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Federal court denies IRS access to taxpayer's work product

A recent federal court decision lends support to taxpayers' efforts to protect their tax accrual workpapers from disclosure to the IRS. The ruling in *U.S. v. Textron Inc.* could prove critical in light of a relatively new accounting standard that requires corporate taxpayers to document their uncertain tax positions and make related public disclosures.

THE CONFLICT

The IRS closely guards its right to access internal corporate documents, including tax accrual workpapers. Relying on a 1984 U.S. Supreme Court decision, the agency has asserted that a company's tax accrual workpapers fall within the scope of documents it may review as part of its tax audit and examination procedures.

These workpapers include documents describing and assessing the risk a taxpayer assumes regarding uncertain tax positions. The documentation can provide the IRS with information about the taxpayer's aggressive tax positions and an assessment of its own risk.

The IRS, however, has traditionally maintained a "policy of restraint" when it comes to actually demanding tax accrual workpapers in routine tax audits. It usually will request the documents only when it has exhausted all other sources of information.

THE IRS' STAND ON FIN 48

In the past several years, the IRS has intensified its enforcement activity for abusive tax shelter transactions — modifying its policy of restraint. In 2002, the agency announced it would be more aggressive in requesting workpapers. It now requires production of workpapers in audits of certain suspected tax shelters that the IRS refers to as "listed transactions."

These increased efforts overlap with the Financial Accounting Standards Board's (FASB's) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). Under the standard, which applies to periods beginning after Dec. 15, 2006, corporate taxpayers must analyze and document their uncertain or controversial tax positions.

The IRS has determined that FIN 48 documentation qualifies as tax accrual workpapers to which it can demand access. The *Textron* case, however, suggests that courts may impose some limits on the agency's reach.

THE TEXTRON SITUATION

The *Textron* case involved an IRS audit that focused on nine listed transactions. The IRS was attempting to enforce an administrative summons seeking tax accrual workpapers related to the transactions.

The papers included spreadsheets listing tax positions that Textron's attorney believed the IRS might challenge. They also estimated the chances of prevailing in litigation and the dollar amounts that should be

STANDING FIRM: THE IRS REFUSES TO BACK DOWN

Less than 24 hours after the ruling in *U.S. v. Textron Inc.* (see main article) was handed down, the IRS Chief Counsel announced that the agency didn't believe the papers constituted work product. He added that the IRS would continue requesting workpapers. Soon after, the IRS issued an "action on" decision — or, a declaration about whether it will follow a court's holding — regarding the 2006 Sixth Circuit ruling in *U.S. v. Roxworthy*.

In *Roxworthy*, the court held that two opinions analyzing the tax consequences of certain transactions prepared in anticipation of litigation were protected from an IRS administrative summons. The IRS's "action on" decision described the court's decision as "incorrect," based on the agency's own reading of the factual record.

It recommended "nonacquiescence," signifying that the IRS will not follow the decision in disposing of cases involving other taxpayers. And it stated that the IRS will continue to aggressively challenge "unjustified assertions of work-product doctrine (and other privileges) in all appropriate cases."

reserved in the event Textron didn't prevail. The papers didn't include any factual information about the transactions at issue.

When contacted by the IRS, Textron refused to produce the documents, claiming the summons wasn't issued for a legitimate purpose and that the papers were privileged.

THE ALL-IMPORTANT TESTS

The District Court for Rhode Island denied the IRS's petition for enforcement. It held that, while the summons satisfied rules requiring a legitimate purpose for enforcement of a summons, the workpapers were nonetheless protected under the work product privilege, as interpreted by the First Circuit.

The court noted that two tests are typically applied to determine whether a document was prepared in anticipation of litigation:

1. The "primary purpose" test. This is applied when the primary motivation behind creating the document is to guard against possible litigation.

2. The "because of" test. A less restrictive test adopted by the First Circuit and other courts, it focuses on whether the document was prepared or obtained because of a prospect of litigation.

