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Schedule UTP - Two Major Issues

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Abstract

Although Corporate America is not happy about Schedule UTP, most corporations seem resigned to the schedule's existence and are now attempting to comply. In the process, Corporations have been addressing many technical questions, but two seem to be receiving the most attention: the definition of a "tax reserve", and the application of the transition rule to pre-2010 NOL carryforwards.

The current definition of tax reserve is circular and it is not clear whether it includes certain scenarios (e.g., deferred tax reserves). The application of the transition rule is of significant importance to corporations that incurred NOL carryforwards during the recession from 2007 to 2009 and expect to utilize those carryforwards in 2010 and later years. The author addresses these two issues in depth and offers various alternative approaches.

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Schedule UTP — Two Major Issues

By J. Richard Harvey Jr.

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In this article, Harvey discusses two major issues concerning Schedule UTP: the definition of a tax reserve and the application of the transition rule to pre-2010 carryforwards. This article explores both issues with a key question being: When does the IRS want disclosure of an uncertain tax position?

After this article was drafted, the IRS issued guidance favorable to corporations on the application of the transition rule. However, it did not define a tax reserve and indicated that more guidance is coming on carryforwards in general.

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Introduction

Although corporate America is not happy about Schedule UTP, most corporations and their advisers seem resigned to the schedule's existence and are now attempting to complete the form.

Corporations and the IRS have been addressing many technical questions, but two seem to be receiving the most attention. The first surrounds the definition of a tax reserve. Specifically, the current definition is circular and it is not clear whether it includes certain scenarios (for example, deferred tax reserves). The second surrounds the application of the transition rule to pre-2010 carryforwards.

The two questions may appear at first to be unrelated, but in fact, they are related. This article first explores the alternatives for defining "tax reserve" with a key question being: When does the IRS want disclosure of an uncertain tax position? The article then discusses the application of the transition rule to pre-2010 carryforwards, an issue of significant importance to corporations that incurred carryforwards during the recession from 2007 to 2009 and expect to use those carryforwards in 2010 and later years.

Definition of Reserve in Schedule UTP

The definition is somewhat circular. Specifically, it says that "a corporation or a related party *records a reserve* for a U.S. federal income tax position *when a reserve* for income tax, interest, or penalties with respect to that position *is recorded* in the audited financial statements of the corporation or a related party" (emphasis added).

Although the above definition does clarify that a reserve includes a reserve for tax, interest, or penalties, it does not define what is meant by a "reserve." Most accountants and some lawyers know generally what recording a reserve means, but like most everything in accounting, there are gray areas. For example, are the following reserves?

- reduction of a deferred tax asset (or increase in a deferred tax liability);
- failure to reclassify a deferred tax liability to taxes payable;
- recording of a liability (or reduction of an asset) in purchase accounting[1]; and
- various footnote disclosures (for example, inclusion in unrecognized tax benefits or reduction of an NOL or foreign tax credit carryforward).

If a corporation is trying to avoid disclosing a tax position on Schedule UTP, it may use the lack of definition to argue in some cases that a reserve has not been recorded. Also, because of the uncertainty surrounding the definition of a reserve, corporations sometimes may believe they should disclose tax positions even though the IRS may not want disclosure at that time.

An Accountant's View of Tax Reserves

In general terms, a tax reserve means a business has taken (or plans to take) a tax position on its tax return but has sufficient concern about the position that it does not recognize the position's full impact in its financial statements. That lack of recognition is known as a reserve.

[1]When a business acquires another business, part of the purchase accounting process is evaluating whether the target's tax reserves are appropriate.

