LawTrends

A publication of Eastman & Smith Ltd.

EASTMAN & SMITH LTD.
ATTORNEYS AT LAW
Established 1844

June 2010
volume 8 number 2

FIN 48: Fish or Fowl?

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Heralded by the Financial Accounting Standards Board (FASB) for providing "relevance and comparability in financial reporting of income taxes" and cursed by attorneys and their clients for its waiver of privilege, FASB Interpretation Number 48 (FIN 48) is both vanguard and villain, indistinguishable as a species, except in the eyes of the beholder. It became effective with respect to GAAP financial statements of publicly held companies in 2007, and all privately held companies and nonprofits with balance sheet assets in excess of $10 million beginning with 2009 operations. Businesses and advisors must learn to collaborate in order to realize benefits from this new order, while preserving the confidentiality of tax advice and fairness in due process of tax controversies.

Background

America's experience with tax shelters in the 90's made it clear that companies' aggressive income tax positions could enhance earnings, sometimes masking the actual results of operations. And, if the tax positions are not sustained upon challenge, the unmasking of true economic activity and tax related deficiencies can result in the economic failure of the enterprise, rendering it unable to satisfy its obligations in the ordinary course. And so, financial statements would remain unreliable for comparing one enterprise to another, and in making other financial decisions, unless accounting standards changed to require detection, measurement and proper reflection of tax loss contingencies.

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The Response

FIN 48 is FASB's two step response. It first requires an enterprise to determine if any of its tax positions are "risky," that is, fails the standard that they will "more likely than not be sustained upon the merits," assuming that the government has full knowledge of all relevant information. Second, the potential tax liability from these positions is calculated and reflected on the financial statement. For nonprofit exempt organizations, that may require recasting the organization as fully taxable. As stated, the rule appears simple, effective and elegant.

Vanguard.

The response from professional advisors, however, was immediate and impassioned. Disclosure of a risky tax position to a third party, that is, an auditor charged with a duty to report to others with transparency, can waive work product privilege, attorney client privilege, and the related IRC section 7525 accountant privilege. Private and privileged good faith positions with an element of business risk, supported by a reasonable basis in law, become discoverable where confidentiality was previously protected by law.

This observation was not wasted on IRS Tax Commissioner Douglas Shulman who in May 2007 issued a memorandum to his LMSB Division directing his large and mid-sized business managers and revenue agents to use FIN 48 compliant financial statements to select businesses for examination. Once pointed in the right direction, the IRS has broad discovery power to gather remaining details from taxpayers, their advisors and third parties, and propose tax deficiencies. This power can extend to a CPA's audit accrual work papers with all the work already done, and the revenue agent need only copy it on to his or her report. The courts and many professionals view this approach as inherently unfair, and a violation of the work product privilege, because an internal evaluation of risky positions is often in anticipation of possible litigation, and law otherwise encourages citizens to consult with competent advisors under a promise of confidentiality in order to promote compliance. Although the IRS has historically followed a policy of restraint when it comes to requesting tax accrual working papers, in the face of such a treasure trove any restraint was lifted as it pertains to all FIN 48 disclosures. The IRS earlier made such an exception for tax shelters in Announcement 2002-63.

This new attitude also is reflected in the IRS's position on waiver of work product privilege. Although unsuccessful so far, it has appealed a key adverse decision to the *US Supreme Court in U.S. v. Textron, Inc.*, a tax shelter case. And beginning in 2010, the IRS is requiring all FIN 48 positions to be disclosed on tax returns. The for-profit organization schedule was released this May. For exempt organizations, Form 990 already has a FIN 48 line item that feeds on to a schedule. "IRS's goal is to reduce the time spent selecting taxpayers and identifying issues for audit. *** IRS is otherwise not changing its policy of restraint." Commissioner Shulman, Announcement 2010-9. In response to which ABA Section of Taxation Chair-Elect Charles Edgerton stated "This is a major deviation from what we used to have . . . There's not much left to exercise restraint on. An awful lot of taxpayers will be affected."

As a result, tax planning for most businesses and nonprofits that use GAAP financial statements has changed forever. Businesses must continue to consult with professional advisors in order to comply with complex, ever changing tax laws and interpretations. And realizing this complexity, Congress allows taxpayers to take good faith positions on their returns on any reasonable basis, without penalty. However, FASB and the IRS now require accountants to tattle on their clients' risky tax positions, even though they may be legal and supportable. And, accountants must do so on the financial statements and tax returns their clients pay them to prepare.

The system appears to be fully self-policing. Taxpayers and return preparers must disclose risky tax positions to the IRS so they can be examined and adjusted, or the taxpayer and return preparers are subject to penalties. Preparer penalties can affect professionals' continuing right to prepare and advise with respect to tax returns, and to appear on behalf of taxpayers in court. Penalties can also have a material adverse effect on malpractice insurance premiums.

