In-House Tax Executives Beware: The SEC May Come Calling with a Books and Records Claim

The SEC’s books and records case against Debra Keith, the former vice president for taxes at ConAgra Foods, Inc. (ConAgra) from 1998-2004, should serve as a wake up call to in-house tax accountants to: (1) expect increased scrutiny from the SEC; (2) make themselves aware of their responsibilities under SEC rules and regulations; and (3) act proactively to minimize exposure to claims of securities law violations by the SEC. On June 29, 2007, the SEC announced that it had filed settled civil actions in the U.S. District Court for Colorado against Ms. Keith, as well as other former executives of ConAgra. Ms. Keith settled the SEC books and records claims against her, without admitting or denying the allegations, by agreeing to disgorge $132,456; divestiture of her right to receive a restricted cash payment of $71,712, representing the market value determined on June 28, 2007, of 2,656 shares of ConAgra common stock; pay $19,225 in prejudgment interest; divest 866 unexercised ConAgra stock options; pay a civil penalty of $60,000; and to a permanent injunction restraining and enjoining her from directly or indirectly violating Exchange Act Rule 13b2-l by, directly or indirectly, falsifying or causing to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act, and from aiding and abetting any violation of Sections 13 (a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13. Although settled, a review of the SEC’s allegations of unreasonable behavior by Ms. Keith are important for all in-house tax accountants to understand.

The SEC alleged that Ms. Keith violated Exchange Rule 13b2-1, which prohibits any person from falsifying or causing the falsification, directly or indirectly, of any book, record or account of public companies (books and records violation). The SEC alleged that without the tax errors in the financial statements, ConAgra would have missed the Wall Street analysts’ consensus earnings estimate and thus Ms. Keith profited indirectly from these errors through the ConAgra stock incentive plan. The SEC’s case against Ms. Keith, based on pre-FIN 48 standards, suggests that the SEC will rely more heavily on books and records claims.
in the future, especially now that FIN 48 is effective since the standards for recording the positions have been raised. Therefore, we thought a brief discussion of why in-house tax accountants should expect increased scrutiny from the SEC and what they can do to minimize their exposure might be helpful.

Books and Record

The first step is to understand the purpose of Exchange Rule 13b2 and how courts have interpreted Rule 13b2-1. Generally, the purpose of Section 13b of the Securities Exchange Act of 1934 and Exchange Rule 13b-2 is to force publicly traded companies to maintain accurate records.4 The rule applies to recorded transactions as well as those that should have been recorded.5 To commit an Exchange Rule 13b2-1 violation, a defendant need not be an officer or employee of the company.6 The defendant need not be the sole cause of the company’s false statements or failure to disclose a material fact. Merely “indirectly . . . caus[ing]” a record “to be falsified” is sufficient.7 For example, a violation can occur if reporting to the CEO or CFO of the corporation that improperly completed records were complete—even if at the same time other members in the company improperly switched accounting methods to create false books.8 Finally, to prevail the SEC must prove that a defendant acted unreasonably.9 Although the SEC is reluctant to use negligence as a synonym for unreasonable behavior, acting unreasonably suggests a standard that is tantamount to negligence.

Added to this mix is the fact that FIN 48 raises the standard by which in-house tax accountants will be judged. FIN 48 imposes higher standards of reasonableness that tax accountants must meet: (1) a tax position must be more-likely-than-not of being sustained based solely on its technical merits prior to recognizing the benefit of the tax position for financial statement reporting purposes; and (2) tax positions should be reported as the largest amount of benefit that is cumulatively more likely than not to be realized. In addition, FIN 48 expands a tax accountant’s obligation from consideration of tax positions using a loss liability approach to evaluating all tax positions within the scope of FAS 109, which applies exclusively to income taxes, on an asset approach. By increasing the obligations of tax accountants, FIN 48 lowers the bar for proving unreasonable behavior by tax accountants and makes it easier for the SEC to prove that a tax accountant acted unreasonably.

