comments on the following issues: whether the proposed disclosure would duplicate reporting already required under other forms, such as Form 8275 and 8275-R; whether pass-through entities and tax-exempt entities should be required to report UTPs; and how to report UTPs for variety related entity contexts, such as members of a consolidated financial statement or consolidated tax return or entities that are disregarded for federal tax purposes.

225. I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668 (May 10, 2010). Schedule UTP for 2010 was issued to accompany Form 1120, with related 2010 Instructions for Schedule UTP (Cat. No. 55028G). A tax position is defined as a position taken on a return that would result in an adjustment in federal income taxes relating to items of income, gain, loss, deduction, and credit if the position is not sustained. 2010-19 I.R.B. at 672.

226. *Id.* at 674. According to the instructions, an audited financial statement is one in which an independent third party provided an opinion under GAAP, IFRS, or another country-specific accounting standard, including modified versions (e.g., modified GAAP) that insist that a taxpayer reserve for federal tax positions.

both UTPs and total assets equal or exceeding \$10 million would be required to file the Schedule UTP if it or a related party was:

- A corporation who is required to file a Form 1120, U.S. Corporation Income Tax Return;
- An insurance company who is required to file a Form 1120 L, U.S. Life Insurance Company Income Tax Return, or Form 1120 PC, U.S. Property and Casualty Insurance Company Income Tax Return; and
- A foreign corporation who is required to file Form 1120 F, U.S. Income Tax Return of a Foreign Corporation.²²⁷ According to the instructions, the reported UTPs were the same as set forth in Announcement 2010-9. Thus, the following UTPs must be disclosed:
 - UTPs for which a reserve is recorded on its audited financial statement for the current year (e.g., current year's tax positions, in Part I of the proposed Schedule), or prior year's tax positions that now require a reserve in the current year due to uncertainty, in Part II of the proposed Schedule);
 - UTPs for which a decision not to record a reserve was made (as it was determined that there was less than a 50% probability of settlement with the IRS), the taxpayer is willing to litigate the position and expects to prevail on the merits;²²⁸ and
 - UTPs for which a decision not to record a reserve was made based on the IRS's administrative practice or precedent for not challenging the position.²²⁹

C. Draft Schedule and Draft Instructions

The draft Schedule was set forth in three parts: Part I disclosed the UTPs for the decision to reserve (or not to reserve) made at least 60 days before the filing of the tax return; Part II disclosed prior year UTPs that had not yet been reported on Schedule UTP; and Part III set forth the "concise description" of each tax position listed in Parts I and II, along with disclosure of the primary federal income tax code section that affects the UTP. Once disclosure of the UTP is required, the reporting is not based on the "measurement amount" under FIN 48, but instead on the maximum tax adjustment ("MTA") that would

227. *Id.* Excluded from the disclosure requirements were real estate investment trust or regulated investment companies, pass-through entities, and tax-exempt organizations. A related party is defined as an entity related to the corporation pursuant to I.R.C. §§ 267(b), 318(a) or 707(b), or any entity included in a consolidated audited financial statement which includes the corporation.

228. *Id.* at 675. The taxpayer must demonstrate that it would have litigated this position; such information may be found in the taxpayer's accrual working papers.

229. *Id.* In this case, the reserve would be the amount of the settlement agreed to with the Service but for the IRS's administrative practice.

be then be computed. For tax positions relating to items of income, gain, loss, and deduction, MTA is estimated as 35 percent (highest corporate tax rate) applied to the estimated total amounts of those items.²³⁰ For credits, the total amount of credits in dollars is to be estimated.²³¹ However, the MTA would not include interest or penalties.²³²

It is assumed that the Service required the MTA, instead of the measurement amounts, to avoid having to invade the taxpayer's privacy in ascertaining the amount for which it would have settled the tax position with the IRS. For example, the taxpayer's tax position results in an exposure of \$1 million. Under FIN 48, if it is more likely than not that its position would be sustained but it would settle at \$750,000, it would reserve the balance of \$250,000. Under the MTA, the exposure of \$1 million would be expressed.

Similar to the original proposal, Part III of the proposed Schedule required a concise description similar to that required under Announcement 2010-9.²³³ Noting that disclosure under the draft Schedule UTP may duplicate other reporting requirements, the IRS stated that disclosure under Schedule UTP would be deemed disclosure for purposes of Form 8275 and 8275-R.²³⁴

The comments from the public were uniformly negative, including those from the American Institute of Certified Public Accountants (AICPA)²³⁵ and the American Bar Association.²³⁶ Understandably,

230. I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668, 676 (May 10, 2010). There is an exception for UTPs relating to valuation or transfer pricing tax positions. The proposed Schedule requires the taxpayer indicate whether the UTP is either a valuation or transfer pricing position, but then only requires the taxpayer to rank, separately for valuation and for transfer pricing positions, the amount recorded as reserve under FIN 48 or the estimated adjusted to the federal income taxes if the position was not sustained at 35 percent.