Without clarification of how FIN 48 disclosures affect waiver of privilege, significant legal protections and public policy are compromised. Compromise of the attorney client and related accountant privilege can affect a business's willingness to seek the advice of tax counsel. Without adequate counsel, a taxpayer is more likely to inadvertently violate the law. Compromise of the work product privilege destroys the fundamental due process fairness of tax controversies, as it allows an opposing party to "look into its opponent's playbook."

And, if privilege so waived allows the IRS discovery, why would not the waiver also allow discovery by other third parties in litigation?

Villain.

Understanding the Standard

In setting a standard to measure risky tax positions, FASB chose from those already established by law, and used by tax lawyers and accountants in practice for rendering tax opinions. By selecting the standard of "more likely than not will be sustained upon the merits," it reached beyond the standard Congress set for taxpayers of a "reasonable basis taken in good faith."

"More likely than not" requires a sufficient body of law and interpretation in order to measure the comparative strength of the position. Assuming there has been sufficient time for practical interpretation between a law's enactment and the filing of a return, a taxpayer's facts and circumstances must fit the interpretations applicable within its jurisdiction. Administrative rulings, and the decisions among competing Tax Court and the several circuit courts of appeal regularly disagree. In the final analysis, legal precedent and facts must coalesce to demonstrate success upon the merits is more than 50% likely. To this end, there must be something on point to separate a taxpayer's situation from a mere toss up. In today's legislative climate where new laws are enacted daily, Congress regularly employs more general language, relying upon the IRS to adopt regulations and rulings to extend the law into practice. In many of these situations, it is impossible to satisfy the more likely than not standard. Perhaps that is why Congress chose not to impose typical civil penalties where taxpayers ultimately are proven to be wrong, so long as in good faith they relied upon any reasonable basis. Why not set the FIN 48 standard there?

FASB does not think like a tax lawyer.

Experience

Experience with FIN 48 in practice has been somewhat predictable.

Publicly traded companies are more effective in adapting to FIN 48, as their audit committees and boards are accustomed to dealing with this kind of analysis and regulatory compliance. However, as the *Textron* litigation demonstrates, even publicly traded companies must measure justice against the full cost of the legal process, including an appeal to the US Supreme Court. Taxpayers must question the suitability of any aggressive tax position against the resources of a formidable opponent that funds its litigation budget with tax dollars.

In contrast, our experience in representing privately owned companies during the first four months of 2010 resulted several 11th hour calls from clients, shocked and at odds with their CPA. Many of these situations were the result of misunderstandings which were avoidable.

- The company received an audit engagement letter that contained only a clause disclosing that FIN 48 would be included in its scope. There was no pre-audit discussion of what that entailed, exceptions, exclusions, materiality

standards, and the value of a preliminary evaluation by an internal audit committee, perhaps relying upon the privileged advice of legal counsel as to applicable standards and correction of adverse situations.

- There was no discussion of privilege and how it might be protected, or even a suggestion that the company seek the advice of counsel, even in the obvious circumstance of pending or threatened litigation.

- There was no discussion of the scope and purpose of the FIN 48 disclosure, how it is materially different, and sometimes at odds with advice given by the same accounting firm when consulted in a different context, such as tax advice. In many instances, the same accountants who provided counsel in business decisions, transactions, and tax controversies were the same as those called upon to drill down on FIN 48 disclosure.

- FIN 48 disclosure on a financial statement indicating no material items, resulted in a much broader level of transactional due diligence with a third party, who inquired into the full detail of all audit accrual working papers, and eventually very specific representations, warranties and indemnification agreements. In this situation, the CPA had earlier convinced the company to voluntarily submit to FIN 48 prior to its effective date.

In most of these situations, the audit partner ended up at an audit conference with FIN 48 exceptions to a certified audit, facing a client who felt ambushed. In one situation, there was little time to resolve exceptions with a legal opinion, or a calculation that could resolve the exception within the applicable materiality standard.

Many of these issues can be avoided with disclosure, planning and where a risky position is discovered in audit, resolved by a careful review and analysis of legal counsel.

Recommendations

Audit practice and procedures should be standardized to avoid differences in the attention and care given to FIN 48 inquiry and disclosure. The level of attention devoted to publicly held companies in the interest of price may never be attended to much smaller businesses. However auditors should accept a responsibility to educate clients prior to the audit engagement, encourage best practices that engage internal audit committees on tax positions in advance, even if these committees only include the president, CFO and outside legal counsel. As 2009 was the first year of experience for closely held businesses, we expect that practice will improve over time.

Tax positions should be carefully considered, documented and retained in a permanent internal file. This should reduce the cost and embarrassment of scrambling at the last minute only to discover a tempest in a tea pot.

Once a tax position has been disclosed to a CPA firm, it has been disclosed. If it's disclosed to the auditor, some privilege may be lost, but others might not, depending upon the decision in *Textron*. We expect that over time businesses may engage different accounting firms for audit than those hired for their advice where the businesses value privilege and confidentiality. Businesses will have to evaluate the cost benefit of paying two accounting firms, one to advise on operations and transactions, and another for financial accounting.