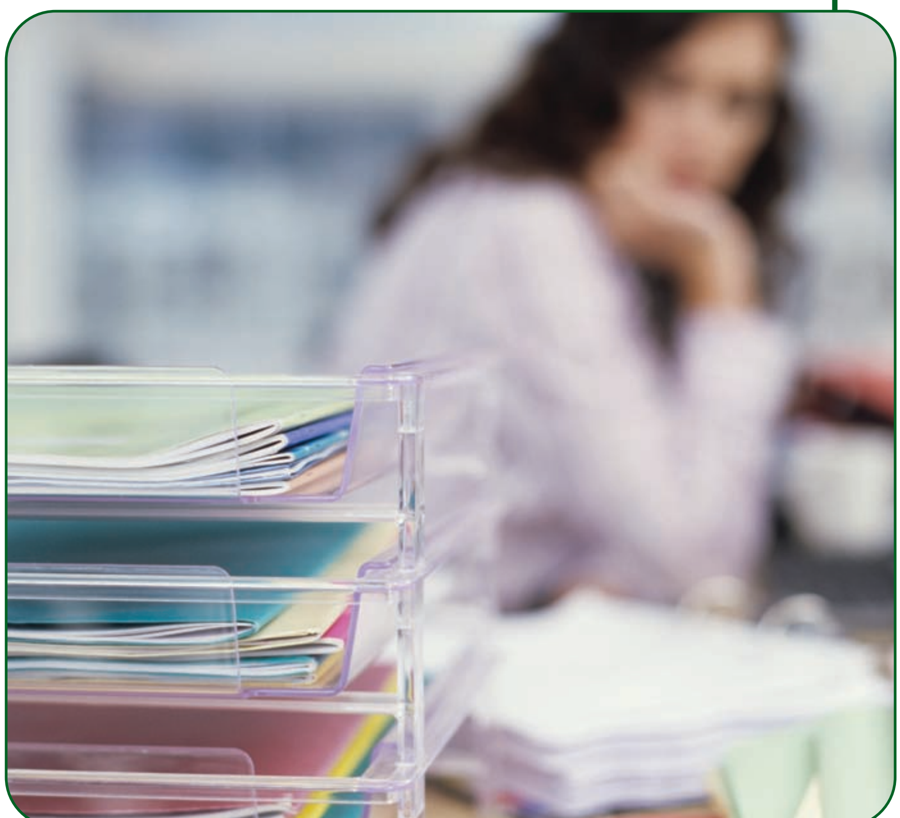
As the court explained, if the document would have been prepared regardless of the anticipated litigation, it isn't protected under the "because of" test.

THE COURT'S FINDINGS

The IRS argued that Textron's workpapers were prepared pursuant to securities laws unrelated to litigation. Therefore, they would have been created regardless of the litigation. The court disagreed, finding that the papers were prepared because of pending or threatened litigation. The court concluded that the workpapers were subject to attorney-client and tax practitioner–client privilege, but Textron waived that protection by disclosing the documents to an auditor.

The court further observed, however, that the disclosure *didn't* waive the work product privilege because it didn't substantially increase the IRS's opportunity to obtain the information in the workpapers. The auditor wasn't a potential Textron adversary or acting on a potential adversary's behalf. And the auditor was under a professional obligation not to disclose any confidential information without Textron's consent.

The IRS could have overcome the work product privilege, but it failed to demonstrate substantial need for the workpapers. The court found that the opinions and conclusions of Textron's counsel and tax advisors would have little bearing on the determination of the company's tax liability. Instead, the court decided, determination must be based on factual information not contained in the workpapers. Forced disclosure of the opinions would put Textron at an unfair disadvantage in any dispute with the IRS.



OUTCOME MIXED

The court's opinion in *Textron* provides a roadmap that corporate taxpayers can follow to protect tax accrual workpapers they deem confidential. But because the years at issue in *Textron* occurred before the standard's effective date, it remains to be seen whether the public filing disclosures required by FIN 48 will waive work product privilege.

Fraud in the footnotes

Omitted financial statement disclosures often tell tales

As any CPA can tell you, the numbers in financial statements rarely tell the whole story. A statement's footnote disclosures often reveal some of the most critical information and can fill in the picture only outlined by the bare numbers.

Fraudulent omissions of these disclosures may distort assets, revenues, liabilities and expenses. Such distortions can prove relevant to a range of legal matters, including shareholder disputes, directors and officers liability, and mergers and acquisitions.

CATEGORIES OF OMISSIONS

Financial statement omissions typically fall into one of several categories:

Liability. U.S. Generally Accepted Accounting Principles (GAAP) require companies to disclose uncertainties or contingencies, such as loan covenants, litigation exposure, disputed contracts, uncertain tax positions and potential environmental cleanup costs. Management may intentionally fail to disclose these contingencies, but financial experts can find them by examining bank statements, sales contracts and warranty documents.

