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Contents

Step Transaction Doctrine Not Applicable to Multi-Step Bargain Sales to Charity

In *Klauer v. Commissioner*,[1] the Tax Court refused to apply the step transaction doctrine to disallow a corporation's charitable contribution deduction for property transferred in a series of bargain sales to a charitable organization to which the corporation had granted options to purchase the property.

The taxpayers were shareholders of Klauer Manufacturing Co., a family-owned subchapter S corporation (the "Corporation"). In 1919, the Corporation began acquiring land in New Mexico, and by 2001, it owned approximately 9,800 acres of vacant land. Included in these acres was 2,581 acres known as the Taos Valley Overlook ("Taos Overlook").

The U.S. Department of the Interior Bureau of Land Management (the "BLM") frequently held discussions with the Corporation about purchasing Taos Overlook, although no agreement was ever reached. Around August 1999, representatives of the Trust for Public Land ("Trust"), an organization exempt from tax under section 501(c)(3) of the Internal Revenue Code ("Code"), approached the Corporation regarding the acquisition of Taos Overlook. Generally, Trust acted as a third-party facilitator for the acquisition of certain properties of interest to certain public agencies and conveyed those acquired properties to those agencies. During its discussions with the Corporation, the Trust contemplated conveying any portion of the Taos Overlook it acquired to the BLM.

Trust supported its operations through appropriations of funds from the U.S. Congress. Trust informed the Corporation that although it desired to purchase the Taos Overlook, it could not be bound to do so due to the lack of certainty surrounding its funding. As a result, on January 23, 2001 (the "Option Date"), the Corporation granted to the Trust an option to purchase annually a portion of the Taos Overlook. Pursuant to the Option Agreement, for $10,000, the Trust was granted an option to purchase the Taos Overlook in three phases. The Option Agreement did not require that the Trust exercise any or all of its options to acquire the phases, and the exercise of one option did not obligate it to exercise another option. The Corporation also required that any portion of the Taos Overlook with respect to which the Corporation granted the Trust an option to purchase during the initial year border an exterior boundary of the Taos Overlook. The purpose of this provision was to ensure that if the Trust decided not to exercise its option to purchase any of the remaining specified portions of the Taos Overlook, the Corporation would own the property in the interior of the Taos Overlook. Eventually, over a period of 3 years and after several modifications to the Option Agreement, the Trust exercised all of the options and purchased the Taos Overlook for a total of $15 million.

The Service's and the Corporation's position: The Corporation claimed that its sales to the Trust under the various options were bargain sales, and it claimed charitable contribution deductions in 2001, 2002, and 2003 for the charitable component of these sales. The Service, however, argued that the step transaction doctrine applied, and the Corporation was treated as selling all of Taos Overlook in a single transaction on the Option Date. On the Option Date, the fair market value of the Taos Property was $15 million, which was the total amount paid by the Trust to the Corporation.

The court held that the step transaction was not applicable, and therefore, the taxpayer shareholders were entitled to the charitable deductions claimed for the bargain sales.

In reaching its conclusion, the court applied three alternative tests in deciding whether the step transaction doctrine applied:

- The "binding commitment" test, which collapses a series of transactions into one if, at the time the first step is entered into, there was a binding commitment to undertake the later step;[2]
- The "end result" test, which asks whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result;"[3] and
- The "interdependence" test, which inquires whether the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series" of transactions.[4]

The Tax Court found none of these tests applicable. The Service argued that the binding commitment test applied because the Corporation was bound and obligated to sell Taos Overlook the moment it entered into the Option Agreement. Additionally, the Trust was committed to purchasing the Taos Overlook, as evidenced by its efforts to obtain funding. The Tax Court, however, found that the Service ignored several facts, including the fact that if the Trust could not secure proper funding, it could not purchase any portion of the Taos Overlook. In such case, the Corporation would have retained the remaining portion(s) of Taos Overlook. The court further stated that the Option Agreement did not require the Trust to exercise any or all of its options, and the Trust's exercise of its option to acquire one phase did not obligate it to exercise the option to acquire another phase. Further, there was no express or implied agreement or understanding that the Trust would buy all of the Taos Overlook. Therefore, neither the binding commitment test nor the end result test was applicable.

