JULY/AUGUST 2008 VOL. 24, NO. 7

CFO

DON'T MESS WITH THE IRS

The agency is taking companies to court more often, and winning. Is it time to rethink your tax position?

BY ALIX STUART

"Many companies that are able to litigate are reluctant to do so," because penalties may mount. FIN 48 also prompts companies to forgo a fight.

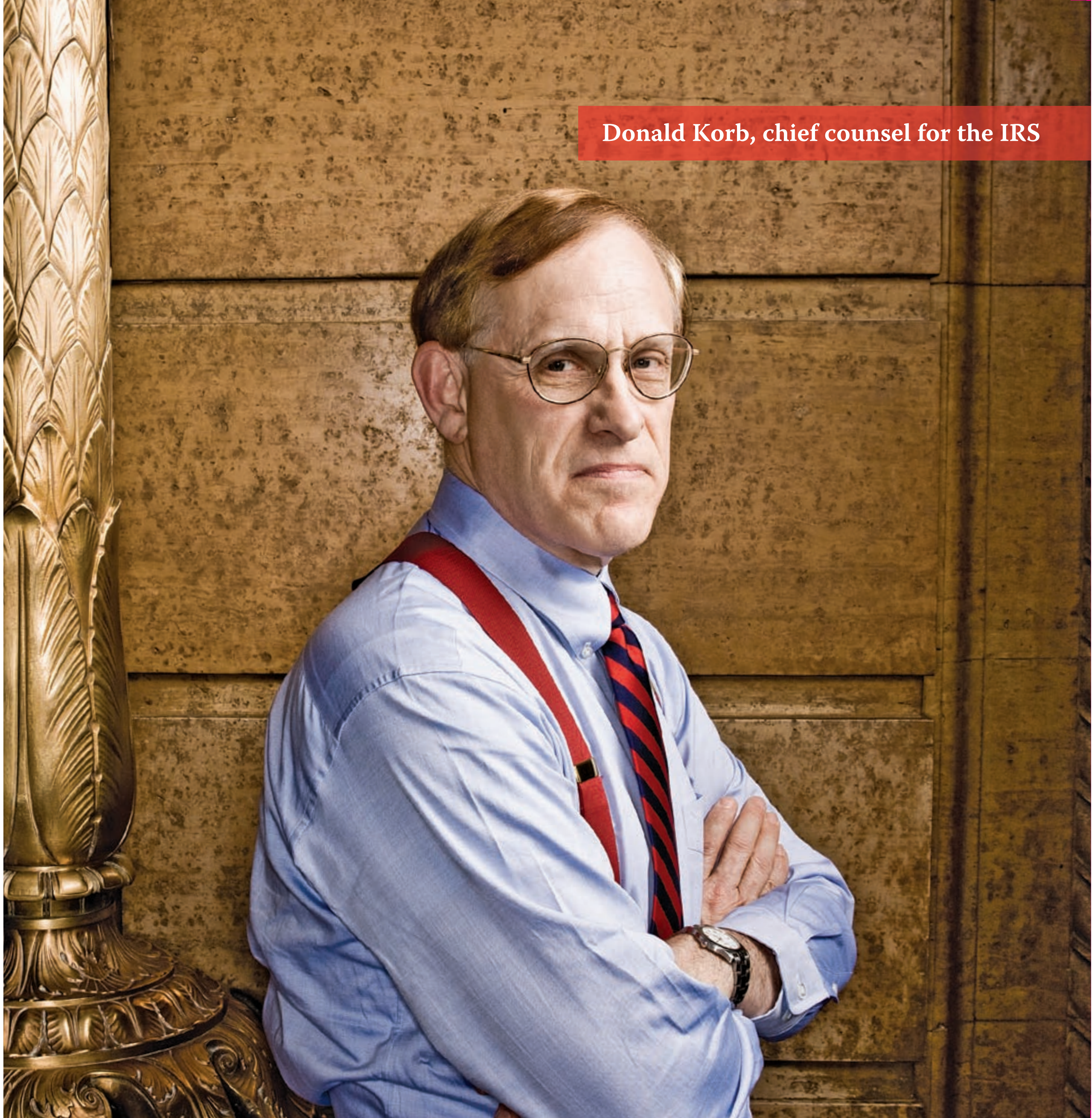
LAWRENCE GIBBS,
FORMER IRS COMMISSIONER

Cover photo by Robert Houser; this page, Katherine Lambert

Don't Mess with the IRS

The agency is taking companies to court more often, and winning. Is it time to rethink your tax position? BY ALIX STUART

APRIL, always the cruelest month for taxpayers, became more so this year when the Internal Revenue Service racked up yet another victory against a corporate tax shelter. At issue was a decade-old transaction



Donald Korb, chief counsel for the IRS

between a U.S.-based financial holding company, BB&T Corp., and a Swedish wood-pulp manufacturer, Sodra Cell.

In 1997, BB&T leased a 22 percent interest in pulp-manufacturing equipment at one of Sodra's mills and immediately subleased it back to Sodra. That brought BB&T a nice deduction. And, the IRS charged, not much else. To the agency, the deal was a prime example of an abusive tax shelter known as lease in, lease out (LILO). Although the transaction predated the 1999 tax code changes that shut down LILOs, the IRS challenged it and won in 2007—the first time such a shelter had been tested in court.

Then, in April, a federal appeals court sided with the IRS. For BB&T, the verdicts meant an additional $1.2 billion paid in taxes and interest to clear its bill for Sodra and similar transactions.

The BB&T case is just one of several major tax-shelter cases won by the IRS in recent months. The shock waves from those victories are reverberating far and wide. Certainly, any of the hundreds of companies that have engaged in LILO or SILO (sale in, lease out) transactions, banned in 2004, will be reviewing their options. Banking giant Wachovia, for one, announced in April that as a result of the BB&T verdict it would take up to a $1 billion noncash charge to earnings related to SILO transactions. Another bank, KeyCorp, said in June that it would take a charge to earnings and capital of up to $1.2 billion, halve its dividend, and issue shares to raise another $1.5 billion—all because of a SILO strategy involving a German waste-to-energy facility that was struck down by the Northern District of Ohio court.