There are two general categories of tax reserves. The first is a reserve that reflects the potential cash tax consequences of a tax position being disallowed on a return that has been filed (or will be filed shortly) — hereafter referred to as a cash tax reserve. The second is all other tax reserves. Generally, the hallmark of the second category is a reduction in a deferred tax asset (or increase in a deferred tax liability) — hereafter referred to as deferred tax reserve.[2] However, the second reserve category also can result in a reduction of tax carryovers (for example, NOL and FTC) that may not result in a reduction of a deferred tax asset.[3]

Although the recording of a tax reserve generally affects both the income statement and the balance sheet, there are exceptions. For example, a tax reserve recorded in purchase accounting usually will not have an immediate impact on the income statement.[4] Thus, accountants generally view a reserve as a balance sheet concept, rather than an income statement concept.[5]

The above description of the types of tax reserves and their balance sheet focus is consistent with Financial Accounting Standards Board Interpretation No. 48, ''Accounting for Uncertainty in Income Taxes,'' which states:

> Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one of the following:
>
> a. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable;
>
> b. A reduction in a deferred tax asset or an increase in a deferred tax liability;
>
> c. Both (a) and (b).

Given that there are two types of tax reserves (that is, cash tax and deferred tax reserves), the IRS needs to determine whether it intended reserves to mean only cash tax reserves or also deferred tax reserves.

Clues to IRS Thinking

Although the IRS has not defined reserve, some clue of what it may have been thinking can be found in Example 9 of the ''Instructions for Schedule UTP,'' and the design of Schedule UTP itself.[6]

Example 9 assumes a corporation takes a questionable position in its 2010 tax return that increases its 2010 NOL carryforward from $100 to $150, which is fully used in 2011. The example concludes there is a tax position for both 2010 and 2011, but since a reserve was only recorded for the 2011 tax position, only the 2011 tax position should be disclosed on Schedule UTP.

There are two interesting observations from Example 9. First, there are two tax positions (that is, 2010 and 2011). The IRS could have conceivably viewed the 2011 tax position to be a continuation of the 2010 tax position, but it did not.[7] Second, the facts assume a reserve was recorded in 2011, but not 2010. The unanswered question is: Why didn't the corporation in Example 9 record a reserve for its 2010 NOL carryforward? Specifically, can one infer from the example that the IRS may have been thinking of reserves as only cash tax reserves?

If the corporation had a 2010 NOL carryforward of $150, it could have recorded a deferred tax asset in its 2010 audited financial statements. If there was uncertainty about the NOL carryforward, it may have recorded less of a deferred tax asset to reflect such uncertainty (that is, a deferred tax reserve). Thus, one might attempt to interpret Example 9 to mean the IRS does *not* consider a deferred tax reserve to be a ''reserve'' for purposes of Schedule UTP.

Unfortunately, one cannot draw a definitive conclusion because there are other possible explanations for why the corporation did not record a reserve in 2010. For example, the corporation may not have thought the tax position was uncertain in 2010,[8] or may not have been able to project sufficient future taxable income to justify a deferred tax asset (that is, the corporation recorded a valuation allowance, rather than a deferred tax reserve).[9]

Parts I and II of Schedule UTP also may provide a minor clue to the IRS's thinking. Part II, column (g) requires corporations to list the prior tax year in

[2]A deferred tax reserve should not be confused with a Financial Accounting Standard No. 109, ''Accounting for Income Taxes,'' valuation allowance referring to the possibility that the business may not have sufficient taxable income to recognize its deferred tax assets.

[3]For example, if a business has not recorded a deferred asset because of insufficient future taxable income, some accountants may still view the business as recording a reserve to the extent it reduces the amount of NOL carryforward disclosed in the tax footnote.

[4]Rather, the offsetting adjustment is usually to goodwill, rather than tax expense.

[5]Nevertheless, the recording of an expense can be indicative that a reserve has been recorded.

[6]*Doc 2010-20911, 2010 TNT 186-54.*

[7]One possible reason could have been that the definition of reserve was not clear and the IRS was concerned that if it concluded there was only a tax position in 2010 and a corporation viewed itself as recording a reserve in 2011, the IRS may be stuck with no disclosure.

[8]And changed its mind in 2011.

[9]However, as mentioned in *supra* note 3, some accountants still may think a reserve exists if the NOL carryforward disclosed in the footnotes is reduced for the uncertainty.

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which a tax position was taken. Part I does not include such a column. If the IRS had wanted reserves to include deferred tax reserves, one might have expected that Part I would have a column indicating the future tax return that would be affected by a tax position with a deferred tax reserve.