The court also found the interdependence test inapplicable because the individual steps in the transaction had independent significance and were not part of a larger transaction. First, the exercise of one or more of the options, but not all, would not have been fruitless without the Trust's exercise of all of the options. Second, the Corporation and the Trust contemplated that all of the options would not be exercised, as evidenced by the Corporation's insistence on retaining the interior portion of Taos Overlook in the event that the Trust did not exercise all of its options.

Therefore, the Tax Court held that the step transaction doctrine did not apply, and the charitable contribution deductions were allowed.

[1] T.C. Memo 2010-65 (2010).

[2] *Penrod v. Comm.,* 88 T.C. 1415, 1429 (1987).

[3] *Id.*

[4] *Cal-Maine Foods, Inc. v. Comm.*, 93 T.C. 181, 199 (1989).

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UPREITs – Bottom-Dollar Guaranty ("BDG") Agreements

UPREITS and Bottom-Dollar Guaranty Agreements

An "umbrella-partnership real estate investment trust" (an "UPREIT") is nothing more than a traditional real estate investment trust ("REIT") the only asset of which is a partnership interest in a limited partnership.[1] As a general rule, in an UPREIT transaction, or any partnership or LLC contribution transaction for that matter, the Code provides that no gain or loss is recognized when a partner contributes property to a partnership;[2] the partnership takes a carryover basis in the property and the contributing partner takes a substitute basis in the partnership interest.[3] In many cases, however, the exception to this general rule is the norm. Parties wishing to roll up their interests in an UPREIT transaction should take careful steps to avoid unintentionally triggering taxable gain by the contributor. Under Code Sec. 752, taxable gain can arise from the deemed distribution of cash that may occur upon the transfer of debt-encumbered property to the umbrella partnership.[4] This article focuses on the primary tax planning and structuring issues relating to the taxable gain under Code Sec. 752 that might arise in an UPREIT transaction.

UPREITs in general

Generally speaking, an UPREIT structure is created by first having the REIT form an "operating partnership." The REIT then, generally, transfers all its assets to the partnership in exchange for a general partner interest (and possibly also limited partner units) in the operating partnership. Other real estate investors then transfer interests in their real property or in real property partnerships or LLCs to the operating partnership. The real estate investors receive limited partnership interests or units in the operating partnership, which are structured to be economically similar to stock in the REIT. The holders of limited partnership units ("OP Units") receive the right to convert their OP Units into stock of the REIT. Under this structure, taxable income generally is deferred until the OP unitholder decides to convert all or part of the OP Units held. Generally speaking – absent a sale of the contributed property[5] or a deemed distribution of cash in excess of the contributor's outside basis in the OP Units (as discussed further in this article)[6] – if the OP unitholder retains such OP Units until death, a basis increase eliminates the built-in taxable gain remaining in the property.[7] The "deemed" distribution of cash created under Code Sec. 752 can be a trap for the uninformed, much like other deemed transactions that occur under U.S. federal income tax laws.[8] In some cases, the proper use of a "bottom-dollar guaranty" agreement might alleviate this risk.

Code Sec. 752: nonrecourse debt allocations and deemed distributions of cash

Most real estate investments are leveraged, and many of them, especially those financed with conduit debt over the past number of years, are leveraged with nonrecourse debt. The federal income tax rules governing the allocation of nonrecourse debt may cause a latent hazard in UPREIT transactions: potential taxable gain for the contributing partner.

As a limited partner, the contributing partner normally will share only in nonrecourse indebtedness of the operating partnership, as recourse debt is allocated to the partner bearing such recourse liability.

The contributing partner's initial tax basis in the OP Units should equal (i) the contributor's tax basis in the contributed property, reduced by (ii) the amount of debt relief occurring upon the contribution, and increased by (iii) his or her post-contribution share of the operating partnership's indebtedness. In most cases, the contributing partner should avoid initial gain recognition on account of his or her share of debt secured by his contributed property. However, a contributor could recognize substantial gain in certain cases. For example, to the extent the partner is relieved of liability upon a contribution, and is not allocated a sufficient amount of partnership debt, the net excess of the liability relief over the contributor's outside basis in OP Units will trigger taxable gain from the deemed sale of his partnership interest. The remainder of this article focuses on some of the situations where gain might arise and how one might structure the transaction to minimize or defer such gain.