LILOs and SILOs haven't been the only shelters in the IRS's crosshairs. Last April, in a case involving a so-called intermediary transaction, a Texas federal court judge decided that Enbridge Energy was liable for more than $155 million in past and future taxes, plus penalties. Enbridge had bought stock in a pipeline company in 2001 through what was eventually deemed a sham company, thus gaining tax deductions.

PORTRAIT BY BILL CRAMER

Even companies that aren't harboring any tax shelters on their books may not be safe. Experts say the IRS's treatment of all types of tax disputes is changing as the agency applies the tough tactics it used in shelter cases to more-ordinary transactions. Gerald Kafka, global chair of Latham & Watkins LLP's tax-controversy practice group, calls this "the trickle-down effect," which includes more national coordination on issues, a greater involvement of attorneys, and more requests for information from corporate advisers and other third parties. This new approach, coupled with an unprecedented amount of new disclosure required from companies, has made the IRS a fundamentally tougher opponent, both in court and out. "The odds are overwhelmingly in our favor," says Donald Korb, chief counsel for the IRS since 2004.

Making an Example out of You

It wasn't too long ago that the IRS was considered a toothless tiger by big companies with smart tax departments. "There was a long time when the IRS couldn't litigate its way out of a paper bag," claims one attorney, noting that the agency routinely lost transfer-pricing cases in the 1990s. That began to change several years ago when the IRS adopted a new strategy of brinkmanship, pushing more cases to trial to make examples of corporate defendants. In particular, the agency won dozens of cases against companies that engaged in life-insurance and contingent-liability shelters.

