CAN TAX AUTHORITIES AUDIT WORKPAPERS? CANADIAN EXPERIENCE FOLLOWS U.S. RULE

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INTRODUCTION

When a Canadian or U.S.-based multinational finds itself under audit, the taxpayer and the tax authority are often at odds over what documentation is subject to disclosure and what remains beyond the prying eyes of the tax authority. In a landmark series of recent court cases in Canada, the Canada Revenue Agency ("C.R.A.") was given access to accounting workpapers and background documentation for transfer pricing reports to verify a position taken in a client's tax return. This is a major development in Canada. In the U.S., in contrast, the I.R.S. has been given access to workpapers and other information for many years. A comprehensive look at the long history of U.S. transparency may provide a roadmap of what Canadian-based multinationals should expect regarding matters of transparency.

TAX AUDITS

Whether a taxpayer is resident in Canada or the U.S., it may be subject to an administrative examination to determine whether tax liability has been calculated correctly in the tax return.

When the taxpayer is a large multinational, that tax audit involves a significant investment by the tax authorities in terms of staffing and resources. The examination portion of the audit may involve the issuance of information requests and possibly follow-up summonses that are intended to obtain data that may be used to test whether the taxpayer's claimed positions are justified under relevant tax law.

In a sense, the multinationals begin their investment long before the audit begins. They have sophisticated tax lawyers on staff and also retain sophisticated outside tax advisors. At the close of the year, the books and records of the enterprise are audited by a major accounting firm for the purpose of providing certification of the reported results.

When a tax examiner requests information regarding a specific transaction, the taxpayer may object on the grounds that the requested documentation is protected – either by attorney-client privilege or under the work product doctrine of privilege. The attorney-client privilege is a common law concept that dates back several centuries. The privilege protects information disclosed by the client to the attorney for the purpose of obtaining legal advice. The work product doctrine states that a party may not discover documents and tangible things prepared in anticipation of litigation or trial by a party or its representative. The work product privilege does not cover material assembled in the ordinary course of business or pursuant to public requirements that are unrelated to litigation or for other non-litigation purposes.[1]

A flash point for disclosure not covered by the work product doctrine is the tax provision analysis that forms part of the audit workpapers in support of a corporate taxpayer's published financial statements. When prepared by the audit firm, the tax provision analysis represents an outside professional's view regarding the expected tax exposure of a corporation in order to arrive at after-tax net profits. The analysis is designed to provide assurance that that the tax provision in the financial statement accurately portrays the financial condition of the company.

CANADIAN CASES

Source of C.R.A.'s Audit Powers

Subsection 231.1 of the Canadian Income Tax Act ("Act") grants broad powers to the C.R.A. to inspect, audit, or examine books, records, and inventory of a taxpayer. In carrying out its examination, the C.R.A. may issue a notice to a taxpayer requiring it to furnish information specified in the notice.[2] If a taxpayer refuses to comply, the C.R.A. may apply to the courts for a compliance order, if the requested information or document is not protected by solicitor-client privilege.[3]

Focus of C.R.A. Information Requests

In 2017 and 2018, a series of cases came before the Canadian Federal Court addressing the validity of a C.R.A. application for a compliance order seeking the production of tax workpapers and requesting the right to interview individuals who were officers and employees of the taxpayer.

In *MNR v. Cameco*,[4] the C.R.A. sought to interview 25 employees of Cameco to verify the information contained in its transfer pricing reports prepared by KPMG for tax years 2010 through 2012. In *BP Canada Energy Company v. MNR*,[5] the C.R.A. sought access to the taxpayer's tax accrual workpapers setting out its uncertain tax position for a specific year, not for the purpose of the initial examination of the tax return for that year but for the examination of tax returns filed for subsequent years. In *Canada (National Revenue) v. Atlas Tube Canada ULC*,[6] the C.R.A. sought access to a draft due diligence report prepared by EY, which had been prepared as part of an acquisition and reorganization of Atlas' corporate group.