The Regulations governing how nonrecourse indebtedness ("NRD") is allocated among partners use a three-tier approach:

- *Tier One*: the contributing partner's share of "partnership minimum gain."[9]

- *Tier Two*: the amount of built-in gain attributable to the contributing partner under Code Sec. 704(c) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities in full satisfaction of the liabilities and for no other consideration.[10]

- *Tier Three*: the contributing partner's share of the partnership's excess nonrecourse liabilities (those not allocated under the preceding two tiers) as determined in accordance with the partner's share of partnership profits.[11]

Tier One NRD Allocations – partner minimum gain: Generally speaking, minimum gain is the amount by which the NRD encumbering a property exceeds a taxpayer's federal income tax basis in such property.[12] However, where property is "revalued" for Code Sec. 704(b) purposes, such as when property is contributed to a partnership, minimum gain is measured by reference to the agreed value of the property, not its tax basis.[13] In an UPREIT transaction, the property presumably will have an agreed value in excess of the debt to which it is subject, so that no NRD will be allocated to the contributing partner under the first tier.

Tier Two NRD Allocations – built-in gain: The second tier creates a hypothetical sale of the contributed, built-in gain property for the amount of the nonrecourse liability and for no other consideration. The UPREIT operating partnership would recognize gain on this hypothetical transaction, and all of this gain would be allocated to the contributing partner under the contributed-property allocation rules of Code Sec. 704(c). This hypothetical transaction gives the contributing partner a second-tier NRD allocation in an amount equal to this built in gain. In most cases this allocation amount is sufficient to avoid gain recognition on the UPREIT contribution.

Tier Three NRD Allocations – substantial economic effect: The partners may specify in their partnership agreement the interests in partnership profits they wish to use for purposes of allocating excess nonrecourse liabilities as long as the interests specified are reasonably consistent with allocations of some other significant item of partnership income or gain that has substantial economic effect under Code Sec. 704(b). Alternatively, tier three nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. In addition, the partnership may first allocate an excess nonrecourse liability to the contributor up to the amount of built-in gain that is allocable under Code Sec. 704(c) in situations in which the property is subject to the nonrecourse liability to the extent that the built-in gain exceeds the amount of the liability allocated in the second tier. To the extent that the partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributor, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other third-tier methods.[14] Excess nonrecourse liabilities are not required to be allocated under the same method each year. In each case, one should be careful in appropriate circumstances about debt from persons related to the partnership.[15]

Bottom-Dollar Guarantees

To address the gain that occurs upon a Code Sec. 752 deemed distribution of cash that is in excess of a contributing partner's outside basis, UPREITs often give a contributor the opportunity to enter into a "bottom-dollar guaranty" agreement. Under such an arrangement, the contributor guarantees certain UPREIT debt that will not kick-in unless the fair market value of the property falls below the stated dollar amount of the guaranty.[16] Accordingly, the guarantor will have liability for the full guaranteed amount only in cases where the contributed property becomes worthless.

With this potential tax-deferral benefit in mind, taxpayers and their advisors must realize that there are a number of issues that must be addressed in properly structuring a bottom-dollar guaranty, including, but not limited to:

- Evaluating the terms of the guaranteed debt and the nature of the collateral to ensure that there will be a substantial equity cushion that minimizes the risk of actual liability in the event that the operating partnership defaults on the guaranteed debt. For example, one should tread carefully before entering into a bottom-dollar guaranty if the property is subject to substantial environmental contamination, or is a property of a type likely to become subject to environmental contamination.

- Carefully structuring the liability trigger(s) under the guaranty. For example, one might consider (i) limiting the duration of the guaranty, (ii) automatic extensions of the guaranty, or (iii) using a guaranty that terminates automatically unless a notice for extension is provided by the contributor.[17] Of course, the more aggressive the terms of such limitations on the guaranty, the more elevated the risk that the IRS might challenge the validity of such a guaranty.

