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LIVING WITH TRANSPARENCY

Tax Executives Institute

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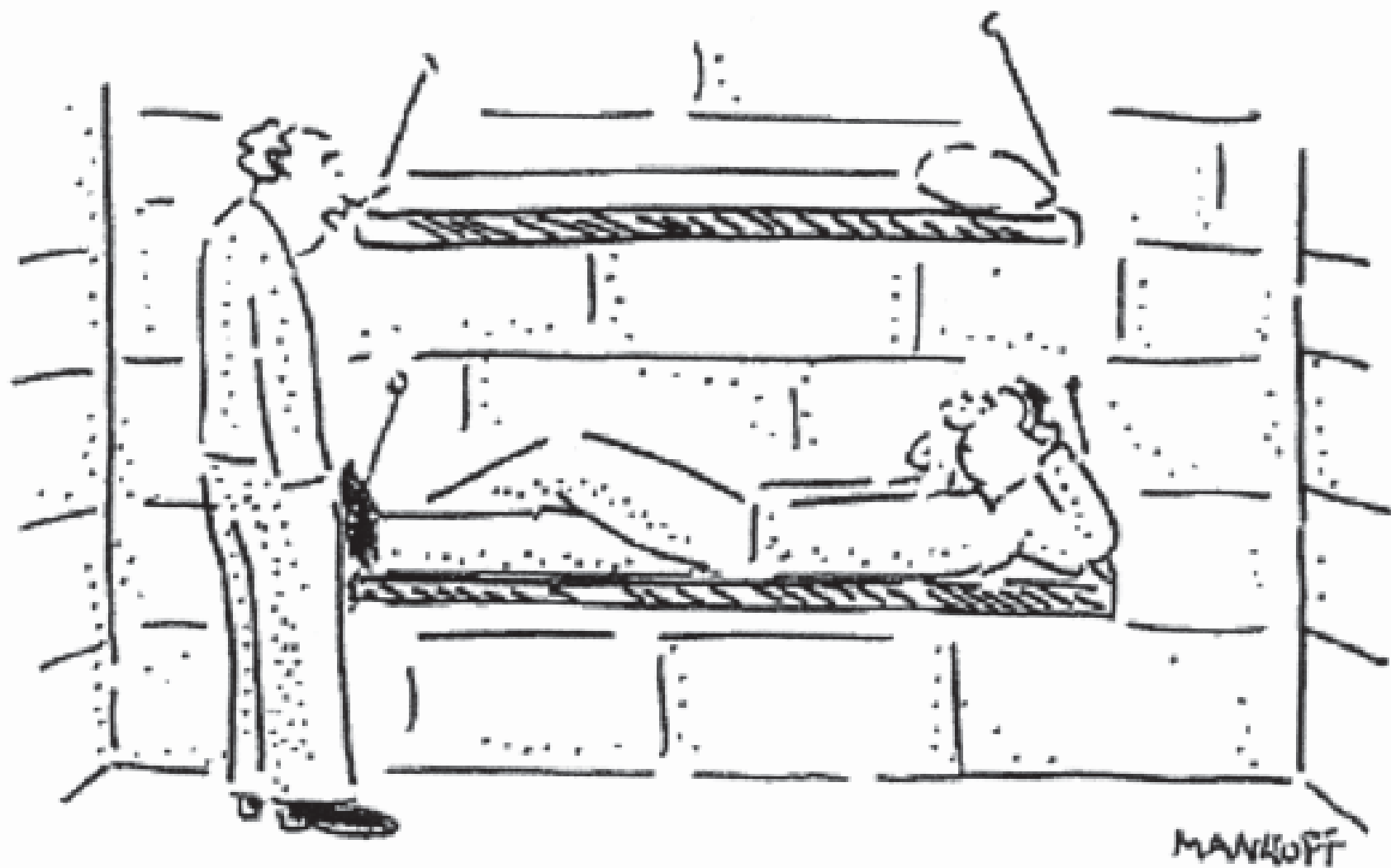


INCREASING TRANSPARENCY

- **Historical Perspective – Abuses and Government Reaction**
- **Self-assessment → Self-audit**
- **Specific Issues**
 - ▶ Reportable Transaction Requirements
 - ▶ FIN 48
 - ▶ Tax Accrual Workpapers
 - ▶ The Future?