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[1] *Hickman v. Taylor*, 329 U.S. 495 (1947); *Wells Fargo v. U.S.*, Civil No. 10-mc- 57 (D. Minn., June 4, 2013).
[2] Section 231.2 of the Act.
[3] Section 231.7 of the Act.
[4] 2017 F.C. 763.
[5] 2017 F.C.A. 61.
[6] 2018 F.C. 1086.

Access to Interview Key Personnel of the Taxpayer

Cameco is one of the world's largest uranium producers and is headquartered in Saskatoon, Saskatchewan. Cameco has several foreign subsidiaries. In the *Cameco* case, the C.R.A. sought to interview 25 employees of Cameco and its related non-Canadian subsidiaries for purposes of substantiating a transfer pricing report prepared by KPMG for tax years 2010 through 2012. The employees were situated in Switzerland, the U.S., Barbados, and Canada. The C.R.A. offered to interview these individuals at their locations or by videoconference.

In the past, Cameco had granted the C.R.A. access to its personnel for assessment of tax years 2003 through 2006. The oral information obtained from the personnel led to a reassessment of those years that was subsequently challenged by Cameco. The matter was pending before the Tax Court of Canada when the C.R.A. applied for a compliance order seeking access to a larger number of Cameco's personnel for assessment of tax years 2010 through 2012. The Federal Court refused to issue a compliance order on the basis that issuing such order would prejudice Cameco:

> When the first audits were performed, Cameco agreed to have its personnel interviewed only by a CRA official. Those interviews were not recorded, though Cameco lawyers were allowed to be present during the interviews. Both the CRA and Cameco personnel took notes of the interviews. When the matter for those years proceeded to the Tax Court of Canada and Notices to Admit were served, it was found that the two parties had very different recollections of what was said at the oral interviews. . . . If the Minister's position is accepted, the CRA can compel oral interviews from as many persons as they see fit without any procedural limits. Oral interviews as sought on these facts at the audit stage would undermine procedural safeguards provided at the appeal stage. Furthermore, the Minister could use an isolated statement by an employee which the taxpayer would be forced to disprove at trial.

The C.R.A. requested to have a court reporter present during the interview process to prevent misinterpretation of information. However, the court rejected the request, as it would result in replicating an examination for discovery in a Tax Court proceeding with the C.R.A. hand picking interviewees instead of Cameco choosing its own officers for examination.

Access to Tax Workpapers for Future Audits

The *BP Canada* case is the first Canadian case to address an attempt by the C.R.A. to access a taxpayer's tax accrual workpapers without advancing any particular justification for their production. Tax accrual workpapers are papers created by or for independent auditors in order to assist in the process of certifying financial statements in accordance with Generally Accepted Accounting Principles ("G.A.A.P."). Tax accrual workpapers are used to identify uncertain positions and provide for reserves that will allow an independent auditor to certify that financial statements fairly and accurately reflect the financial situation of the corporation under audit.

In the course of the C.R.A.'s examination of BP Canada for 2005, the examiner identified an issue relating to refund interest paid by the C.R.A. to BP Canada. The accounting turned out to be erroneous, as the refund interest payment should have been booked in 2005. During the examination process, several accounting entries in an account entitled "Interest Expense Taxes Payable – Disputed Accruals Account" came to surface. The C.R.A. examiner sought access to the tax accrual workpapers from BP Canada to support the entries in that account. BP Canada refused on the basis that the disclosure of tax accrual workpapers was unnecessary in the fact pattern as only refund interest was questioned by the examiner. That issue was resolved, leading BP Canada to contend in effect that the C.R.A. examiner was partaking in a "fishing expedition." Further, BP Canada argued that disclosure of its tax accrual workpapers would not only provide the C.R.A. with a roadmap to its uncertain tax positions but would also allow access to the analysis behind those positions. BP Canada, therefore, appealed to the Federal Court of Appeal and the Chartered Professional Accountants of Canada ("C.P.A.C.") participated as an intervener in light of the broad scope of the issue. The C.P.A.C. argued that the formal requests for the production of tax accrual workpapers should not be routine and uncontrolled, and that the obligation to produce these papers to the C.R.A. would undercut the public interest role of C.P.A.C. members in certifying financial statements. The court summarized the concerns of the C.P.A.C. in the following language