- Analyzing the impact of rights of subrogation under state law (when dealing with recourse debt). Absent a waiver of such rights, state law will cause the tax debt allocation rules to allocate debt basis to the party subject to liability from a guarantor's right of subrogation.

- Ensuring (to the extent negotiations allow) that the guaranty requires the lender to exhaust other avenues for recoupment before acting against the guarantor, rather than waive such defenses, as often required by lenders.

- Confirming there is consideration for the guaranty, so that it is not challenged as a fraudulent conveyance.

- Reviewing the terms of pre-existing bottom-guarantee commitments. One cannot legitimately offer all of the bottom to more than one limited partner.[18] If there is more than a contributor desiring to enter into a bottom-dollar guaranty, the agreements should provide for sharing the bottom of the Operation Partnership's indebtedness. This should contemplate not only current limited partners making bottom-guarantees but also future limited partners who may wish to make bottom-dollar guarantees.[19]

- Finally, one must review the Reg. §1.752-2(j)'s anti-abuse rules and how they might impact a proposed allocation of the UPREIT's debt liability.

Conclusion

In many cases, proper implementation of a bottom-dollar guaranty will be a resourceful tool for deferring taxable gain in an UPREIT transaction. However, in each case, the use of a bottom-dollar guaranty must be crafted carefully to achieve the contributor's goal of deferring tax in connection with joining the REIT's family of investors. Inevitably, this will be a fact-driven analysis. Failure to focus on a transaction's specific circumstances may result in undesirable tax consequences to the contributor, as well as ugly investor relations issues for the REIT.

[1] For a more detailed discussion of the federal income tax considerations of UPREITs, *see* T. Cuff, "Investing in an UPREIT – How the ordinary partnership provisions get even more complicated," J. TAX'N Volume 102, Number 01, Jan. 2005 (hereinafter "Cuff Article").

[2] *See* I.R.C. § 721. All references to the Code or Sections refer to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

[3] *See* I.R.C. §§ 723 and 722.

[4] *See*, R. Lipton, P. Carman, et al., Partnership Taxation, LexisNexis Graduate Tax Series, pgs. 65-66 ("hereinafter, "Partnership Taxation").

[5] If the operating partnership sells the property while OP Units are held, Code Sec. 704(c) will cause gain to be recognized by the contributing OP unitholder. For additional information on issues arising under Code Sec. 704(c), *see* G. Dance, "The Contributor Takes It All? The Code Sec. 704(c) Consequences of a Book-Down of Built-in Gain Property," J. of Passthrough Entities, Jan.-Feb. 2009, pg. 5; M. Lay, "Allocation of Basis and Code Sec. 704(c) Gain in Partnership Divisions", J. of Passthrough Entities, May-June 2009, pg. 5; and D. Forst, "Code Sec. 704(c) Ceiling Rule a Trap for the Unwary," J. of Passthrough Entities, May-June 2009, pg. 15.

[6] *See* I.R.C. § 752 and the Regulations issued thereunder.

[7] *See* D. Cullen, "UPREITs (Part II): Addressing Book-Tax Disparities," J. of Passthrough Entities, Sept.-Oct. 2009, pg. 21, for a discussion of how such gain might be recognized by a contributor over the UPREIT's investment holding period. In addition to the debt relief rules under Code Sec. 752, one should also be concerned about the recapture rules under Code Sec. 465(e) in connection with an UPREIT transaction: prior deductions are recaptured if "zero exceeds the amount for which the taxpayer is at risk in any activity at the close of any tax year." *See*, *supra*, endnote 2, Cuff Article at 53.

[8] *See*, e.g., Subpart F of the Code (deemed dividends that occur from certain types of income earned by a controlled foreign corporation).