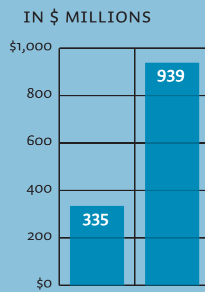
To be sure, few tax disputes actually go to trial. According to the IRS, about 85 percent of disputes are settled through alternative means, including the agency's internal appeals process. But experts who advise companies in their dealings with the IRS say it's getting harder to reach agreements in each step of the process leading to litigation (see "Appealing Options," page 60).

For his part, Korb says that, in general, the IRS would rather settle than litigate. But to encourage more settlements, the agency is deliberately pushing some companies to trial—refusing to settle for less than 100 percent of taxes owed, plus penalties and interest—in order to make an example of them. The idea is to win a number of cases and thus pressure other companies that made similar transactions to "fold their tents" and pay up, says Korb. "At some point, if the government wins four or five cases, it's going to be hard to have give-and-take," he warns.

Katherine Lambert

Penalty Shock

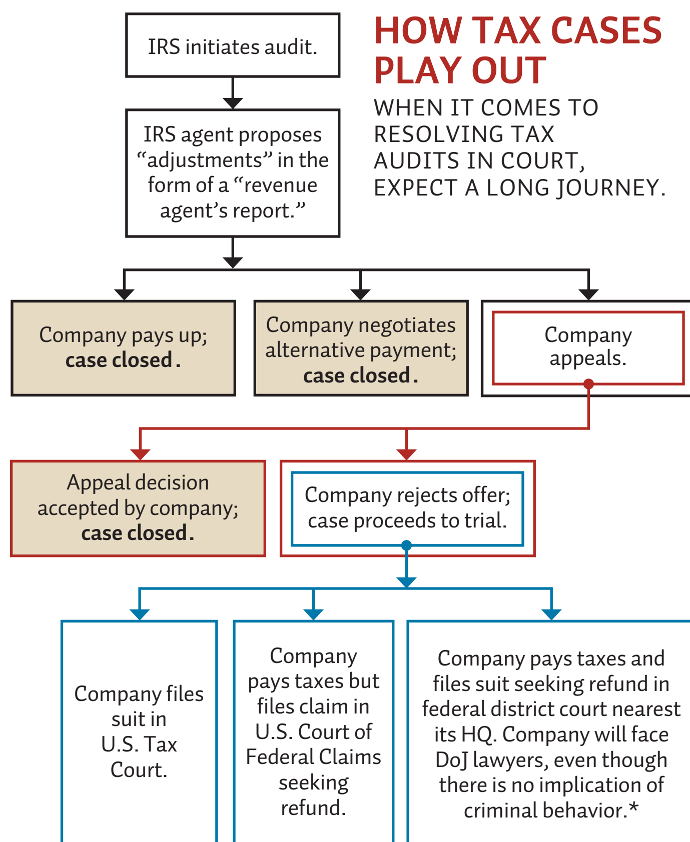
The rise in income-tax-related corporate penalties



Source: Internal Revenue Service

Keep It Simple, Taxpayer

On the other hand, some companies would rather fight than settle. Reading International, a cinema-complex owner and operator, recently turned down an IRS settlement offer of $8 million that emerged after a mediation session in 2005 and plans to "aggressively litigate," according to its most recent filings with the Securities and Exchange Commission. The dispute concerns which of Reading's subsidiaries should bear the tax liability for a 1996 stock sale. "While there are always risks in litiga-



biggest concern," he says, since it automatically makes the IRS suspicious.

That simplicity will come in handy when it's time to round up witnesses, too. Experts say the ideal witness in a tax case is a business executive who can explain why the tax benefits were merely the side effect of an essential business transaction. But the best witnesses are typically "scared to death," because the transactions they are asked to defend are so complicated, says Gibbs. (Tax and finance executives "don't tend to be very credible," notes Gibbs, because they obviously have a vested interest in the tax side.)