When the company is involved in litigation, direct questioning of counsel can help uncover what management might have hidden. In some cases — for example, when counsel seems uncooperative or is new to the company — checking court records in relevant jurisdictions may be called for.

Management fraud. Regulators require a company to disclose any uncovered management fraud if material revenues or earnings were derived from the fraud, or if the fraud creates the risk of losing a significant business relationship. Even when fraud losses aren't material, any party interested in weak links and potential risks will want to know about the fraud.

Management fraud usually is discovered through tips. To elicit critical information, CPAs know what questions to pose to current and former employees, as well as to third parties such as vendors, suppliers and customers.

Significant events. A company's financial statements must disclose any significant events or one-time charges likely to affect future financial statements, such as the beginning of manufacturing obsolescence. Other items that must be disclosed include:

- Charges that result from material write-downs of inventory and goodwill,
- Charges related to closing down a segment of the business,
- Development of competitive products or technology,
- Plans to make major purchases or assume loan obligations, and
- Significant credit or discounts against sales.

In some cases, the company must disclose these even when they occur subsequent to the financial statement date.

> *Companies must disclose changes in accounting methods, estimates, principles and practices if the change materially affects their financial statements.*

When you suspect significant events haven't been properly disclosed, a CPA can conduct interviews with employees likely to know about one-time charges or other items. An expert may, for example, speak with sales, engineering, warehouse or internal accounting staff.

Related-party transactions. Related parties are considered individuals or companies with the ability to influence one another's financial transactions. For example, an executive or board member may have an undisclosed financial interest in one of the company's suppliers. Related-party transactions frequently are used to illegally shift profits to other entities.

Even if not intended to defraud, transactions among related parties may require an accountant to normalize the earnings. If, for example, the company rents facilities from a related party at a below-market rate, it will skew the bottom line by understating expenses. CPAs uncover undisclosed transactions by comparing a list of key employees with public records of businesses that have relationships with the company. If the company's officers are also listed as officers of these businesses, further investigation is warranted.

Accounting changes. A company's choice of accounting methods can shape its financial results. For instance, the cash-basis method, though not GAAP, records revenue only as it's received and expenses only as they're paid. Under the accrual method, income is recorded at the time of sale, regardless of when payment is received. And expenses are recorded only when goods or services are received.

Companies must disclose changes in accounting methods, estimates, principles and practices if the change materially affects their financial statements. Such changes include those in depreciation methods, standards for revenue recognition and calculation of accruals.

READING BELOW THE LINES

Although GAAP requires specific disclosures, attorneys can easily fall prey to a fraudulent report that omits disclosures. Don't take financial statement numbers at face value — an accounting expert can identify disclosure omissions and determine how they affect the reported numbers.

Forensic investigations

How phased engagements control costs, scope

The cost of forensic accounting investigations can be daunting. But some CPAs are trying to ease the financial pain by offering phased (or staged) engagements. The advantages of this approach for both attorneys and their clients make it worth considering.

BREAKING IT DOWN

A phased engagement breaks down the scope and time frame of a forensic accounting investigation into steps, which are predetermined by you, your client and your financial expert. Each stage comes with its own set of deliverables, making it easier to manage time and costs. Results are based on limits, also of your own design, which keep the investigation process from going on longer than it needs to.

At the end of each stage, you can determine whether to proceed and, if so, whether to expand or restrict the scope of each step or the overall engagement. This way, all involved parties can control each phase and closely monitor findings and costs. And, with all of the CPA's resources focused on the current step, rather than spread across multiple stages, a phased engagement can facilitate a quicker completion and response to your inquiries.

GETTING STARTED

As with most forensic investigations, a staged engagement begins with you, your client and CPA defining the matter, identifying relevant issues and establishing the overall scope, including its limitations. You then project each stage's time frame, cost and deliverables.

From there, your CPA helps determine whether a supportable cause of action exists. He or she examines original source data, such as books, records and documents gathered through discovery or that are otherwise available. Then, your expert provides a written or oral report of the preliminary findings that recommends whether to proceed, identifies potential risks and details additional data required.

Each stage comes with its own set of deliverables, making it easier to manage time and costs.

At this point, you may reach a crossroads where you must decide to expand the engagement by moving ahead or terminate it entirely. If you opt to halt the engagement after the preliminary report, you incur no additional costs. If you choose to proceed, however, the scope of the engagement will likely be better defined and may garner better results.