[9] Treas. Reg. §1.752-3(a)(1).
[10] Treas. Reg. §1.752-3(a)(2).
[11] Treas. Reg. §1.752-3(a)(3).
[12] *See Tuffs v. Comm'r,* 461 U.S. 300 (1983); *see also*, *supra*, endnote 5, Partnership Taxation, pgs. 63 and 125-127. Note that a partner's share of minimum gain is determined in accordance with the rules of Reg. §1.704-2(g)(1).
[13] *See* Treas. Reg. §1.752-2(d)(3).
[14] Treas. Reg. §1.752-3(a)(3). *See also*, *supra*, endnote 2, Cuff Article at 52, fn 15.
[15] *See* Treas. Reg. §1.752-2(d)(1).
[16] *See*, *supra*, endnote 2, Cuff Article at 54.
[17] *Id.* at 54 -55.
[18] *See*, *supra*, endnote 2, Cuff Article at 54.
[19] *Id.* at 54.

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Subchapter S and Q Sub Banks Following Notice 97-5 for Expenses Relating to Tax Exempt Income Should Consider Filing Refund Claims

On March 17, 2010, the U.S. Court of Appeals, Seventh Circuit, reversed the U.S. Tax Court's decision in *Vainisi v. Commissioner*, 132 T.C. No. 1 (2009), which held that an S corporation that is a bank (or in this case a bank holding company that was an S corporation and owned a bank that had made a qualified Subchapter S subsidiary election (a "Q-sub")) is required, under the provisions of Section 291 of the Internal Revenue Code of 1986, as amended, (the "Code"), to increase the amount of its taxable income by 20-percent of the amount of the bank's interest expense that is considered attributable to certain qualified tax exempt-obligations that are owned by the bank, despite the plain language of Code Section 1363(b)(4), which provides that "section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years." The bank in the *Vainisi* case had been a Q-sub for longer than 3 years. The 7th Circuit's decision is not surprising in that the IRS' position in the *Vainisi* case was clearly contrary to the plain language in the Code.

The decision in the *Vainisi* case is well-reasoned and is solid support for an S corporation or Q-sub bank and its shareholders (regardless of whether they reside in the 7th Circuit) to file amended returns and/or claims for refunds with respect to past returns if the S corporation or Q-sub bank followed the IRS' position in Notice 97-5 and the Treasury regulations, and reduced their deduction for interest expense by 20-percent of such expense attributable to certain tax-exempt obligations owned by the bank, even though the S corporation or Q-sub bank had not been a C corporation during any of the 3 immediately preceding taxable years. The decision also provides ample support for claiming a full deduction for interest expense attributable to certain tax-exempt obligations owned by the S corporation or Q-sub bank in future taxable periods as well, at least until such time as the Code is amended by Congress to provide otherwise. We would be happy to assist any clients with the filing of amended returns and/or claims for refund. Generally, a claim for refund must be filed within three (3) years from the time the return was filed or within two (2) years from the time the tax was paid, whichever period expires later.

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Tax Advantaged Ways to Utilize a Corporate Sponsored Charitable Organization

There are several tax and non-tax reasons to establish a corporate sponsored 501(c)(3) charitable organization. Tax benefits generally include a current income tax deduction and avoidance of gain on a subsequent disposition of appreciated property. Non-tax benefits include the publicity, goodwill, and marketing benefits associated with charitable giving, the ability to isolate charitable giving in a separate entity and strategically focus such charitable giving, and the ability to maintain consistent philanthropy by establishing an endowment. This memorandum focuses on less-utilized but uniquely tax-advantaged rules available to corporate sponsored charitable organizations, including (1) employee disaster relief and emergency hardship assistance programs, (2) employee scholarship programs, and (3) use of the "conduit" rules to obtain a fair value deduction with respect to gifts of appreciated property.

1. Employee Disaster Relief and Emergency Hardship Assistance Programs

A corporate sponsored charitable organization may conduct disaster relief and emergency hardship assistance programs for the benefit of its sponsoring corporation's employees. With respect to a corporate sponsored "private foundation" (e.g., where the charitable organization receives substantially all of its support from the corporation), relief may be provided to employees who are victims of any Presidentially declared disaster, which may include an earthquake, flood, hurricane, or tornado. With respect to a corporate sponsored "public charity" (e.g., where the charitable organization receives support from the corporation and employees), relief may be provided to employees who are victims of any Presidentially declared disaster or any emergency hardship resulting from a severe personal crisis, such as a fire, accident, illness, death, or crime.

