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# FEDERAL TAX UPDATE

**State Bar of Texas Annual Meeting  
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# HOT TOPICS

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- **Work-Product Doctrine and *Textron***
- **Uncertain Tax Positions**
- **Economic Substance**

# WORK PRODUCT DOCTRINE

- *Hickman v. Taylor*, 329 U.S. 495 (1947)
- Fed. R. Civ. P. 26(b)(3)
- Protects documents prepared in anticipation of litigation
  - Fact work product
  - Opinion work product – “mental impressions, conclusions, opinions, or legal theories” (strongest protection)

# WHAT QUALIFIES?

- **“Prepared in Anticipation of Litigation”**
  - **“Because of” test – “in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation”;** most circuits
  - **“Primary purpose” test – “the primary motivating purpose behind the creation of the document was to aid in possible future litigation”;** *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982)
  - **Neither extends to documents prepared in ordinary course of business, or irrespective of the litigation**

# TAX ACCRUAL WORKPAPERS

- **Companies Accrue Reserves for Potential Tax Liabilities**
  - Roadmap for audit?
  - Disclosure of settlement position?
- ***U.S. v. Arthur Young*, 465 U.S. 805 (1984)**
  - Tax accrual workpapers are relevant to audit
  - No privilege or work product privilege for accountants
- **IRS Policy of Restraint**
  - Exception: listed transactions and “financial accounting irregularities”

# SUMMONS ENFORCEMENT

- **IRS Summons Power**
  - *United States v. Powell*, 379 U.S. 48 (1964)
- **Privileges from Disclosure**
  - Attorney-client privilege – waived by disclosure to auditor
  - Tax Practitioner privilege – waived by disclosure to auditor
  - Work product doctrine – the last line of defense

# THE BOMBSHELL

- ***United States v. Textron*, 577 F.3d 21 (1st Cir. 2009) (en banc), petition for cert. filed (Dec. 24, 2009)**
  - Tax accrual workpapers are not “work product”
  - Applied a “prepared for use in litigation” standard
  - “Every lawyer who tries cases knows the touch and feel of materials prepare for a . . . lawsuit. . . . No one with experience of law suits would talk about tax accrual workpapers in these terms.”
  - Focused on discussion in *Hickman v. Taylor* of witness interviews, draft briefs, outlines for cross examination.

# STATUS

- **Cert. petition denied May 24, 2010 – to the surprise of most observers**
- **Possible wider application – legal analysis and risk assessment regarding non-tax issues, if provided to outside auditors to evaluate need for reserve?**

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# WHY?

- **“Tax gap”**: Estimated difference between tax owed under law and amount paid
  - 2001: gross = \$345 B; net (enforcement) = \$290 B
- **IRS is asked to collect more with fewer resources**
- **Up to 25% of audit time is spent searching for issues rather than discussing and evaluating**
- **New disclosure requirement will help prioritize selection of issues and taxpayers to audit**

# FINANCIAL STATEMENTS RESERVES

- **FIN 48**
  - Reserve full benefit of issue unless more likely than not correct
  - If more likely than not, reserve amount taxpayer would likely concede in settlement, assuming full knowledge by IRS
- Present aggregate information in financial statements
- But the taxpayer analyzes, and documents in tax accrual workpapers, by individual issues
  - Usually not requested by the IRS – policy of restraint

# NEW DISCLOSURE REQUIREMENT

- **Filed with tax return**
- **Required for business taxpayers with assets of \$10 million or more**
- **Implicit compromise**
  - **Less information than in tax accrual workpapers**
  - **But required from all qualifying taxpayers rather than limited by IRS policy of restraint**

# WHAT WILL BE REPORTED

- **For each “uncertain tax position”**
  - **Concise description in sufficient detail for the IRS to determine the nature of the issue**
  - **Maximum potential tax liability attributable – how much additional would the taxpayer pay if it fully conceded the issue**
- **Not requesting risk assessment information – well, maybe**

# WHAT IS AN UNCERTAIN TAX POSITION?

- **A position for which the taxpayer (or a related entity) recorded a reserve in its financial statements**
- **A position for which the taxpayer did not record a reserve because**
  - **It intends to litigate (and win) unless the IRS fully concedes**
  - **The IRS has a general administrative practice not to challenge such positions**

# PRACTICAL EFFECT

- **Often the tax position, although “uncertain” because of ambiguity or lack of guidance, is correct and no additional tax should be due**
- **But, armed with knowledge that the taxpayer likely would concede at least part of the benefit, will the IRS auditors write up everything automatically?**
- **The IRS says no, but will have to provide training, align incentives, and allocate resources to make this work**

# QUESTIONS

- **“Objective and quantifiable measure” of each position**
- **Materiality and level of aggregation**
- **Privilege and possible broad subject-matter waiver**
- **Penalties – not identified yet, but the IRS is considering**

# STATUS

- **IRS requested comments by June 1, 2010; received from 50 individuals or organizations**
- **Requirements may change somewhat before they're finalized, but likely not much**
- **Intend to require taxpayers to report on their 2010 tax returns filed in 2011**

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# JUDICIAL DOCTRINE

- **A way to deny tax benefit even when transaction complies with literal requirements of Code**
- **Test usually involved two prongs**
  - **Objective – transaction was reasonably expected to change taxpayer’s economic position (e.g., earn a profit) to a substantial degree**
  - **Subjective – transaction had a significant non-tax business purpose**
- **Courts have applied the tests differently**
  - **Taxpayer must prove both prongs to prevail**
  - **Taxpayer must prove either prong to prevail**
  - **Unitary (flexible) approach**

# HISTORY

- Popular way to combat tax shelters
- Early success but a few recent taxpayer victories
- Supreme Court has not addressed since 1978
- Several unsuccessful attempts to codify over the past decade
- Finally enacted in Health Care and Education Reconciliation Act of 2010

# CODIFICATION

- No change to existing judicial framework of whether to apply
- But defines how taxpayers satisfy the test
  - Meaningful change in economic position and substantial non-tax business purpose
  - If profit potential is basis for either prong
    - Must take into account transaction fees/expenses and (under appropriate circumstances) foreign taxes
    - Present value of reasonably expected pre-tax profit must be “substantial” in relation to present value of expected net tax benefits

# PENALTIES

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- **Included in the existing 20% “accuracy-related” penalty, but**
- **No reasonable cause exception**
- **If not adequately disclosed, 20% penalty becomes 40%**

# LEGISLATIVE HISTORY

- **Economic substance doctrine does not apply when tax benefits are consistent with Congressional purpose (e.g., certain targeted credits)**
- **Safe harbor for longstanding judicial and administrative practice, where choice between meaningful economic alternatives is based on tax advantages**

# SAFE HARBORS

- Capitalizing a “business enterprise” with debt or equity
- Operating a foreign business in a domestic or foreign corporation
- Corporate reorganization or organization
- Related party transactions, as long as they follow arm’s length and other applicable concepts