In a corporate fraud case, for example, the CPA may determine that certain employees are highly unlikely to be fraud perpetrators. If the engagement continues, the expert can focus on those suspects who haven't been cleared. But your client, who may be comfortable that key employees have been absolved and other employees aren't in a position to perpetrate fraud, may decide to terminate the engagement. In doing so, your client will certainly save money, but he or she could still be at risk for fraud.

FULL SPEED AHEAD

If you do decide to proceed, your CPA conducts an in-depth document analysis. He or she expands the field of review to encompass a greater number of books, records, transactions and documents obtained from the opposing party. The analysis could include:

- Financial statements,
- The general ledger,
- Journal entries,
- Petty cash reconciliation,
- Cash receipts and disbursements,
- Canceled checks, wire transfers and debit and credit memos (front and back),
- Bank statements,
- Income tax returns,
- Related-party transactions, and
- Merchant accounts.

When reviewing transactions, the expert traces each step and examines any supporting documents from, for example, purchase requisitions to related general ledger entries. In some cases, the requisite data may not be in a useful form or may be entirely inaccessible. The CPA then needs to reconstruct books, records or transactions.

It's unlikely, however, that an expert will be able to reconstruct data out of whole cloth, so your expert will likely look for evidence in books and records that can support reconstruction. These might include canceled checks, leases and shipping documents. A CPA also may turn to third parties, such as vendors, suppliers, customers and banks, to verify the investigation's findings.

At this point, the CPA issues another written report that details the findings, remaining risks and any additional information that still must be obtained. The report concludes with a recommendation to expand the investigation, conduct more discovery or conclude the matter.

SMALL STEPS

A phased engagement breaks the often complex forensic accounting investigation process into discrete and manageable segments. This type of engagement may not be appropriate for every client — but, for those particularly concerned about cost and time, a phased investigation is worth considering. ◗

FIN 46 may affect valuations of partnership interests

Several years ago, in response to a rash of corporate financial scandals, the Financial Accounting Standards Board (FASB) released Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities*. Because FIN 46 could have implications when valuing partnership interests for litigation purposes, it may be of interest to you.

THE STANDARD'S GENESIS

FIN 46 interprets an accounting standard for consolidated financial statements previously issued by the AICPA's Committee on Accounting Procedure. That standard required an enterprise's consolidated financial statements to include subsidiaries in which the enterprise holds a controlling financial interest. Typically, the standard was applied when a company had a majority voting interest in a subsidiary.

FASB determined that the so-called voting interest approach wasn't effective for identifying controlling financial interests in entities not controllable through voting interests. The standard was equally ineffective when used to analyze entities whose equity investors didn't bear the entity's residual economic risks.

FIN 46 MANDATES

A variable interest entity (VIE) is a corporation, partnership, trust or any other legal business entity that either doesn't have equity investors with voting rights, or does have equity investors with voting rights, but they don't provide sufficient financial resources for the entity to support its activities. In the latter case, these entities often hold financial assets such as loans, receivables, real estate and other property.

FIN 46 mandates that a VIE be consolidated by a company if that company is subject to a majority of the risk of loss from the VIE's activities. Consolidation also is required if the company is entitled to receive a majority of the VIE's residual returns. In these cases, the assets, liabilities and results of the VIE's activities should be included in the company's financial statements.

A company that consolidates is described by FIN 46 as the "primary beneficiary." The standard notes that the ability to make decisions doesn't constitute a variable interest. Instead, it indicates that the decision maker should carefully consider whether it holds sufficient variable interests to qualify as a primary beneficiary. A company that holds significant variable interests but isn't a primary beneficiary is subject to disclosure requirements.

LITIGATION MATTERS

The FASB standard may arise in litigation related to buy-sell agreements, estate taxes and, most often, divorce. For example, a spouse might have established multiple business entities, such as a corporation along with a real estate partnership that owns the building in which the corporation operates. Under FIN 46, the corporation's financial statements must consolidate the partnership.

The question in litigation is whether, when valuing an asset, the financial expert should perform a single consolidated valuation or two separate valuations. It can make a real difference, because the different entities could very well carry different capitalization rates. Applying one capitalization rate in a consolidated valuation can produce an inaccurate value.

LEVERAGING THE STANDARD

Of course, FIN 46 is an accounting standard, not a law. So the question of whether to consolidate VIEs for valuation purposes is unsettled. Work with your financial expert to make sure he or she is prepared to argue the appropriate position in court.