Relief must be provided based on an objective determination of need and the selection committee should be comprised of individuals who are not in a position to exercise substantial influence over the sponsoring corporation. In addition, the disaster relief and emergency hardship assistance programs cannot be used by the sponsoring corporation to recruit or induce employment or otherwise satisfy an obligation to provide employee benefits. See IRS Publication 3833, Disaster Relief, for additional discussion regarding disaster relief and emergency hardship programs. If the requirements are satisfied, donors who contribute to the charitable organization are entitled to an income tax deduction and the relief payment is not treated as taxable compensation to the employee.

2. Employee Scholarship Programs

A corporate sponsored charitable organization may conduct a scholarship program for the benefit of its sponsoring corporation's employees and/or children of such employees. Scholarships must be awarded on an objective and non-discriminatory basis. The scholarship program may not be used to induce employment or represent compensation for services, and availability must be limited by non-employment related factors. With respect to a corporate sponsored private foundation, the scholarship selection committee must also be independent from the private foundation and sponsoring corporation, and the scholarship program must be approved in advance by the IRS. See IRS Rev. Proc. 76-47 for additional requirements. If the requirements are satisfied, donors who contribute to the charitable organization are entitled to an income tax deduction and the scholarship payment is not treated as taxable compensation to the employee.

3. Conduit Rules - Fair Value Deduction for Gifts of Property to a Private Foundation

Corporate sponsored charitable organizations typically qualify as private foundations because most of their support is provided by the sponsoring corporation. Under these circumstances, sponsoring corporations often limit their donations to cash contributions since the deduction for contributions of appreciated property to a private foundation is generally limited to the cost basis in the property. If the private foundation can qualify as a "conduit" foundation in the year of contribution, however, the amount of the charitable deduction with respect to a donation of appreciated property may equal the fair market value of such property, assuming there is no depreciation recapture with respect to the property.

A private foundation can qualify as a conduit foundation if it (a) satisfies the minimum distribution requirements for the current and all prior years and (b) makes additional distributions in an amount equal to the contributions received (excluding cash) for the year. These requirements may be satisfied by making actual current distributions and/or by electing to treat as current distributions any excess distribution carryovers from the prior five taxable years. See Treas. Reg. § 53.4942(a)-3(c)(2)(iv). Therefore, a corporate sponsored private foundation with excess distribution carryovers may easily satisfy the conduit rules in an amount equal to such carryovers, which often expire unused.

To discuss this issue further, please speak to your Bryan Cave contact, or to:

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Federal Income Tax Reporting of Uncertain Tax Positions

On January 26, 2010, the IRS announced development of a tax return schedule to be used by certain taxpayers to report uncertain tax positions ("UTP") reserved in their financial statements. The IRS released a proposed draft of the "Schedule UTP" ("Schedule") on April 19th, with related instructions ("Instructions"). The Schedule has not been made final, but it clarifies some (though not all) issues raised by taxpayers and practitioners in response to the January announcement. The IRS reiterated that it will not make final the Schedule until it has received and reviewed the comments to the Schedule and the Instructions. Comments were due by June 1, 2010.

Schedule UTP

The Instructions provide that calendar-year taxpayers are not required to submit the Schedule with their 2009 returns. Moreover, a taxpayer with less than $10 million in assets (book value) is not required to submit the Schedule. With respect to taxpayers with assets equal to or over $10 million, only the following taxpayers are required to submit the Schedule with their 2010 tax returns:

- Corporations that file a Form 1120
- Insurance companies that file a Form 1120-L or a Form 1120-PC
- Foreign Corporations that file a Form 1120-F

Such taxpayers must report the UTPs for which they, or a related taxpayer, have recorded a reserve in an audited financial statement pursuant to GAAP, IFRS, or some other accounting standard. This reporting requirement only applies where the taxpayer decides to record the reserve at least 60 days before filing the tax return. Taxpayers must also report UTPs for which a reserve is not recorded due to either the taxpayer's plan to litigate or its belief that the IRS will not contest the position as a matter of administrative practice.