Given no such column exists in Part I, one could surmise the IRS was thinking of only cash tax reserves. Unfortunately, that also is not dispositive. It is possible the IRS just wanted to know that certain line items on the current tax return were going to change, even though the changes did not affect the current year's cash tax liability. Plus, the IRS would get disclosure again in a later year when the uncertainty led to a cash tax reserve.

In summary, although both Example 9 and the design of Schedule UTP may point to the IRS defining reserves by reference to cash tax reserves, one cannot reach a clear conclusion. As a result, the IRS should clarify the definition of ''reserve,'' but must first ask itself several key questions.

Key Questions and Observations

When does the IRS want disclosure of a potential tax issue? Does it only want disclosure of a tax issue that could result in the payment of cash (or reduction of a refund) for a return already filed, or about to be filed? Or does it want disclosure sooner, even though the tax position does not yet have a cash tax impact? Also, does the IRS want to get disclosure more than once for certain tax issues?

Example 9 illustrated those questions in the context of an NOL carryforward, but another example might be as follows:

> Assume a corporation does an aggressive transaction in 2010 that results in the corporation increasing the tax basis of an asset from $0 to $100 million, but the corporation does not plan to sell the asset until 2015. In that case, the corporation might record a deferred tax reserve for the transaction in 2010. Such deferred tax reserve likely would convert to a current tax reserve when the benefit of the transaction is claimed on the 2015 return. In that case, does the IRS want disclosure in 2010, 2015, or both years?

In large part, the answer to those key questions should depend on how the IRS plans to use Schedule UTP disclosures for both guidance and audit purposes. From a guidance perspective, the IRS should prefer disclosure as early as possible. Benefits would include being able to identify potentially aggressive transactions and shut them down sooner, and being able to clarify less aggressive issues so that taxpayers and auditors have resolutions more quickly.

From an audit perspective, it is less clear what the IRS should prefer. Theoretically, the Large Business and International Division also should prefer to obtain the information sooner to educate its agents. However, one practical issue is whether LB&I will do anything with the information if an audit adjustment would not have a cash tax impact. Another practical issue is whether LB&I has the ability to keep track of an uncertain tax position that is first identified in, say, 2010, but does not have a cash tax impact until, say, 2015.

If LB&I does not have the ability to do that type of tracking (or to obtain the ability quickly), then it would seem to drive the IRS toward one of the following alternatives:

- only request disclosures of tax positions that have an existing cash tax impact (that is, result in cash tax reserves); or
- request disclosure of tax positions upon recording of *both* (i) a deferred tax reserve, *and* (ii) a current tax reserve (that is, 2010 and 2015 in the prior example).[10]

If the IRS is considering the second alternative, it should be noted that it is possible a corporation could record a deferred tax reserve but not have a ''tax position'' as defined in the instructions.[11] The reason is that the uncertainty related to a deferred tax reserve may only affect a line item in a future year's return. Although not recommended, if the IRS wants disclosure of *all* uncertainties that result in a deferred tax reserve, then it may need to adopt one of the following approaches:

- Expand the definition of ''tax position'' to include line-item changes to *both* filed returns *and* returns expected to be filed in the future. That way, even though the tax return was not affected in any way in the year the deferred tax reserve is recorded, disclosure would be required.
- Abandon the current two-prong approach to when disclosure is required (that is, there is a tax position and a reserve is recorded). Instead, disclosure would be required when a tax reserve is recorded in the audited financial statements.

Of those two approaches, the first would seem to be least disruptive to the IRS because it retains the two-prong approach and ensures the IRS would obtain disclosure at *both* the time a deferred tax

[10]This approach effectively gives the IRS the best of both options (*i.e.*, early disclosure, but also an ability to keep track of when a tax position will have a cash tax impact and most likely result in an audit adjustment).

[11]Generally defined as a ''position that would result in an adjustment to a line item on that tax return . . . if the position is not sustained.''

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reserve is recorded *and* again when a cash tax reserve is recorded. The disclosure when the deferred tax reserve is recorded would most likely be of benefit for guidance purposes, while the disclosure related to the cash tax reserve would most likely be used for audit purposes.

