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together

The Proposed IRS Policy Change:
Its Impact on Corporate Governance and
Corporate Litigation Risk Management

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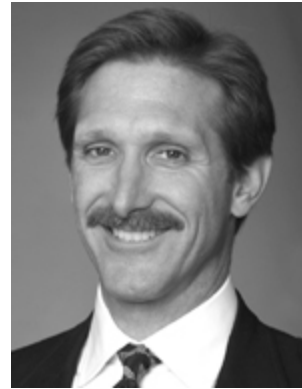
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Program

- A brief overview of the IRS proposal to disclose uncertain tax positions and maximum amounts.
- How audit committees and GCs can address potential changes in corporate governance procedures and risk management.
- How GCs and their staff can anticipate and reduce litigation risks.
- Q&A
- CLE (and CPE) Credit Application Guidelines

Current IRS Policy

- Corporate taxpayer signs and files return based on decisions about tax positions.
- Corporate tax returns often incorporate uncertain tax positions.
- In rare and limited circumstances taxpayers are required to “disclose” uncertain tax positions in the tax return filings.
- IRS generally has three years from the time the return is filed to start a civil corporate examination.

Current IRS Policy

- IRS usually asks questions through “IDRs”. Taxpayers generally provide documents or written answers.
- IRS exam process is about the IRS finding issues.
- IRS might or might not catch an issue. Sometimes called the “audit lottery.”
- IRS examiners often review public filings and focus on references to financial accounting reserves (e.g., Fin 48 reserves).
- IRS policy of restraint with respect to FIN 48 workpapers and *Textron* case.

IRS Commissioner Shulman

January 26, 2010

- “Today, we spend up to 25 percent of our time in a large corporate audit searching for issues rather than having a straightforward discussion with the taxpayer about the issues.”
- “It would add efficiency to the process if we had access to more complete information earlier in the process regarding the nature and materiality of a taxpayer’s uncertain tax positions.”
- “We could have asked for more ... a lot more ... but chose not to.”
- “This is a game-changing strategy for the IRS.”



IRS Announcement 2010-9

The IRS proposed a new return schedule:

1. Schedule must include “a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve on it’s financial statements.”
2. Schedule must include a statement of “the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer’s risk regarding its likelihood of prevailing on the merits).”

Proposed Tax Return Schedule

- To be sufficient, the description must contain:
 - A list of the Code sections potentially implicated by the position;
 - A description of the taxable year or years to which the position relates;
 - A statement of whether the position involves an item of income, gain, loss, deduction or credit against tax;
 - A statement of whether the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both;
 - A statement whether the position involves a determination of the value of any property or right; and
 - A statement whether the position involves a computation of basis.

Proposed Tax Return Schedule

- Schedule must include a statement of “the maximum amount of potential federal tax liability attributable to each uncertain tax position...”
- The maximum amount is “determined without regard to the taxpayer’s risk regarding its likelihood of prevailing on the merits.”
 - 60% chance of winning an issue – still must state maximum amount.
- No materiality threshold.
 - Small reserve – still must disclose maximum amount.

“Uncertain Tax Positions”

- Any position for which a reserve must be established under FIN 48 or other accounting standards (IFRS and/or local GAAP).
- “[U]ncertain tax positions will include any position related to the determination of any United States federal income tax liability for which a taxpayer or a related entity has not recorded a tax reserve because (i) the taxpayer expects to litigate the position, or (ii) the taxpayer has determined that the Service has a general administrative practice not to examine the position.”
- Do you need to disclose if you have a tax opinion on the issue?

Scope and Comment Period

- General rule - the new form will apply to taxpayers with total assets in excess of \$10 Million.
- Also applies to a taxpayer that prepares financial statements, or is included in the financial statements of a related entity that prepares financial statements, if that taxpayer or related entity determines its U.S. federal income tax reserves under FIN 48, or other accounting standards relating to uncertain tax positions involving U.S. income tax.
- Comments on proposal due March 29, 2010.

Tax Risk and Controls

- Tax risks and controls fall squarely within the scope of most Audit Committee duties today.
- Often Audit Committees do not include a tax expert, making oversight in this area particularly difficult.
- Doug Shulman, IRS Commissioner, has said "You, the board, have to oversee how management manages tax expense. That means some level of understanding, a set of policy principles and then a control system of reporting...."

Tax Oversight as a Standard Component of Enterprise Risk Management

- Tax risk covers all sources of risk that may create an unexpected adverse outcome from a tax position.
- Tax risk assessment and control procedures need to be built into any company's control procedures.
- Regular reporting to the Audit Committee and active oversight by the Committee of tax risk and control procedures is essential as part of the total risk management environment.

Assessment of Uncertain Tax Positions Should be a Part of the Audit Committee's Function, Even Without the New IRS Position

- Audit Committees should require management to keep them appraised of tax positions that carry a meaningful risk of being overturned where such action could result in a material risk to the company.
- Management should regularly report tax positions that carry a risk of material loss.
- The Audit Committee should participate in the assessment of the appropriate level of such risk, as it does with other risks of a financial nature.
- Typically this advice should come from the legal department or outside counsel as privileged communications.

Boards and Audit Committees Typically Need to Rely on Management or Outside Advisors in making Tax Judgments

- Unlike financial experts, most Boards and Audit Committees do not have tax experts among their members.
- Section 141(e) of the Delaware Corporation Law specifically authorizes Boards and Committees to rely in good faith on reports, opinions or statements from management, employees and others as to matters that the directors reasonably believe are within such other person's professional or expert competence.
- The foregoing is a key protection and Boards and Audit Committees should insist on expert advice to assist them in making these judgments as to tax risks.

IRS Position and Potential Corporate Governance Quandaries

- The new IRS position creates a quandary for Audit Committees:
 - On the one hand, Audit Committees should be requiring reports regarding uncertain tax positions;
 - On the other hand, if the IRS prevails in its new position, the Committee will have detailed knowledge of the information and could incur liability for failure to disclose such information.
- Ultimately, the Audit Committee needs to continue to fulfill its fiduciary duties, so it will have no choice other than to continue to be well-informed.

Development of Disclosure Procedures

- If the IRS position prevails, all companies will need to develop new disclosure controls and procedures with respect to these risks.
- It will take some time for standards to develop in this regard. In the meantime, consistency in style and format with other risk reporting is recommended.

A Litigator's Perspective

- *Textron* and erosion of the protection for work product
- Inspection of books and records - Section 220 and *Thomas & Betts*
- Derivative litigation - *Marshall v. Kovacevich, et al.*

Questions?

Thank you for your participation.