> Professional accountants have a direct role in ensuring a degree of confidence in publicly-traded corporations' financial statements through independent auditing. Because they act in the public interest, they are subject to professional and ethical obligations, such as an obligation of integrity, a duty of care, and a duty of objectivity. . . . In keeping with those obligations, professional accountants have to review [tax accrual workpapers] prepared by the corporations which they audit in addition to preparing their own [tax accrual workpapers].
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> [The C.P.A.C.] thus fears that the order, if allowed to stand, will cause corporations to 'hesitate to voluntarily and fully disclose their tax risks.' Moreover, routine access by the Minister to subjective opinions on tax risks may 'discourage corporations from preparing such analysis in order to protect it from disclosure.'
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> [The C.P.A.C.] invites the Court to interpret subsection 231.1(1) of the Act in light of 'the global context of rules of professional ethics and financial reporting.' This means that only objective information would be subject to production, such as the 'disclosure of all transactions that could have a material impact on the corporation's tax liability, without identifying the degree of tax risk that any of those transactions may have.'

Notwithstanding the legal arguments submitted by the C.P.A.C., the Federal Court of Appeal held that a taxpayer could be ordered to produce tax accrual workpapers where the tax accrual workpapers pertain to a specific issue under an existing audit. However, the deeper issue was whether subsection 231.1(1) allows general and unrestricted access to this information. In the *BP Canada* case, the C.R.A.'s request was specific to an existing audit. However, there was no existing audit pertaining to the information requested, and the C.R.A. sought access to BP Canada's uncertain tax positions for the purpose of using these positions to facilitate future audits. Therefore, the court held that BP Canada could not be compelled to produce the tax accrual workpapers.

Access to Workpapers in an Ongoing Audit

In the *Atlas Tube* case, the C.R.A. sought a compliance order application before the Federal court seeking the release of a due diligence report prepared by EY pursuant to a reorganizational transaction in 2012 which included the purchase of an unrelated company by Atlas's parent corporation, a U.S. entity. The due diligence report was prepared by the accounting firm, EY, to understand whether the Canadian sister corporations and Atlas had sufficient tax losses to offset the future revenue of the newly acquired entity. The C.R.A. initiated an examination of the tax return of Atlas. in the course of which it requested a copy of the due diligence report. Atlas argued that the report was cloaked under solicitor-client privilege and therefore could not be released.

The Federal Court concluded that dominant purpose of the report was to inform the decision whether to proceed with the transaction and at what price. Because the purpose of the report was not to obtain legal advice, the court held that the solicitor-client privilege did not apply. The report included, *inter alia,* the tax attributes of the target corporations and the material tax exposures resulting from the prior Canadian tax filings including an assessment of the probability that the filing positions leading to the tax exposures would be sustained if challenged by the C.R.A. The court concluded that the assessment and evaluation represent accounting opinions by EY, which cannot be characterized as prepared for the purpose of obtaining legal advice on the structuring of the transaction.

The court also distinguished the *BP Canada* case on the basis that the report requested in the *Atlas* case was made in the context of an active examination of particular issues unlike the *BP Canada* case where the purpose was to facilitate future audits.

U.S. EXPERIENCE

Financial Accounting Conceptual Background

SFAS 109 (Accounting for Income Taxes)

Financial accounting concepts of income recognition are not identical to U.S. tax accounting concepts. As a result, pre-tax income for financial accounting standards may not look anything like the taxable income on a corporate tax return. The disparity could result from a variance in cost basis resulting from the computation of depreciation under two different sets of accounting standards or may reflect a mere difference in income or expense recognition rules.

To illustrate, assume an item of depreciable property is sold for a combination of cash and purchase money notes held by the seller calling for payment over time. For financial accounting purposes, all gain is recognized immediately upon the sale. That is the time when income or gain is more likely than not realized. For tax purposes, the recognition of gain may be deferred under rules applicable to an installment sale, where gain is recognized as payments are received. In addition, the amount of the gain may be measured differently. If a risk exists regarding the likelihood that full payment of the installment notes will be received, the amount of the gain for financial statement purposes may be adjusted for a reserve that takes into account the risk of full and timely payments of the promissory notes issued by the purchaser. No such reserve is generally allowed for tax purposes, which defers the effect of a potential loss until the loss occurs.