IRS adoption of the second approach (that is, abandon the two-prong approach) may cause some practical problems. For example, the IRS may only get disclosure when the deferred tax reserve is recorded and may not know the specific year the issue creates a potential tax cash impact.[12] The problem is not insurmountable, but it introduces complications that may require a *change* in the basic design of Schedule UTP that could delay its implementation.[13]

In summary, the IRS has lots of questions to answer. Nevertheless, it would appear it has three basic options:

- Option 1: Only require disclosure of tax positions when there is a potential cash tax impact — in those cases, they would keep the current Schedule UTP design and just define tax reserves by reference to cash tax reserves.
- Option 2: Require disclosure when there is a tax position as currently defined and either a cash tax or deferred tax reserve — this approach would allow the IRS to maintain the current Schedule UTP design and effectively give the IRS the best of both worlds (that is, early disclosure if a deferred tax reserve is recorded and additional disclosure when the deferred tax reserve is converted to a cash tax reserve). However, it is possible corporations could record a deferred tax reserve and not have a tax position as currently defined. In those cases, the IRS would likely get disclosure of those issues only when a cash tax reserve is recorded.
- Option 3: Require disclosure of tax issues when a deferred tax reserve is recorded and again when a cash tax reserve is recorded. If this option is selected, the easiest way to accomplish it may be for the IRS to expand the definition of ''tax position'' to include expected line-item changes on future returns. However, there may be other approaches.

As a practical matter, the vast majority of federal tax reserves are cash tax reserves. Although some deferred tax reserves are recorded, they mostly relate to the use of tax carryforwards (for example, NOLs and FTCs). Thus, one doubts that Option 3 would result in a material number of earlier disclosures to the IRS. Given the complexities of implementing Option 3 right now, the IRS should focus on either Option 1 or Option 2. Unless the IRS can make a convincing argument that the additional information provided by Option 2 can be used effectively, my recommendation would be to adopt Option 1.

If the IRS decides it only wants disclosures when a cash tax reserve is recorded, another way to get that result could be to narrow the definition of a ''tax position.'' For example, a tax position could be defined by reference to a potential change in the tax liability for a tax return, rather than a potential change in a line item of a return. In that case, it would not be as crucial for the IRS to define ''reserve.'' Nevertheless, in order to avoid confusion, the agency also may want to define the term by reference to cash tax reserves.

The bottom line is that the IRS needs to determine when it wants disclosure. Once that decision is made, it can develop a definition of ''tax reserves'' that accomplishes the desired result.

Pre-2010 Carryforward Used in 2010 or Later

Before the IRS issued guidance on March 23,[14] another major Schedule UTP issue was whether the transition rule, as currently drafted, applies to a pre-2010 tax position that increased a pre-2010 NOL carryforward that is ultimately used in 2010 or a later year.

For example, assume a corporation takes a questionable position in its 2009 tax return that increases its NOL carryforward from $100 to $150. The $150 NOL carryforward is fully used in 2010. Given these facts, does the use of the $150 NOL carryforward in 2010 require disclosure on the corporation's 2010 Schedule UTP?[15] Further assume the corporation recorded a deferred tax reserve in its 2009 audited financial statements for the questionable position and that in its 2010 audited financial statements the deferred tax reserve became a cash tax reserve.

That scenario presents a major issue for corporations (for example, financial institutions) that had large NOLs during the recession that will be carried forward into 2010 and later years. As the instructions are drafted, the technical issue ultimately depends on (i) the definition of a ''tax position,'' (ii)

[12]In the example discussed, would the IRS be able to correlate disclosure of the uncertain tax position in 2010 with the 2015 cash tax impact?

[13]For example, there may need to be separate lines on Part I to reflect the year or years to which the reserve relates. If they are not known at the time of initial disclosure of the issue, a mechanism needs to be developed to inform the IRS.

[14]See FAQ 3 in *Frequently Asked Questions on Schedule UTP*, *Doc 2011-3763*, *2011 TNT 36-3*.

[15]These are the same basic facts as Example 9 in the instructions, but the NOL carryforward is from 2009 to 2010, rather than 2010 to 2011.

