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

By Michelle M. Henkel (Alston & Bird LLP)

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. Textron, Inc., 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
• 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.

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Worker Classification: A Checkered History

By Joseph B. Darby III (Greenberg Traurig LLP)

Worker classification matters to the IRS because it thinks it gets better tax compliance from employees than from independent contractors. Beginning in the late 1960s, the IRS began to increase the number of employment tax audits, in part because of perceived low tax compliance by many independent contractors. Early IRS rules on employment status developed more or less on an audit-by-audit basis, with predictably erratic results. Whole industries in which workers were historically characterized as independent contractors were suddenly told, on audit, that workers were in fact employees. Meanwhile, within the same industry, one employer might be required to treat its workers as employees, while a competitor was allowed to treat its workers as independent contractors. It was, to say the least, a mess.

Section 530

In 1976, Congress literally asked the IRS to stop these audits while it tried to straighten out the chaos. This resulted in Section 530 of the Revenue Act of 1978 (Section 530), which is one of the most important provisions of federal tax law not actually found in the Internal Revenue Code. Section 530 provides a “safe harbor” that relieves employers from paying withholding and employment taxes if certain criteria are met. Section 530 reads in relevant part as follows:

TAX LIABILITY.
(1) IN GENERAL.—If—
(a) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and
(b) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer’s treatment of such individual as not being an employee, then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

Basicall, Section 530 said that so long as an employer had a reasonable basis for treating an individual as an independent contractor, had treated all similarly situated workers in a consistent manner, and had filed the appropriate

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