FIN 48 (Accounting for Uncertainty in Income Taxes)[7]

The foregoing example related to the sale of property is a relatively straightforward fact pattern. The complexity increases when a loss or credit is derived from one transaction but is used immediately to reduce tax otherwise due on income from another transaction. The reduction in tax resulting from the validity of the loss is viewed as a tax position for financial statement purposes. Deciding whether the tax benefit from the loss is recognized and determining how much is recognized are accounting decisions made under the principles of FIN 48.

FIN 48 is an interpretation of SFAS 109 regarding the calculation and disclosure of reserves for uncertain tax positions. The evaluation of a tax position in accordance with FIN 48 is a two-step process:

1. The first step relates to recognition of a benefit arising from a tax position. In this step, the company determines whether it is more likely than not that a tax position will be sustained based on the technical merits of the position upon conclusion of examinations, I.R.S. appeals procedures, and litigation processes. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the company presumes that the position will be examined by the appropriate taxing authority and that the examiner has full knowledge of all relevant information.

2. The second step in the evaluation process is measurement. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of tax benefit that is more than 50% likely to be realized upon ultimate settlement.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which any of the following occurs:

- The threshold is met (e.g., by virtue of another taxpayer's favorable court decision)

- The position is "effectively settled" by virtue of the closing of an examination where the likelihood of the taxing authority reopening the examination of that position is remote

- The relevant statute of limitations expires

Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 is reported as an adjustment to the opening balance of retained earnings (or other appropriate

[7] Now codified in accounting literature as ASC 740-10.

components of equity or net assets in the statement of financial position) for the year of adoption, presented separately.

Arthur Young & Co. Case

In 1975, the I.R.S. began a routine examination to review Amerada Hess's corporate income tax liability for the tax years 1972 through 1974. When the audit revealed that the company made questionable payments of $7,830 from a "special disbursement account," the I.R.S. initiated a criminal investigation of Amerada's tax returns in addition to the civil examination. In that process, the I.R.S. issued an administrative summons to Arthur Young & Co., pursuant to Code §7602 as in effect prior to the adoption of the Internal Revenue Code of 1986.[8] The summons required Arthur Young to make available to the I.R.S. all its Amerada Hess files, including its tax accrual workpapers. The client instructed Arthur Young not to comply with the summons.

The I.R.S. commenced an action in Federal district court for enforcement of the summons. The district court found that Arthur Young's tax accrual workpapers were relevant to the I.R.S. investigation and refused to recognize an accountant-client privilege that would protect the workpapers.[9] The Court of Appeals for the Second Circuit agreed that the tax accrual workpapers were relevant to the I.R.S. investigation but held that the public interest in promoting full disclosure to public accountants and ensuring the integrity of the securities markets required protection for the work that such independent auditors perform for publicly-owned companies.[10] The court of appeals fashioned a work product immunity doctrine for tax accrual workpapers prepared by independent auditors in the course of compliance with Federal securities laws.

Ultimately, the Supreme Court held that the tax accrual workpapers were relevant to the I.R.S. audit and therefore discoverable.[11] In addition, the Supreme Court found that no accountant-client privilege exists under Federal or state law. Unlike an attorney, whose role is to represent a client in the most favorable light possible, financial statement audit firms have a public responsibility to ensure that a company issuing publicly-traded stock accurately reports its financial accounts to the public. In substance, the Supreme Court acknowledged that financial statement auditors have a responsibility to users of financial statement information. This responsibility can create an adverse relationship between the company and its auditors.

Announcement 2002-63

Having won its case against Arthur Young, the I.R.S. understood that total and complete access to tax accrual workpapers would inhibit a full analysis by the outside accountants. Consequently, it scaled back its demands to see accountants' tax accrual workpapers except in extraordinary circumstances. In Announcement

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8 All statutory references are to the Internal Revenue Code of 1986 ("Code") as in effect at the time, unless otherwise stated.