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whether a reserve is recorded "with respect to" that tax position, and (iii) how the transition rule is interpreted. Below is my analysis of those three issues before the posting of the IRS guidance.

The corporation has a tax position in 2009,[16] and it may or may not have a tax reserve recorded for its 2009 tax position.[17] Regardless, the 2009 tax position is clearly grandfathered under the transition rule and therefore, no disclosure is necessary.

The corporation also has a tax position in 2010[18] unless the transition rule provides relief. Because there are two distinct tax positions (that is, 2009 and 2010), and because there is nothing in the transition rule that deems the 2010 tax position to be a continuation of the 2009 tax position, it seems clear that the transition rule as drafted provides relief only for the 2009 tax position.

The analysis then turns to whether a reserve is recorded for the 2010 tax position. Because there is a cash tax reserve recorded in the 2010 audited financial statements, it would seem clear that a reserve has been recorded for the 2010 tax position and that disclosure would therefore be required on the 2010 Schedule UTP. The only argument to the contrary would be if a corporation could somehow argue that *any* reserve recorded is for the 2009 tax position and not the 2010 tax position. That argument seems to be a significant stretch because there would be a cash tax reserve directly related to the 2010 tax position, but it further supports the need for clarification on the definition of "reserve" and when a reserve is recorded "with respect to" a tax position.

Given how the instructions are drafted, my analysis is not favorable to corporations that would like to avoid disclosing the use of the $150 NOL carryforward in 2010. However, all is not lost. There are two possible scenarios in which corporations could nevertheless obtain a favorable result.

First, from a policy perspective, the IRS could decide that the 2010 tax position is just a continuation of the 2009 tax position and therefore should be grandfathered. The main policy argument *against* this relief is that the corporation is taking a tax position on a 2010 tax return and if it does not want to disclose that tax position to the IRS, it need not claim the benefit of the $150 NOL carryforward. Rather, it could claim just a $100 NOL carryforward. On balance, it is a close call, and the IRS could justifiably reach either policy conclusion.

Second, if the IRS were to materially change the design of Schedule UTP and *only* require disclosure when a reserve was first recorded in the financial statements (for example, a deferred tax reserve), it is possible the use of the 2009 NOL carryforward in 2010 would not need to be disclosed. However, as discussed above, a general change in the design of Schedule UTP could create other problems the IRS may have to live with for years.[19] Thus, if the IRS decides it wants to provide relief to corporations with pre-2010 NOL carryforwards, it should provide specific relief, rather than attempting to change the basic design of Schedule UTP.

In the FAQs, the IRS effectively extended the grandfather rule to the use of pre-2010 NOL carryforwards in 2010 or later years. Thus, corporations with pre-2010 NOL carryforwards will no longer be concerned about reporting uncertain tax position on Schedule UTP related to the future use of those carryforwards.

Given the IRS did not provide a theory for that conclusion, it is unclear whether the IRS just extended the grandfather rule, or has concluded that use of the pre-2010 carryforward is not a tax position. Rather, the agency stated that "[a]dditional guidance will be forthcoming regarding reporting requirements for the use of NOLs and credit carryforwards." It is possible it is reviewing Example 9 in the broader context of when a reserve is recorded.

Two Other Miscellaneous Reserve Related Issues

As described at the beginning of this article, there may be two additional reserve-related issues the IRS should consider addressing in any future guidance. First, can tax reserves recorded as part of purchase accounting trigger disclosure on Schedule UTP for a previously undisclosed tax position of the target? If so, how should the disclosure be made? Second, if a corporation has a tax position for a temporary difference and fails to reclassify a deferred tax liability to taxes payable, when should it disclose that tax position?

- **Purchase accounting** — As the acquirer is stepping into the shoes of the target, it seems clear the IRS should want disclosure of any previously unreported tax positions when reserves are recorded as part of purchase accounting. However, it is not clear in the current

[16]If the $50 questionable deduction is challenged, several line items on the 2009 tax return will be changed. That analysis is consistent with the conclusion in Example 9.

[17]Because it is not clear whether the definition of "reserve" includes deferred tax reserves.