Engaging the company's law firm to evaluate tax positions, and provide advice on remedies and disclosure is the safest way to deal with the unknown. The lawyer should not be a tax return preparer, so he/she and the firm cannot be compelled to turn over information used in connection with preparation of the return under the IRS summons power. In this way, the lawyer can volunteer, but cannot be compelled to answer questions of the auditor when evaluating FIN 48 issues. The lawyer can, and should, carefully evaluate positions, and develop a reasonable approach with the audit committee, to satisfy the standard, without danger of losing privilege when the issues are discussed, researched and resolved.

Finally the working papers used to determine FIN 48 disclosure should segregate certain records from others, in order to maintain confidentiality, because some may be discovered by the IRS (and perhaps other third parties) and others may not. The following separation should be considered:

- List of tax positions/issues that may be considered under FIN 48. Keep the list separate from the analysis.
- Internal evaluation, including the advice of legal counsel other than the auditor or tax return preparer, or other non-privileged person, of the legal positions involved in the listed positions/issues (may be protected if care is used).
- The calculation of the loss contingency and other valuation (likely to be protected under work product privilege, provided that it is segregated and properly protected as confidential).

Over time, practice should evolve to a point where the Vanguard FIN 48 will not be defeated by the Villain. Until then, only the care and attention of business with the collaboration of advisors can achieve this result.

Addendum: US Supreme Court Declines to Review *Textron* Decision

On May 24, 2010, the US Supreme Court declined to review a decision on work product privilege, affecting the protection of confidential communications among clients, their attorneys and accountants, *Textron, Inc. and Subsidiaries v. United States*.

A brief case history makes the point. In 2001, one of Textron's subsidiaries hired outside legal and accounting firms to evaluate a business strategy of a type later listed by IRS as a tax shelter. Textron anticipated the potential for litigation with IRS, and with the assistance of its advisors, identified the risky positions, evaluated the chances of success on the merits and quantified the potential amounts of additional tax liability. Some of this evaluation was also required of Textron's CPA firm in its audit of financial statements, and was ultimately reflected in tax accrual workpapers.

As anticipated, IRS did examine Textron's tax returns and demanded that they turn over the accountant's workpapers, even though they reflected advice given by attorneys and accountants, and Textron's litigation strategy. Attorney client, accountant client and work product privileges were asserted. The district court ruled that attorney client and accountant client privileges applied but were waived because the advice was disclosed to the accountant in connection with an audit. The court found, however, that the information was protected by the work product privilege, because the tax accrual workpapers were prepared in anticipation of litigation, and that without the risk of litigation they would not have been prepared. The First Circuit Court of Appeals initially agreed with the district court's decision on work product privilege, but later reversed itself in a 3-2 decision after it agreed to rehear the case by the entire panel. The reason for its reversal was that some of the analysis contained in the workpapers was required of the CPA firm in its audit/preparation of financial statements.

A similar conclusion had been reached by the Fifth Circuit in *United States v. El Paso*, the only other case on point, where the court noted that other circuits might take a different view. So, at least for now, none of the federal circuit courts of appeal have found the tax accrual workpapers to be protected, and the US Supreme Court has decided that the issue is not sufficiently important for review.

Will the highest court be persuaded to hear the issue in the future? Since the preparation and audit of Textron's 2001 financial statements, the scope of a CPA's tax accrual analysis has expanded from tax shelters to "all risky tax positions." Because of FIN 48, more circuits will be given an opportunity to address this issue, and perhaps reach a different conclusion. For now, taxpayers must take care in restricting the scope of an accountant's review in audit and preparation of financial statements to only that which is necessary, and should keep further analysis of potential litigation positions confidential from their own accountants. It seems counterintuitive and contrary to sound tax policy for the courts to require taxpayers to protect information from the persons who are acting as tax advisors and counseling them on how to comply with complex laws, in order to avoid the risk of opening the sensitive information to later discovery.

It also is fair to observe that if these testimonial privileges do not protect tax accrual workpapers from the IRS, the information might be open to discovery by other third parties. On the other hand, the court's decisions limiting privilege may have been influenced by privacy laws, that otherwise continue to protect taxpayer information from disclosure to other third parties, where it was obtained by IRS in an examination.

The scope of the *Textron* decision is yet to be fully appreciated.

Mr. Harden is the member of Eastman & Smith responsible for the Firm's tax practice. He is active in transactional business practice and frequently represents clients in tax controversies with IRS, state and local authorities. He is peer reviewed and recognized in Best Lawyers in America (since 1995) and Ohio Super Lawyers every year since its inception. He has a masters of tax law (LL.M) from New York University, a juris doctor from the University of Toledo College of Law and a bachelors of business administration, majoring in accounting, from The University of Notre Dame. Mr. Harden works out of our Toledo office (419-241-6000).

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