231. *Id.*

232. *Id.*

233. *Id.*

234. *Id.*

235. See Letter from Alan R. Einhorn, Chair, Tax Executive Committee, American Institute of CPAs, to Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service (June 1, 2010) available at <http://www.aicpa.org/InterestAreas/Tax/Resources/IRSPracticeProcedure/Advocacy/DownloadableDocuments/F%20AICPA%20Comments%2006.01.2010%20on%20Ann%202010.9.pdf>; Letter from Patricia A. Thompson, Chair, Tax Executive Committee, American Institute of CPAs, to Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service (Dec. 2, 2010), available at <http://www.aicpa.org/InterestAreas/Tax/Resources/IRSPracticeProcedure/Advocacy/DownloadableDocuments/AICPA%2012.02.2010%20UTP%20letter.pdf>.

236. See Letter from Stuart M. Lewis, Chair, Section of Taxation, American Bar Association, to Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service (May 28, 2010), available at <http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/052810comments.authcheckdam.pdf>.

the accountants were more concerned with the differences between the accounting requirements and the new disclosure on the draft Schedule UTP, whereas attorneys were more concerned with the protections afforded under the various privileges, particularly the work product doctrine. In fact, the Internal Revenue Service Advisory Council ("IRSAC"), which affords the IRS an organized public forum with the public to discuss relevant tax administration issues, was critical of the Service's new approach and the final Schedule in its November 2010 report.²³⁷ Some of the comments actually questioned the Service's legal authority to require disclosure of UTPs.²³⁸ The lone supporter of the Service's proposal was Senator Carl Levin of Michigan, chair of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, who advocated that the proposal be strengthened to cover even more taxpayers.²³⁹

D. *Reaction from the Practitioner Community*

Moving quickly after the comment period, the Service issued proposed regulations on September 9, 2010, under I.R.C. § 6012 (relating to the returns of income corporations) and § 6011 (relating to persons liable for a tax imposed by Title 26 that are required to make a return) affirming the requirements set forth in Announcement 2010-30, applicable for returns filed for tax years beginning after December 15, 2009, and ending after the date of publication of the final regulations in the Federal Register.²⁴⁰ In effect, the Service was affirming its legal authority to compel UTP disclosure pursuant to its returns powers. Comments to the proposed regulations were due by October 12, 2010, and a public hearing was to be scheduled for October 15, 2010. The Service affirmed in the proposed regulations that Congress had given it broad authority in specifying the form and content of tax returns as long as it promulgates regulations requiring persons/entities liable for a tax to file such returns.²⁴¹ By requiring the disclosure of UTPs, the Service stated that such "information will aid the IRS in identifying those returns that pose the most significant risks of noncompliance

237. See INTERNAL REVENUE SERVICE ADVISORY COUNSEL FACTS, available at <http://www.irs.gov/taxpros/article/0,,id=167596,00.html>.

238. See *Firm Seeks Changes in Proposal to Require Reporting of Uncertain Tax Positions*, 2010 TAX NOTES TODAY 102-15 (2010).

239. See *Sen. Levin Backs Proposal to Require Reporting of Uncertain Tax Positions*, 2010 TAX NOTES TODAY 100-14 (2010).

240. Prop. Treas. Reg. § 1.6012-2 (Sept. 9, 2010).

241. *Id.*

and in selecting issues for examinations.”²⁴² These proposed regulations were finalized in December of 2010.²⁴³

As expected, there were numerous comments to the proposed regulations and a hostile backlash from the tax practitioner community. The Service classified these comments into five different categories:

- The use by the Service of the disclosed information;
- The intersection of the new disclosure rules with its existing policy of restraint;
- The burdens associated with the new reporting requirements;
- The change in relationship between the Service and the taxpayers, including its auditors and advisors; and
- The Service’s authority to require the reporting of UTPs.²⁴⁴

In anticipation of an IRS announcement that it would be releasing a substantially modified proposed Schedule UTP and its Instructions, Commissioner Douglas Shulman delivered a speech before the American Bar Association’s Tax Committee on September 24, 2010.²⁴⁵ Using the familiar theme of transparency, Commissioner Shulman reiterated the goals of the proposed reporting rules for UTPs, which would promote “certainty regarding the taxpayer’s tax obligations sooner rather than later”; consistency across taxpayers; and efficiency of government resources.²⁴⁶ The clear intent of the rules was to assist the IRS in prioritizing taxpayers for examinations, identify issues where there was uncertainty in order to further future guidance, and obtain relevant information regarding UTPs.²⁴⁷ But to be sensitive to the tax practitioners’ concern that the reported information was too much and too soon, Shulman noted that relief would be provided.²⁴⁸ As to the second issue of waiver of privilege in connection with UTP, he noted that the Service would be issuing a second announcement affirming its policy of restraint and stating that it would not be seeking documents otherwise deemed to be privileged.²⁴⁹ By the end, the damage had been done – pitting the IRS against corporate taxpayers and their representatives – affording greater distrust and more adversarial relationships between the two.