9 *U.S. v. Arthur Young & Co*., 496 F. Supp. 1152 (S.D.N.Y. 1980).

10 *U.S. v. Arthur Young & Co,* 677 F.2d 211 (2S Cir. 1982).

11 *U.S. v. Arthur Young & Co*, 465 U.S. 805 (1984).

2002-63, the I.R.S. explained the circumstances in which tax accrual workpapers would be requested during the cause of an I.R.S. examination:

- Workpapers could be requested in the course of the examination of any return filed on or after July 1, 2002, claiming a tax benefit arising out of a listed transaction, which in broad terms is a tax shelter in the view of the I.R.S. If the listed transaction was disclosed on the taxpayer's tax return, the review is limited to those workpapers related to the listed transaction. On the other hand, if the listed transaction has not been disclosed on a tax return, the I.R.S. will request all tax accrual workpapers.

- If the I.R.S. determines that tax benefits have been claimed from multiple investments in listed transactions, the I.R.S., as a discretionary matter, may request all tax accrual workpapers. It does not matter whether the listed transactions were disclosed on a tax return.

- If there are reported financial accounting irregularities requiring a restatement of the earnings of a taxpayer that reported an investment of a listed transaction, the I.R.S. could request all tax accrual workpapers as a discretionary matter.

Textron Case

In 2003, the I.R.S. began an audit of Textron's tax return for 2001 and found that its subsidiary had participated in nine listed transactions that were potential tax shelters. In each of the nine instances, Textron purchased equipment from a foreign utility or transit operator and leased it back to the seller on the same day. The I.R.S. determined that these were sale-in, lease-out ("S.I.L.O.") transactions,[12] which are listed as potential tax shelters subject to abuse by taxpayers. The I.R.S. issued an administrative summons[13] to obtain the books, papers, records, or any other data that may be relevant to the inquiry.[14] Since Textron claimed benefits

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[12] For an excellent discussion of a S.I.L.O. transaction, see Wood and Hollingworth, "SILOs and LILOs Demystified," *Tax Notes* (October 11, 2010), p. 195. According to the authors, through March 12, 2004, when U.S. tax law was revised to eliminate the tax benefits of these transactions, U.S. taxpayers were involved in at least 400 S.I.L.O. transactions, claiming tax deductions of more than $35 billion.

[13] 26 U.S.C. §7602 (2006).

[14] In pertinent part, the subpoena served on Textron demanded the following documents:

> All accrual and other financial workpapers or documents created or assembled by the Taxpayer, an accountant for the Taxpayer, or the Taxpayer's independent auditor relating to any tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to any footnotes disclosing reserves or contingent liabilities on audited financial statements. They include, but are not limited to, any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes.

from multiple transactions, the I.R.S. sought all the workpapers for the years in question[15] from both Textron and its outside auditors, Ernst & Young. Textron refused to hand over its workpapers and intervened in the summons served on Ernst & Young.

The I.R.S. brought an enforcement action in connection with the administrative summons. Textron claimed that the documents listed in the summonses were protected from disclosure under the attorney work product doctrine. The main issue in the litigation was whether the documents being demanded were prepared routinely or in anticipation of litigation. In the latter case, the documents would be privileged.

The U.S. Federal District Court for the District of Rhode Island, which was the court of original jurisdiction, ruled that the work product privilege was applicable.[16] The decision was appealed by the I.R.S. to the First Circuit Court of Appeals.

The work product doctrine offers protection for documents by or at the direction of an attorney that are prepared in anticipation of litigation or for trial by or for another party or its representative.[17] A "because of" test is applied to determine whether a document is protected by the attorney work product doctrine. A document is protected if, in light of the nature of the document and the facts of a particular case, the document can be said to have been prepared because of the prospect of litigation. Conversely, a document is not protected from disclosure if it is prepared in the ordinary course of business or it would have been created in essentially similar form in the absence of the litigation. The work product doctrine applies in tax summons enforcement proceedings.[18]

Textron argued that the workpapers were prepared to ensure that a sufficient amount was set aside in the event of a dispute the I.R.S. The analysis of the tax positions in the return were conducted by the company's legal counsel. Textron argued that the analysis was prepared to analyze potential litigation with the I.R.S. over the very tax shelters that had been identified and the company's need to set aside reserves in case the tax benefits were disallowed by the I.R.S.