Then there is the issue of documentation. Supporting opinion letters that come from the same accounting or law firm that sold a tax shelter will not be very persuasive, says Gibbs. Other documents may contain damning details. In BB&T's case, the court noted that not only had an internal assessment of the deal concluded it was "tax-driven," but that Sodra's tax advisers had also characterized the deal as a purely financial transaction that did not affect its interest in the plant.

Still, some companies settle even when they believe they have a defensible case. "Many companies that are able to litigate are reluctant to do so," comments Gibbs, in large part because they don't want to run the risk of incurring a

TO BE SURE, FEW TAX DISPUTES ACTUALLY GO TO TRIAL. ACCORDING TO THE IRS, ABOUT 85 PERCENT OF DISPUTES ARE SETTLED THROUGH ALTERNATIVE MEANS.

tion, we believe that a settlement at the level currently offered by the IRS would substantially understate the strength of our position," the company says. The case is now in the discovery phase, in anticipation of a trial in 2010.

Companies that choose to litigate have several options as to where to file their lawsuit (see "How Tax Cases Play Out," this page). They can file in the U.S. Tax Court, the U.S. Court of Federal Claims, or the federal district court nearest the company's headquarters. The choice of venue hinges on many factors, say lawyers. Cash flow is one: a company can defer paying its taxes if it files in U.S. Tax Court, but it will also face less-favorable odds, as the court's judges are generally tax experts. By contrast, federal district courts require companies to pay taxes up front and then seek a refund, but they have traditionally offered better odds to plaintiffs.

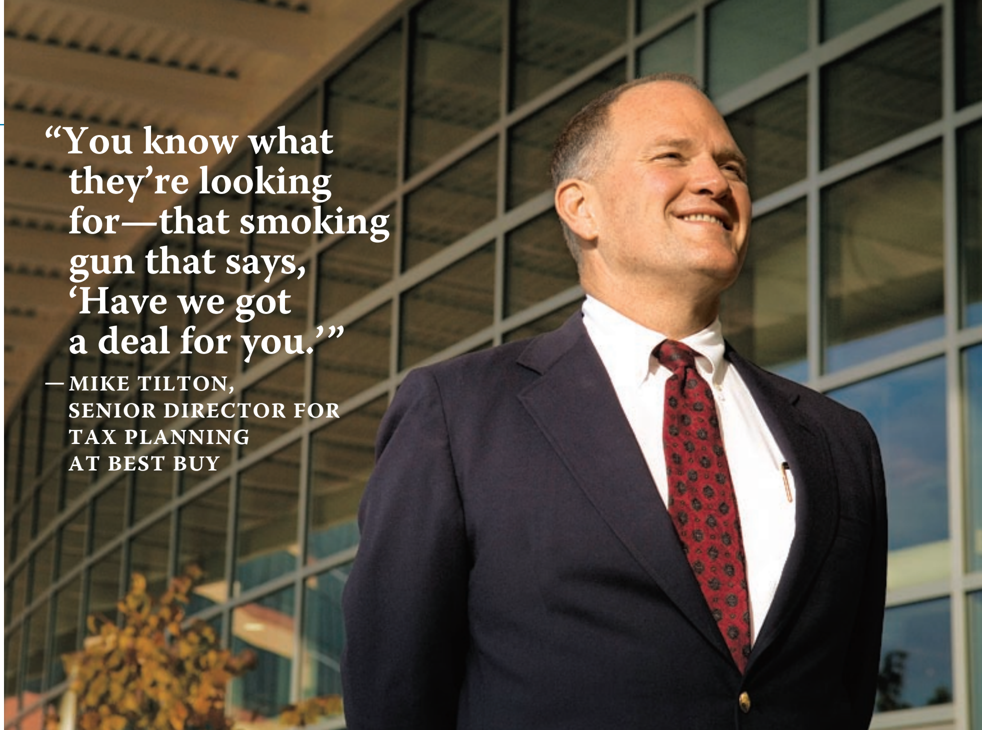
What makes a good case for trial? "The best way to defend any planning transaction is to make it as simple as possible," something easily explainable to a layperson, says Lawrence Gibbs, IRS commissioner from 1986 to 1989 and now a partner at law firm Miller & Chevalier. "Complexity is really the

tax penalty, not to mention negative publicity. Under current policy, tax penalties can accrue automatically depending on the amount in dispute, even if a company has paid its taxes in full and is seeking a refund. As a result, the IRS's take from corporate penalties has nearly tripled, from a net $335 million in 2002 to $939 million in 2007.