242. *Id.*

243. Treas. Reg. § 1.6012-2 (as amended in 2010).

244. I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428 (Sept. 24, 2010).

245. Douglas Shulman, Commissioner, Internal Revenue Service, Prepared Remarks to the American Bar Association (Sept. 24, 2010).

246. *Id.*

247. *Id.*

248. *Id.*

249. *Id.*

E. *Announcements 2010-75 and 2010-76*

By September 24, 2010, the IRS issued two announcements: Announcement 2010-75²⁵⁰ concerning the final Schedule UTP (and its Instructions), and Announcement 2010-76²⁵¹ relating to the IRS's policy of restraint. In the former announcement, the IRS backed off from a number of its initial proposals in the following respects:

- To afford the covered entities in Announcement 2010-30 additional time to comply, a five-year phase-in was provided based on the corporation's asset size. The filing of Schedule UTP would be required beginning with 2010 tax years for corporations with total assets equal to or exceeding \$100 million (as opposed to the proposed \$10 million); filing of the schedule would be delayed to 2012 tax years for corporations with total assets equal to or exceeding \$50 million and to 2014 tax years for corporations with total assets equal to or exceeding \$10 million.²⁵²
- There will no longer be a requirement to report tax positions for which no reserve was recorded due to the taxpayer's determination that the IRS's administrative practice was not to raise the issue under audit.²⁵³ As for the requirement to report tax positions for which no reserve was recorded because of an expectation to litigate, the final instructions permit the taxpayer to rely on its reserve decisions made for financial statement purposes and therefore, do not mandate the corporation to reassess such decisions at the time the schedule is completed.²⁵⁴
- Instead of reporting the actual MTA for each UTP, the final rules call for a ranking of all reported tax positions for which a reserve has been taken based on the amount of the reserve (including transfer pricing and valuation) and a designation as to whether the reserve for such position exceeds 10% of the aggregate reserves (i.e. materiality) for all other tax positions reported on the schedule. For tax positions for which there was no reserve required to be posted, no size needs to be determined for such positions and they can be assigned any rank by the taxpayer.²⁵⁵
- In the description of each UTP required to be disclosed, the requirements relating to the rationale and nature of the uncertainty have been eliminated as they conflicted with the IRS's

250. 2010-41 I.R.B. 428 (Sept. 24, 2010).

251. 2010-41 I.R.B. 432 (Sept. 24, 2010).

252. I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428 (Sept. 24, 2010). The final instructions to Schedule UTP did not exclude Compliance Assurance Program (CAP) or CIC taxpayers from the reporting requirements. However, the Service expects to issue Schedule UTP compliance in a forthcoming CAP guidance.

253. *Id.*

254. *Id.* The final instructions do not give guidance as to how a taxpayer should document an expectation to litigate; however, the Service assumes the taxpayer would continue to document through the same process as used in the FIN 48 rules.

255. *Id.*

policy of restraint.²⁵⁶ Hence, the taxpayer's assessment of the hazards of the tax position or the pros and cons for the position do not have to be disclosed.²⁵⁷ Now the taxpayer need only disclose the relevant facts affecting the tax treatment of the position in order to inform the IRS of the identity of the tax position and the nature of the issue. This latter position is consistent with the current disclosure requirements under Form 8275.

- To promote consistency between Schedule UTP reporting and FIN 48 reporting, tax positions that are immaterial under applicable financial accounting standards or are sufficiently certain such that no reserve is required under such standards do not have to be reported.²⁵⁸
- Reporting under Schedule UTP involves only U.S. federal income tax positions and not foreign or state tax positions.²⁵⁹ The corporation is to report only its own tax positions on the Schedule UTP, not those of a related party.²⁶⁰
- The final instructions do not provide for any penalties for non-disclosure or incomplete disclosure. To avoid duplicative filing, disclosure of a tax position on the Schedule UTP will be treated as if the corporation filed Form 8275 or 8275-R regarding that tax position. As long as the transaction is not a reportable transaction, disclosure on the Schedule UTP will satisfy the disclosure requirements of I.R.C. § 6662(i). The Service will continue to explore avenues to eliminate duplicative reporting requirements.²⁶¹

