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IRS' Schedule of Uncertain Tax Positions Raises Concerns for Preserving Privilege

In response to a claimed need to allocate IRS resources to significant issues and improve audit efficiency, the IRS issued Announcement 2010-9 in January 2010, setting forth a new initiative that would require certain business taxpayers to disclose uncertain tax positions (UTP) on a new schedule that would be filed with their federal income tax returns. In April 2010, the IRS released the promised "Schedule UTP (Form 1120)" in draft form, along with the related instructions. The new UTP disclosure requirement has generated much discussion within the tax community, and resulted in many comments being submitted to the IRS by practitioners and professional organizations.

Because Schedule UTP seeks information that has historically not been available to the IRS except through the disclosure of tax accrual workpapers, one concern is whether Schedule UTP is an attempt to circumvent the debate over the privileged nature of tax accrual workpapers. In *United States v. States v. Textron, Inc.*, 577 F.3d 21, the First Circuit Court of Appeals held that these workpapers are not subject to work product privilege because they were not prepared for use in litigation. 577 F.3d 21 (1st Cir. 2009), *cert denied* May 24, 2010. Even if the IRS does not change its policy of restraint with respect to when it will request these workpapers, there is a further issue of whether Schedule UTP itself results in a waiver of privilege. In public forums, the IRS has emphasized that Schedule UTP seeks only factual information, not potentially privileged information relating to tax litigation assessments and individual tax reserves. As discussed below, however, taxpayers seeking to preserve privilege could face new challenges when the IRS finalizes this schedule later this year.

Disclosure Requirements of Schedule UTP

Under the IRS' current proposal, the new UTP disclosure requirements are applicable to corporations that (i) file corporate income tax returns on Forms 1120, 1120 F, 1120 L or 1120 PC; (ii) have assets of at least \$10 million; and (iii) issue audited financial statements or have their operations included in a related party's audited financial statements. These large corporate taxpayers will be required to file Schedule UTP with their corporate income tax returns if they have a federal income tax position for which the corporation or a related party (i) has recorded a reserve in its or a related party's audited financial statements; (ii) has not recorded such a reserve because it has decided to litigate the position; or (iii) has not recorded such a reserve because the IRS has an administrative practice of not auditing such position.

Schedule UTP currently requires taxpayers to disclose the following information for each current year UTP and each prior year UTP that was not previously disclosed:

- up to three primary Internal Revenue Code sections related to the UTP,
- the temporary or permanent nature of the UTP,
- the EIN of the pass-through entity if UTP relates to such an entity,
- the identity of any UTP reported because of an IRS administrative practice not to audit the issue, and

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- the maximum tax adjustment amount for any UTP, unless such UTP relates to a valuation or transfer pricing issue, in which case the UTP will be ranked by either the amount of the reserve or the largest amount of the potential tax adjustment.

For all of the listed UTPs, taxpayers also are required to disclose a “concise description” that allows the IRS to identify the tax position and the nature of the uncertainty. Importantly, the instructions to Schedule UTP specifically state that this description:

must include a statement that the position involves an item of income, gain, loss, deduction, or credit against tax; a statement whether the position involves a determination of the value of any property or right or a computation of basis; and the **rationale for the position and the reasons for determining the position is uncertain.** [Emphasis added.]

Comments to the current version of Schedule UTP were due to the IRS by June 1, 2010, and the IRS expects to issue the final form in time for filing with corporate income tax returns for any taxable year beginning on or after January 1, 2010.

Privilege Concerns

Although the IRS defends its Schedule UTP against privilege concerns by stating that it is not seeking tax litigation assessments and individual tax reserves, any description that contains the taxpayer’s “rationale” or “reasons” underlying a UTP threatens to reveal an adviser’s confidential advice or mental impressions, conclusions and opinions, which are at the very core of what is protected and intended to be protected by attorney-client privilege, federal tax practitioner privilege and work product privilege. See, e.g., *Hickman v. Taylor*, 329 U.S. 495 (1947); *Regions Fin. Corp. v. United States*, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,345, WL 2139008 (N.D. Ala 2008); *United States v. United Shoe Machinery*, 89 F. Supp. 357 (D. Mass. 1950); I.R.C. § 7525; Fed. R. Civ. Proc. 26(b)(3).

If information is included on the Schedule UTP that is otherwise protected by attorney-client privilege or federal tax practitioner privilege, such disclosure will result in a subject matter waiver. If, on the other hand, such information is protected by the work product privilege, the disclosure will not result in a general subject matter waiver but, under the Federal Rules of Evidence, it could result in waiver of any undisclosed communications or information concerning the same subject matter that ought to in fairness be considered together.

Corporations and their return preparers should consult with knowledgeable advisors on the implications that compliance with Schedule UTP could have on the applicability of privilege. With the Supreme Court’s recent denial of certiorari in the *Textron* case, corporations also should consult with counsel on the privileged nature of their tax accrual workpapers and other tax-sensitive information. Caution should be exercised in determining what documents to prepare, when to prepare them, who should prepare them and how to minimize distribution of such documents.

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