HISTORICAL PERSPECTIVE – SEC ENFORCEMENT

- **THE EARNINGS NUMBERS GAME – “COOKIE JAR” RESERVES**
 - ▶ Failure to establish sufficient reserves to pay taxes
 - ▶ Over-accrual of tax reserves and use of such reserves to meet earnings estimates
 - ▶ Use of tax reserves to disguise other fraudulent accounting practices
 - ▶ Aggressive tax planning for the purpose of generating financial earnings



"The long and short of it was that generally, accepted accounting practices weren't as generally accepted as I thought."



RESPONSE TO EARNINGS MANIPULATIONS

- **SARBANES-OXLEY**
- **PUBLIC COMPANY OVERSIGHT ACCOUNTING BOARD (PCOAB)**
- **FASB INTERP. No. 48 (FIN 48): Accounting for Uncertainty in Income Taxes**
 - ▶ **FAS 109: Accounting for Income Taxes**
 - ▶ **FAS 5: Accounting for Contingencies**



HISTORICAL PERSPECTIVE – TAX COMPLIANCE

- **ABUSIVE TAX AVOIDANCE TRANSACTIONS a/k/a “CORPORATE TAX SHELTERS”**
 - ▶ **“We are starting with high-income individuals and corporations not because they are the biggest contributors to the tax gap – they are not. But there is political resonance and a sense of fairness that comes from compliance at the high end.”**
 - former Commissioner Mark Everson
 - ▶ **The “modified Willie Sutton” approach**



RESPONSE TO TAX COMPLIANCE

- **Dramatic increases in fraudulent returns and aggressive tax planning**
- **Limited resources for audits and white collar crime prosecutions**
- **“We cannot audit our way to full compliance. . . . We need to supplement our efforts with new tools, such as more information reporting, soft notices and self-correction options for taxpayers.” – Commissioner Doug Shulman, July 18th**
- **Use transparency to focus compliance efforts**



THE ENFORCEMENT PENDULUM





REPORTABLE TRANSACTION REQUIREMENTS



INCREASING PRESSURE FOR DISCLOSURE

- **Congress first required organizers to register tax shelters and maintain investor lists in 1984**
- **Taxpayer disclosure requirements imposed by regulation in 2000**
- **American Jobs Creation Act of 2004 – giving the disclosure requirements teeth**



AJCA – FAILURE TO DISCLOSE

- **§ 6707A penalty – \$200,000 for listed transactions, \$50,000 for other reportable transactions.**
 - ▶ **Even if tax treatment is eventually upheld**
 - ▶ **No reasonable cause/good faith defense, limited possibility of abatement or rescission**
 - ▶ **Must be reported to SEC if it relates to a listed transaction**
- **Enhanced accuracy-related penalties**
- **Statute of limitations suspended for undisclosed listed transaction**
- **Enhanced material advisor penalties**



APPLICATION OF § 6707A

- Immediately assessable; need not wait for the conclusion of the audit
- Penalty can be grossly disproportionate to tax benefit
- IRS generally allows pre-assessment Appeals review
- Expedited Appeals review (90 days) is generally limited to two issues:
 - ▶ Was disclosure required (e.g., was transaction “substantially similar” to listed transaction)?
 - ▶ Did taxpayer adequately disclose (may require perfect compliance)?
- As of 7/30, only 8 instances when § 6707A was proposed or assessed – but expect increasing use by the IRS



FIN 48



"It's funny how two intelligent people can have such opposite interpretations of the tax code!"



FIN 48 PROCESS – GAAP FINANCIAL STATEMENTS

- **Two-step Accrual Process**
 - ▶ **More Likely Than Not Recognition Threshold**
 - ▶ **Largest Amount with Greater than 50% Likelihood of Realization**
- **Disclosures**
 - ▶ **Tabular Reconciliation of Unrecognized Tax Benefits**
 - ▶ **12 Month Forward-Looking Estimate of Change**
- **Evidentiary Support**

FIN 48 – FINANCIAL IMPACT

- **Increased cost of maintaining excess reserves**
- **Asymmetric reporting incentives**
 - ▶ **Study showed that many firms with excess reserves decreased the reserves prior to adopting FIN 48 (earnings adjustment)**
 - ▶ **Firms that had under-reserved increased the reserves as part of adoption (equity adjustment)**
- **But no evidence that firms were attempting to “hide” from the IRS by removing all reserves from their books before adopting FIN 48**