Sunk costs may also induce companies to settle. FASB Interpretation (FIN) 48, which requires companies to assess the strengths of their tax positions and reserve for any amount they think they might lose, makes it more likely that a company has already set aside money for tax payments in dispute. That lessens the sting of actually paying them, at some level, and also makes a restatement less likely, further reducing the costs of folding the tents.

The administrative annoyance of maintaining proper reserves and adding interest to them is also an incentive to settle. "Thanks to FIN 48, many companies are trying to get through their cases, even if they think they're going to win, so that they don't run the risk of having interest accruals to tax reserves," says Gibbs.

For that matter, a CFO may well decide to settle if the disputed transaction preceded his or her tenure at the company. "The people who are left behind to clean up the mess often don't want to go to the mat, because it wasn't their transaction," says Korb. "We hear that a lot."



"You know what they're looking for—that smoking gun that says, 'Have we got a deal for you.'"
—MIKE TILTON, SENIOR DIRECTOR FOR TAX PLANNING AT BEST BUY

Pressing for More Information

Still another reason some companies may shy away from court is that recent disclosure rules have given the IRS powerful tools for probing the most sensitive tax-related documents. Since 2005, companies have been required to file M-3 schedules, which reconcile book and tax accounting and spell out differences between temporary and permanent credits. In previous years, IRS agents "would look at SEC tax accounting, but not really understand it," says Cheryl Anderson, director of federal income tax for Ryan, a tax advisory firm. "Now they do." That means it's harder to get easy wins in negotiations, such as agreeing to abandon a temporary tax credit in one year and then using it in another.

FIN 48 itself could also cause more problems. So far, the disclosure it requires about uncertain tax positions has proved less helpful to the IRS than originally feared, in part because companies are not required to distinguish among federal, state, local, and international taxes. However, there's little to stop the agency from asking for more detail.

In some cases, the IRS will even ask a company to release its tax-accrual work papers that explain the company's thinking about a transaction, a category that could include FIN 48 documentation as well. So far the agency has requested work papers from some 140 companies involved in tax shelters. Two companies, Textron Corp. and Regions Financial, are fighting those requests in court.

But even if they win their cases, the IRS won't be deterred from seeking work papers from other companies, say experts. "It would be oversimplifying to say that every company in the First Circuit [where Textron's appeals case is being heard] would be safe if the court affirms Textron's position," says Latham & Watkins's Kafka. Both cases, he notes, "have a very specific set of facts" not likely to occur at other companies.

The Senate could push that policy even further. Last year its permanent subcommittee on investigations asked some companies for more disclosure, and has said it is likely to hold a more formal hearing in the future.

Even when shelters aren't involved, the IRS has been pressing for more and more information. Revenue agents are presenting "super," or broadly worded, information document requests for transactions that aren't on any watch lists, says

MOST TAX DISPUTES ARE RESOLVED OUT OF COURT, BUT REFUNDS MAY BE HARDER TO OBTAIN IN THE FUTURE.

Appealing Options

HISTORICALLY, seeking a second opinion through the IRS Appeals Division hasn't been a bad option for companies in a tax dispute. Although the process can take two or three years, "for ordinary issues the Appeals Division is slanted toward the taxpayer," says Cheryl Anderson, director of federal income tax for Ryan, a tax advisory firm. Recently, fruit grower Dole Food successfully challenged its auditor's assertion that it underpaid taxes by $175 million between 1995 and 2001. In addition to a $1 million refund, the company says it is likely to reduce its income-tax provision by $60 million and goodwill by $70 million. Hercules Inc. and Integra Bank have also recently claimed tax refunds as a result of appeals.