[18]If the 2009 NOL carryforward is partially disallowed in 2010, then it will result in multiple line items on the 2010 tax return changing (*e.g.*, taxable income and tax liability). Also, Example 9 makes clear there should be a 2010 tax position in this example.

[19]Specifically, the IRS may not get disclosure when it needs it (*i.e.*, when cash is at stake), and Schedule UTP may need to be redesigned.

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instructions whether the acquirer is a related party for purposes of tax positions taken by the target before the acquisition. Thus, the IRS should consider clarifying that potential issue by more clearly defining ''related party,'' giving an example, or preferably both.[20]

- **Temporary differences** — Assume a calendar year corporation claims a $100 deduction in its 2010 tax return but will not record the $100 expense in its audited financial statements until 2011. Further assume the corporation to be uncertain of its ability to sustain the 2010 tax deduction but is absolutely sure it is entitled to a deduction in 2011.

Textbook accounting for such uncertainty would be to reclassify some or all of the $35 ($100 x 35 percent) deferred tax liability related to the temporary difference to taxes payable in its 2010 audited financial statements. Also, the corporation would include the amount of the reclassified deferred tax liability in its 2010 FIN 48 footnote disclosure of uncertain tax benefits (UTBs) and record a reserve[21] in its 2011 audited financial statements to reflect the potential interest it could be charged starting on March 15.

As a practical matter, many corporations only record the interest reserve in the 2011 audited financial statements and the effect of the potential uncertainty in the FIN 48 footnote disclosure of UTBs. Because it is often immaterial to the balance sheet, some corporations do not make the reclassification from deferred tax liability to taxes payable in their 2010 audited financial statements.

When clarifying the definition of reserve, the IRS should focus on when it wants disclosure in the above scenario. Specifically, does it want disclosure on the 2010 Schedule UTP, Part I, or is it happy getting disclosure in Part II of the 2011 Schedule UTP when the interest reserve is recorded?

If the IRS wants disclosure in 2010, special care will be needed to make sure the definition of ''reserve'' obtains that result. For example, in addition to defining tax reserves as reductions in assets or increases in liabilities, the IRS could include a catchall definition of ''reserve'' that makes inclusion in UTB disclosure the equivalent of recording a reserve.[22]

Summary

Tax reserves can be divided into two major categories: cash tax reserves and deferred tax reserves. The IRS should clarify the definition of ''tax reserve,'' with the major issue being whether so-called deferred tax reserves are included. In reaching a decision, the IRS needs to determine when it wants disclosure of an uncertain tax position — does it only want disclosure when cash is at stake (that is, when a cash tax reserve is recorded), or does it want earlier disclosure in those cases when a deferred tax reserve is recorded before a cash tax reserve?

The answer to that question should depend primarily on whether the IRS can effectively use earlier disclosures for both guidance and audit purposes. If it can, then it should define ''tax reserves'' to include both cash tax and deferred tax reserves. Otherwise, it should limit the definition to only cash tax reserves. If the IRS does want disclosure upon the recording of a deferred tax reserve, it likely will also need additional disclosure when the deferred tax reserve is converted into a cash tax reserve.

The application of the transition rule to pre-2010 NOL carryforwards is a major issue for corporations that incurred NOLs during the 2007 to 2009 recession that will be carried forward to 2010 and later years. Imbedded in the NOL carryforwards are pre-2010 tax positions. The pre-2010 tax positions are clearly protected by the transition rule in Schedule UTP.

However, the use of the pre-2010 NOL carryforward in a post-2009 year creates a separate tax position. Absent specific relief, the 2010 tax position will be disclosed when a cash tax reserve is recorded with respect to such tax position. Given there are policy arguments for and against this result, the IRS could decide to provide explicit relief, or it could decide no relief is warranted. In the FAQs, the IRS decided relief is warranted.

[20]The IRS also would need to expand the use of column (d) in Part II of Schedule UTP to cover not only flow-through entities, but also the employer identification number of the target.

[21]The interest reserve could be recorded in either a taxes payable account or an interest payable account.

[22]If the IRS decides *not* to include deferred tax reserves in the definition, it should be aware that UTBs include tax positions related to both cash tax and deferred tax reserves.

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