FIN 48 – TAXPAYER CONCERNS

- **Tilts the Field Toward the IRS**
 - ▶ Roadmap for audit
 - ▶ Disclosure of settlement position
- **“It would not be overstating the case to conclude that FIN 48 may prove to be one of the most significant enforcement tools the IRS has been presented with in recent years.” – Robert Willens, Lehman Brothers**
- **FASB Response**
 - ▶ IRS acts in broad public interest in collecting taxes
 - ▶ Only aggregate disclosures required
 - ▶ IRS has book/tax reconciliation from Form M-3
- **IRS Reaction**
 - ▶ Disclosures too general to directly assist audit



FIN 48 – TAXPAYER CONCERNS

- **Effect of public disclosures**
 - ▶ **More likely that IRS will audit if reserves are high?**
 - ▶ **But aggregated amounts in disclosures do not provide a roadmap**
- **What about the underlying detail used to determine the necessary reserve?**
 - ▶ **IRS position – FIN 48 workpapers are “tax accrual workpapers,” subject to the policy of restraint**



COMPARE TO PROPOSED AMENDMENT OF FAS 5 (LOSS CONTINGENCIES) (Exposure Draft 6/5/08)

- **Expand required disclosures**
- **Require specific quantitative and qualitative disclosures**
- **Tabular reconciliation of recognized loss contingencies**
- **Limited exemption if disclosure would prejudice entity in dispute**



PROPOSED AMENDMENT OF FAS 5 – PREJUDICIAL EXEMPTION

- **“For certain contingencies, such as pending or threatened litigation, disclosure of certain information about the contingency may be prejudicial to an entity’s position (that is, disclosure of the information could affect, to the entity’s detriment, the outcome of the contingency itself).”**
- **Solution – allow aggregation at a higher level than by the nature of the contingency. If still prejudicial, the entity can forego disclosing only the information that would be prejudicial.**
- **What about the information provided to the auditors?**

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TAX ACCRUAL WORKPAPERS



IRS ACCESS TO TAX ACCRUAL WORKPAPERS

- ***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”
 - ▶ Policy under reconsideration due to FIN 48, but unchanged for now?
- **Summons Enforcement**



SUMMONS ENFORCEMENT

- **IRS Summons Power**
 - ▶ 26 U.S.C § 7602
 - ▶ *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



WORK PRODUCT DOCTRINE FOR TAX ACCRUAL WORKPAPERS

- **Does Work Product Doctrine Apply?**
 - ▶ **“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”**
 - ▶ **Neither extends to documents prepared in ordinary course of business, or irrespective of the litigation**



WORK PRODUCT DOCTRINE FOR TAX ACCRUAL WORKPAPERS

- **Is Work Product Waived by Disclosure to Auditor?**
 - ▶ **Test is disclosure to party who is adverse (or conduit to adversaries) – is an auditor adverse?**
 - ▶ **Not yet decided by any of the Circuit Courts of Appeal**
 - ▶ **District courts divided, but most conclude there is no waiver**
 - ▶ **Two cases in the context of tax accrual workpapers, currently on appeal**



CURRENT CASES

- ***United States v. Textron Inc.*, 507 F.Supp.2d 138 (D.R.I. 2007), argued before 1st Cir. on Sep. 5, 2008**
 - ▶ Tax accrual workpapers are relevant; other privileges apply but were waived by disclosure to auditor
 - ▶ Work product doctrine applies under “because of” test; no waiver by disclosure to auditor
- ***Regions Fin. Corp. v. United States*, 101 A.F.T.R.2d (RIA) 2179 (N.D. Ala. 2008), on appeal to 11th Cir.**
 - ▶ Tax accrual workpapers are relevant; other privileges apply but were waived by disclosure to auditor
 - ▶ Did not choose between tests; work product applies under either; no waiver by disclosure to auditor

BUT IN THE 5TH CIRCUIT

- ***United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982)**
 - ▶ Applied the primary purpose test
 - ▶ Concluded tax accrual workpapers:
 - Normally prepared by in house or outside accountants
 - Did not require consultation with attorney
 - Prepared “for financial reporting purposes alone”
 - Prepared “solely to insure balance sheet accrual for contingent liabilities”
- **Difficult hurdle**

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THE FUTURE?



INCREASING TRANSPARENCY

- **IRS reconsideration of policy of restraint?**
- **Current economic climate leading to more pressure on corporate taxpayers**
 - ▶ **Response to GAAP disclosures of FIN 48?**
 - ▶ **Proposal to make corporate tax returns available for public inspection – former Commissioner Mark Everson, Op-ed, *Washington Post*, 10/18/08**

HOW DO YOU BOIL A FROG?