In conjunction with this Announcement, Announcement 2010-76 was issued on the same day, expanding the Service's policy of restraint.²⁶² Noting that the identification of UTPs for the new Schedule UTP occur during the process of preparing financial statements in accordance with the standards of FIN 48, independent auditors may request copies of legal opinions and other documents to comprehend the legal basis for the position and to determine the amount of its reserves in order to audit the taxpayer's financial statements. Therefore, the Service affirmed that documents otherwise privileged under the attorney-client privilege, the tax practitioner privilege, or the work product doctrine will not be required to be divulged during an audit on the premise that the privilege has been waived through disclosure

256. *Id.* Disclosure is now limited to the relevant facts affecting the tax treatment of the position so as to inform the IRS of the identity and nature of the position, consistent with its policy under Form 8275.

257. I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428 (Sept. 24, 2010).

258. *Id.*

259. *Id.*

260. *Id.*

261. *Id.*

262. I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010).

of the Schedule UTP.²⁶³ However, if the taxpayer had waived such privilege, a request for tax accrual workpapers is made in accordance with the IRS Manual for unusual circumstances, or the taxpayer has claimed the benefits of a listed transaction, the Service may request such documents.²⁶⁴ When requesting tax reconciliation workpapers during an audit, the current procedures will permit the taxpayer to redact information regarding the concise description of the UTPs, the amount of the reserves for each UTP, and computations used to ascertain the ranking of UTPs.²⁶⁵

This announcement was followed by a directive to all LB&I personnel from Steven Miller, Deputy Commissioner for Services and Enforcement, reflecting on the policy that the IRS could take regarding UTPs by its LB&I examiners and personnel.²⁶⁶ It affirmed that a central process would be developed within LB&I to analyze UTPs for a variety of reasons: identification issues and returns for audit; detection of trends and areas needed for guidance; proper treatment of UTPs which could include publishing more guidance, recommendation for new legislation, and referral for audit.²⁶⁷ Regarding audit techniques to be used by IRS examiners, the IRS cautioned that examiners would be approaching an audit with the understanding that UTPs could exist due to lack of guidance in the law and ambiguity with respect to the law.²⁶⁸ Hence, such tax positions may not require an audit but simply aid in the identification of issues by the agent. The Service noted that its LB&I examiners would receive specific training in the handling of UTPs.²⁶⁹

VI. CONCLUSION

The new accounting requirements under FIN 48 have caused considerable problems, especially for large publicly traded corporate taxpayers. It is evident that the IRS wishes to take advantage of the transparency now required by the accounting and securities law to compel disclosure under the federal income tax law. Unfortunately, it is not apparent that it has the legislative authority to do so. While the Service has used its summons powers in the past to force disclosure of

263. *Id.*

264. *Id.*

265. *Id.*

266. STEVEN T. MILLER, DIRECTIVE FOR ALL LARGE BUSINESS AND INTERNATIONAL DIVISION (LB&I) PERSONNEL, (2010), available at http://www.irs.gov/pub/newsroom/internal_directive.pdf.

267. *Id.*

268. *Id.*

269. *Id.*

tax accrual workpapers, its 2010 initiative relied on its return powers (not its summons powers) under which it may not have the authority or the penalty power to force disclosure of UTPs.²⁷⁰ Hence, it is not surprising that the IRS announcement declares that it will appeal to Congress for such legislative relief. Whether such appeal will be successful remains to be seen.

As taxpayers and advisers sift through the new UTP schedule to provide a concise description of the UTP and applicable facts, they will be especially concerned as to whether such disclosure results in a waiver of privilege. If taxpayers limit descriptions of UTPs in order to protect related privileges, the Service may end up with very limited information from the returns. Without the statutory authority to impose a penalty, the Service will be hard pressed to penalize limited disclosure. Despite its policy of restraint, one may question whether the tension between the taxpayer's assertion of privilege and the IRS's policy of restraint worsens the examination process, thereby reducing audit efficiency.

The greater overall concern is that much discussion between taxpayers and advisors (both accountants and attorneys) will go "underground" in order to avoid such disclosure. Such unintended consequences of the new UTP disclosure rules would be to the detriment of the IRS. But the much bigger gorilla in the room is simply that the federal income and corporate tax rules are so complex and many are so uncertain, that any given corporate taxpayer will have numerous UTPs that will have to be discussed with the taxpayer and outside independent auditor/attorney. Congress has this issue on its agenda for 2011. While the IRS's enforcement costs and resources may be limited, the productive cost to society as a whole of having private corporate taxpayers work for the benefit of the IRS is clearly questionable.

270. See Lipton, *supra* note 104, at 261 (questioning the Service's ability to compel disclosure of UTP without regard to whether it could assess a penalty for the position on the return).