The I.R.S. argued that the work product privilege was lost because the workpapers also served a business or regulatory purpose – the accuracy of the published financial statements. Textron needed to prepare the same analysis to comply with the transparency rules applicable to capital markets in the U.S. It also argued that Textron could not have anticipated litigation at the time the accrual workpapers were prepared, and in any event, no specific litigation was identified by Textron. Finally, the I.R.S. argued that an adversarial relationship existed between the taxpayer and its independent auditor, so when the papers were shown to the audit firm, Textron caused the workpapers to lose any privilege that may have existed.

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[15] I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72 (July 8, 2002).
[16] *U.S. v. Textron Inc. & Subsidiaries*, 507 F. Supp. 2d 138 (D. R.I. 2007).
[17] Fed. R. Civ. P. 26(b)(3)(A).
[18] *Upjohn Co. v. U.S.*, 449 U.S. 383, 386 (1981).

A three-judge panel of the appeals court initially ruled in favor of Textron[19] regarding the application of the attorney work paper doctrine. The initial opinion acknowledged that Textron and the I.R.S. had a contentious relationship in regard to the examination of the company's tax returns. Evidence presented to the district court indicated that Textron was audited by the I.R.S. on a continuous basis. In every three-year audit cycle, hundreds of I.R.S. adjustments were made without challenge. Where adjustments were disputed, the matter was resolved through a conference with the audit team, by presentation of arguments to the I.R.S. Office of Appeals, or in litigation. The appeals court held that while not all aspects of a tax examination are adversarial, the resolution of disputes through administrative processes, including proceedings before the I.R.S. Appeals Office, is litigation. Consequently, the appeals court initially ruled in favor of Textron.

The I.R.S. timely petitioned the appeals court asking for review by the entire panel of judges in the court. The original decision by the appeals court was vacated, additional briefs were submitted, and *amicus curiae* briefs were filed by interested parties that might be affected by the ruling of the court. The full appeals court held that the Textron tax analysis workpapers were independently required by statutory and audit requirements and that the attorney work product privilege was not applicable.[20]

The final decision characterized the problem in the following terms:

> . . . [H]ow far work product protection extends turns on a balancing of policy concerns rather than application of abstract logic . . . [in the context of] a document [that] is not in any way prepared 'for' litigation but relates to a subject that might or might not occasion litigation.

The appeals court looked to *Hickman v. Taylor* for guidance:

> Proper preparation of a client's case demands that he 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 . . . This work is reflected, of course, in interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways – aptly though roughly termed . . . as the 'work product of the lawyer.'

On this basis, the Supreme Court declared that the interrogatories, which sought witness interviews conducted by opponent's counsel in preparation for litigation, were protected by a qualified privilege. That privilege is now codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure regarding disclosure of material to the opposing side in litigation. The tax accrual workpapers simply did not meet this standard. The immediate motive of Textron in preparing the tax accrual workpapers was to fix the amount of the tax reserve on Textron's books and to obtain a clean

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[19] 553 F.3d 87 (1st Cir. 2009).
[20] 560 F.3d 513 (1st Cir. 2009).

financial opinion from its auditor. Merely because Textron wanted to be adequately reserved in the event of litigation does not mean that the workpapers were prepared for use in possible litigation. The workpapers were prepared to ensure that sufficient reserves were established to cover liabilities that might be determined in litigation.

The appeals court concluded that an experienced litigator would describe the tax accrual workpapers as tax documents and not as case preparation material. The fact that the documents were prepared by lawyers or reflected legal thinking is not sufficient to trigger work product protection, even if the subject matter of a document might conceivably be litigated. Those documents are merely another type of material that is assembled in the ordinary course of business or in compliance with public requirements unrelated to litigation. They do not have immunity from disclosure.