A taxpayer's current year tax return should disclose its UTPs taken (but not reported) in prior year tax returns. However, a taxpayer is not required to report a UTP that it has already taken <u>and reported</u> in a prior year tax return unless it again takes the position in the current year tax return. Under the Schedule's transitional rules, taxpayers subject to 2010 reporting are not required to report their prior year's tax positions—i.e., such prior year UTP reporting is prospective only. For example, a taxpayer is not required to report on its 2010 return a UTP that was taken in a its 2009 return. Yet, a taxpayer is required to report on its 2011 return a UTP that was taken (but not reported) in its 2010 return.

In addition to reporting its UTPs, a taxpayer must provide a "concise description" of the UTP and disclose the "maximum tax adjustment" ("MTA") were the IRS to dispute the position. The amount of the MTA does not necessarily equal the amount reserved on the taxpayer's financials. Rather, it is an estimate of the maximum amount of potential U.S. income tax liability associated with the tax year for which the position was taken. For UTPs related to items of income, gain, loss, or deduction, the

Instructions provide that the taxpayer should compute the MTA by multiplying the item by 35%. For UTPs related to tax credits, the taxpayer should compute the MTA by multiplying the item by 100%. Taxpayers are not required to compute an MTA for valuation and transfer-pricing positions. Instead, these items should by ranked by either the size of the reserves or the size of the estimated tax adjustment if the position were not sustained.

A "concise description" of the UTP should include information that "reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the uncertainty." The description must include: (1) a statement that the position involves an item of income, gain, loss, deduction, or credit; (2) a statement whether the position involves a determination of the value of any property or right or computation of basis; and (3) the rationale for the position and the reasons for determining that the position is uncertain. Examples in the Instructions indicate that taxpayers should provide a fairly detailed explanation of the reasons for uncertainty.

Finally, the Instructions provide that a "complete and accurate" disclosure on the Schedule will allow a taxpayer to avoid penalties on tax positions that could otherwise only be avoided by disclosing those positions on the Form 8275 (Disclosure Statement) and the Form 8275-R (Regulation Disclosure Statement).

Unresolved Issues

Although the Schedule and its Instructions address some of the issues raised by practitioners and taxpayers, many issues remain open. These include the following:

<u>Other Entities to which the Schedule May Apply After 2010</u>. As stated above, only certain C Corporations and insurance companies must submit the Schedule with their 2010 tax returns. The Instructions provide that the IRS is still considering the reporting requirements for pass-through entities and tax-exempt organizations. It is unclear how the reporting rules will apply to such entities, which do not generally owe federal income taxes. For example, the disclosure requirement may apply to a pass-through only to the extent it has a UTP at the entity level (e.g., an S corporation that may owe income tax due to its passive investment income). On the other hand, the IRS may require that the pass-through entity disclose UTPs that flow through to the owner's return (e.g., timing of an item of income).

<u>Penalties for Failure to File the Schedule or Sufficiently Disclose</u>. Under the current penalty regime, it appears that the IRS could not penalize a taxpayer for failing to file the Schedule or sufficiently disclosing a UTP on the Schedule. First, it is unlikely that in such instances the IRS could apply the traditional accuracy-related and understatement penalties since the failure to file the Schedule or disclose a UTP does not itself involve an inaccuracy or understatement. Second, the IRS could not likely apply the failure-to-file penalty since that penalty is intended to penalize taxpayers who fail to file their entire return, not a single schedule. However, in the January announcement, the Service indicated that it may seek specific legislation designed to penalize taxpayers who do not file the Schedule or adequately disclose their UTPs.

<u>"Concise Description"</u>. It appears that more guidance is needed for what constitutes a "concise description." The IRS should balance its desire to understand the UTP in the context of its continued policy of restraint with respect to the taxpayer's risk assessments. Particularly, and as noted above, the Schedule currently requests that the taxpayer's description disclose its rationales and reasons for deciding that the position is uncertain. Some commentators believe such a request may constitute overstepping.

Overlapping Disclosure. As discussed above, the Instructions provide that adequate disclosure on the Schedule will allow a taxpayer to avoid penalties without disclosing the same positions on Forms 8725 or 8275-R. It is unclear whether such disclosure should be sufficient with respect to "reportable transactions" that are currently required to be disclosed on Form 8886 and certain book-tax differences that are currently required to be disclosed on the Schedule M-3.

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