But such deals may be harder to come by in the future. Gerald Kafka, global chair of Latham & Watkins LLP's tax-controversy practice group, says the appeals division now requires its officers to obtain approval from issue experts, who make sure that similar cases receive similar offers. **In order to gain any leverage, says Kafka, companies "have to look for something that will differentiate them from the pack—a better set of facts, or perhaps a procedural difference."** One of the best differentiating factors can be the appointment of a new CEO or CFO that coincided with a controversial tax transaction, he says. Statements by a new CFO about maximizing cash flow or decreasing interest cost, for example, may make an otherwise suspect transaction look better. —A.S.

Mark Luinenbug

THE IRS IS STEPPING UP ITS SCRUTINY OF EXECUTIVE PAY.

Tax Hit May Be A Contract Killer

IN RECENT YEARS, the Internal Revenue Service has been on a mission to excise some of the tax-related fat from executive benefits. Now, several high-profile executives, including a former CFO, are bearing the consequences.

In June, the IRS took on billionaire investor Philip Anschutz with one of its first crackdowns on a popular executive stock diversification tool known as a variable prepaid forward contract. Earlier this year, the agency issued an advisory encouraging agents to take a hard line on the contracts, which allow executives to defer taxes on capital gains by lending, rather than selling, stocks to a third party in exchange for an upfront gain. Now Anschutz, who owns large stakes in entertainment, railroad, and oil companies, is disputing back taxes of $143.6 million in U.S. Tax Court related to such contracts.

Experts say the case is likely to be the first of many. “I would expect to see more challenges,” says Steven Rosenthal, partner with law firm Ropes & Gray LLP. “Since there’s been a lot of guidance to the field [tax agents], you would expect the field to be asking questions.”

Landov

The IRS took on billionaire investor Philip Anschutz with one of its first crackdowns on a popular executive stock diversification tool.

Meanwhile, in the past five years the IRS has boosted the number of tax-related cases it refers to the Department of Justice for criminal prosecutions by 40 percent. A good number have involved backdated stock options. According to IRS statistics, 19 of the 114 executives implicated in backdating stock options refused to settle on the agency’s terms (100 percent of taxes owed, plus interest and a 10 percent penalty), so more cases may be forthcoming.

Companies may soon feel the heat as well. The IRS recently issued a new rule that challenges the deductibility of some bonus pay for executives who leave their companies, says tax expert Robert Willens. That ruling could lead to even more efforts by the IRS to curb what it views as excessive executive pay, he adds. “It is not inconceivable that the IRS might start bringing cases in which they assert that the compensation paid is not deductible, in whole or in part, because it exceeded a reasonable allowance for services actually rendered,” says Willens. —A.S.

Mike Tilton, Best Buy's senior director for tax planning. Such requests, he adds, ask for “anything that’s ever been written” about transactions, often because agents don’t understand them. “You know what they’re looking for—that smoking gun that says, ‘Have we got a deal for you.’ And it’s often not there,” says Tilton.

The IRS’s growing power is likely to leave more companies cowering, despite whatever bungles individual agents make. No doubt, tax experts will continue to try to minimize corporate tax exposure. But with even legitimate business deductions, like research and experimentation credits, coming under scrutiny, fewer companies will try to push the envelope. Says Kafka: “A company breaking away from the pack as a result of a specific tax strategy is going to be a lot less likely than in the past.” **CFO**

ALIX STUART (ALIXSTUART@CFO.COM) IS A SENIOR WRITER AT *CFO*.

Reprinted with permission from CFO, July/August 2008. Visit our website at www.cfo.com.
© CFO Publishing Corporation. All Rights Reserved. FosteReprints: 866-879-9144, www.marketingreprints.com.

MILLER CHEVALIER