The appeals court decision for the majority ends with the following comments:

> Textron apparently thinks it is 'unfair' for the government to have access to its spreadsheets, but tax collection is not a game. Underpaying taxes threatens the essential public interest in revenue collection. If a blueprint to Textron's possible improper deductions can be found in Textron's files, it is properly available to the government unless privileged. Virtually all discovery against a party aims at securing information that may assist an opponent in uncovering the truth. Unprivileged IRS information is equally subject to discovery. . . .
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> The practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious. Textron's return is massive--constituting more than 4,000 pages--and the IRS requested the work papers only after finding a specific type of transaction that had been shown to be abused by taxpayers. It is because the collection of revenues is essential to government that administrative discovery, along with many other comparatively unusual tools, are furnished to the IRS. [Footnote omitted.]

Schedule UTP Reporting Uncertain Tax Positions

Having won the right to review tax accrual workpapers, the I.R.S. modified its approach by adopting a plan for transparency of corporate tax returns keyed to the tax return itself.

In a speech before the New York State Bar Association Tax Section Annual Meeting in New York City on January 26, 2010, then Commissioner Doug Schulman announced the introduction of Schedule UTP as a means of coordinating issue identification for tax purposes with the obligations imposed under FIN 48. I.R.S. statistics indicate that up to 25% of its time in large corporate audits is allocated to identifying issues rather than having a straightforward discussion with taxpayers about tax issues. The goal of the I.R.S. is to use the form to reduce the time it takes for I.R.S. examiners to find issues and complete an audit. It does this by assisting the I.R.S. in prioritizing the selection of issues and ensuring that the I.R.S. and taxpayers spend time discussing the law as it applies to the taxpayer's facts. Below is the plan that was announced by Commissioner Schulman:

> Reporting uncertain tax positions would be required at the time a return is filed by certain business taxpayers: those who have both a financial statement prepared under FIN 48 or other similar accounting standards reflecting uncertain tax positions and assets over $10 million. Under the Announcement, these taxpayers would be required to annually disclose uncertain tax positions in the form of a concise description of those positions and the maximum amount of US income tax exposure if the taxpayer's position is not sustained. By concise, we mean a few sentences that inform us of the nature of the issue, and not pages of factual description or legal analysis.
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> Let me say a few things about this proposal. We have taken what I believe is a reasonable approach. We could have asked for more . . . a lot more . . . but chose not to. We believe we have crafted a proposal that gives us the information we need to do our job without trying to get in the heads of taxpayers as to the strengths or weaknesses of their positions. . . .
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> The proposal does not require the taxpayer to disclose the taxpayer's risk assessment or tax reserve amounts. We are asking for a list of issues that the taxpayer has already prepared for financial reporting purposes, in order to improve the efficiency and effectiveness of tax examinations. We are also looking for the maximum exposure, so we can allocate our exam resources appropriately. We need to have a sense of materiality and whether we should spend exam resources on an issue. The principal guidance for completing the form comes from the instructions published by the I.R.S.

A Schedule UTP is required if each of the following four requirements are met: (i) a corporate tax return is filed, (ii) an asset threshold is met, (iii) audited financial statements are prepared, and (iv) either a reserve is reported for a tax position or a reserve is not recorded because a decision has been reached to litigate the tax position if challenged. Each of these requirements is discussed below:

- **Corporate Tax Return Filed**. The corporation files a tax return on Form 1120, *U.S. Corporation Income Tax Return*; Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*; 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.*

- **Asset Threshold.** The corporation has assets that equal or exceed $10 million. If the U.S. branch of a foreign corporation has less than $10 million in assets but the entire corporation meets that threshold, Schedule UTP must be filed.

- **Audited Financial Statements.** The corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year. Audited financial statements mean financial statements on which an independent auditor has expressed an opinion, whether qualified, unqualified, disclaimed, or adverse, under G.A.A.P., I.F.R.S., or another country-specific accounting standard, including a modified version of any of the above. Compilations or reviewed financial statements – which may be prepared in the U.S. without the necessary audit steps to allow the audit firm to issue an opinion – are not audited financial statements for purposes of this test. If a corporation reconsiders whether a reserve is required for a tax position and eliminates the reserve in an interim audited financial statement issued before the tax position is taken in a return, the corporation need not report the tax position to which the reserve relates on Schedule UTP.

- **Reserve Recorded or Decision to Litigate.** The corporation has taken one or more tax positions taken on a tax return for the current or prior year and either it or a related party has recorded a reserve in audited financial statements, or a reserve is not recorded because the corporation expects to litigate the position. This is a two-step analysis: (i) defining a tax position and (ii) determining whether a reserve was taken for financial statement purposes.

A tax position taken on a tax return means a tax position that would result in an adjustment to a line item on any schedule or form attached to the tax return if the position is not sustained.

A tax position is based on the unit of account used to prepare the audited financial statements on which the reserve is recorded (or on which no reserve was recorded because of an expectation to litigate). A unit of account is the level of detail used in analyzing a tax position. The unit of account used by a G.A.A.P. or modified G.A.A.P. taxpayer for reporting a tax position on Schedule UTP must be the same unit of account used by the taxpayer for G.A.A.P. or modified G.A.A.P.

For a non-accountant, the term “unit of account” is not a clear term. However, an example in the instructions suggests that it means the method adopted by a corporation to report an item for accounting purposes. The example looks at two corporations, each independent of the other. Each conducts an independent research and development project, and each intends to claim a credit allowed for the outlays incurred in the activity. Many hurdles must be overcome to benefit from the credit and so the credit is a tax position. One corporation chooses each individual research project as the unit of account for G.A.A.P. financial reporting purposes, since the corporation accumulates information for the tax return at the project level and expects the I.R.S. to address the issues during an examination of each project separately. The other corporation determines that the appropriate unit of account for G.A.A.P. financial reporting purposes is the functional expenditures, based on the amount of its expenditures, the anticipated credits to be claimed, its previous experience, and the advice of its tax advisors. The method chosen by each corporation to accumulate and report information for G.A.A.P. purposes must be used when preparing the Schedule UTP.

A reserve is recorded when an uncertain tax position or a FIN 48 liability is stated anywhere in a corporation’s or related party’s financial statements, including footnotes and any other disclosures, and may be indicated by any of several types of accounting journal entries. The initial recording of a reserve will trigger the reporting of a tax position taken on a return. However, subsequent reserve increases or decreases with respect to the tax position will not trigger reporting.

Although the use of a net operating loss (“N.O.L.”) or a credit carryforward is a tax position taken on a tax return, the use of the N.O.L. or credit carryforward in the carryforward year is not reported on Schedule UTP if the corporation previously reported the tax position that created or added to the N.O.L. or credit carryforward on Schedule UTP.

Once reportable tax positions are identified, they must be ranked by size and reported in order from greatest to least material. The amounts involved for each tax position need not be reported anywhere on Schedule UTP. The ranking of each tax position is determined on an annual basis and is the amount of U.S. Federal income tax reserve recorded for that position.

Finally, a concise description should be given of the tax position. This entails a very brief description of the relevant facts and information that can be reasonably expected to apprise the I.R.S. of the nature of the issue. The description should not include an assessment of the risks for the corporation or an analysis of legal authorities for or against the tax position in the return.

CONCLUSION

When Schedule UTP was first announced by the I.R.S. in 2010, Canadian tax advisers looked with disbelief at the transparency obligations imposed on applicable U.S. corporate taxpayers. Eight years later, the C.R.A. has won court cases giving it wide powers to require a taxpayer to produce documents relevant to identify issues for the year under examination. In comparison to U.S. practice, an unfettered exercise of power can be challenged not only on the grounds laid down by the Federal Court in the *BP Canada* case but also on the basis that a demand violates the general principles of natural justice. In the U.S., Schedule UTP shines a bright light on issues that were of concern at the time a set of audited financial statements were prepared. Access to workpapers, however, is limited to situations where factors suggest that corporate management has an appetite for aggressive tax planning.