By contrast, a claim of false or misleading statements or failure to disclose material facts based on section 10(b) of the Exchange Act and Exchange Rule 10b-5 requires proof of a knowing violation, or one that is severely reckless. Severe recklessness requires proof that an accounting practice is so deficient that the audit amounted to no audit at all (or the tax accountant’s decisions are a sham), or an egregious refusal to see the obvious, or to investigate the doubtful, or that no reasonable accountant would have made the same accounting judgments if confronted with the same facts.10 Comparatively, proving unreasonable behavior is less difficult than proving a knowing violation or one that is based on severely reckless behavior. Therefore, it is reasonable to assume that the SEC will focus on books and records violations that indirectly cause false or misleading statements or the failure to disclose material facts.

Alleged Tax Errors

With these principles in mind, the case against Ms. Keith provides in-house tax accountants with examples of behavior that the SEC regards as unreasonable under pre FIN 48 standards of reasonableness that, quite frankly, many will find disturbing, especially in light of the higher standard of reasonableness to which tax accountants must perform their work. The SEC claimed that Ms. Keith knew or should have known that “ConAgra failed to record adequate income expense in FY 1999, FY 2003, FY 2004, and the first two quarters of FY 1999.”11 The alleged tax error resulted in a restatement for ConAgra’s fiscal years 2002 – 2004 and an aggregate net increase in income tax expense of $105 million in income tax expense.12

Specifically, the complaint alleged that Ms. Keith:

- failed to ensure that ConAgra properly accounted for its income tax in FY 1999;13
- improperly calculated the stock basis following the sale by ConAgra of several beef/pork subsidiaries and, as a result, incorrectly determined that the sale had resulted in a capital loss for tax purposes in FY 2004;14
- knew or should have known that ConAgra’s tax liability for FY 2003 was incorrectly calculated as a result of the use of incorrect methodology to calculate ConAgra’s foreign loss;15
- did not consider appropriate tax strategies in fiscal year 2003 as required by FAS 109 when ConAgra was able to utilize foreign tax credits.16

Pepper Perspective

Tax accountants should be aware that when there is a restatement, the SEC will consider for books and
records violations like those listed above and will point to any incentive compensation as the motive to raid the "cookie jar" to increase or meet earnings projections. Tax accountants can protect themselves from similar charges by acting proactively to refine their processes and procedures to highlight the reasonableness of their judgments regarding tax positions as well as tax strategies. First, tax accountants may want to begin early in the year to understand, explore, and document in writing the factual basis for various tax determinations. Whenever the facts are not readily forthcoming, tax accountants may seek to dig deeper and to document their efforts and conclusions in writing.

Second, tax accountants may want to focus on how to document that their accounting judgments comply with GAAP. For example, tax accountants could test their accounting judgments against FIN 48 as well as FAS No. 5, Accounting for Contingencies, Paragraphs 36 through 38 of APB Opinion No. 20, Accounting Changes, which require reporting the correction of an error as a prior period adjustment when the correction has a material effect on current period income before the effect of the change or on the trend of earnings, and paragraph 18 of APB Opinion No. 9, Reporting the Results of Operations, that requires excluding from current period income a prior period adjustment by adjusting the opening balance of retained earnings in the current period.

It is realistic to assume in the current audit environment that any accounting judgments that may have a material effect on the financial statement will be thoroughly discussed and reviewed by the internal auditors, if any, and the outside auditors. In this process, tax accountants may seek to document that all facts known to them that relate to or may affect the accounting judgment, have been available to the auditors, including any internal or external tax memos, tax opinions, IRS ruling letters, IRS exam correspondence, etc.

Although painful, tax accountants should take their responsibilities under FIN 48 seriously. Documenting the reasonableness of an accounting judgment, particularly those that result in increased income, which allows the company to meet or exceed projected earnings, seems to have been the key focus of the SEC's action. Presumably, if other tax accountants are prepared to testify that the accounting judgment used by the relevant tax professional at the company complies with GAAP and that they would have made the same decision based on the same facts, then it will be more difficult for the SEC to prove that an accounting judgment is unreasonable in that instance.

Although settled, a review of the SEC's allegations of unreasonable behavior by Ms. Keith are important for all in-house tax accountants to understand.

Endnotes

3 SEC v. Deborah Keith, 07-cv-01373 RPM (MJW)(D. Colo.)(June 29, 2007 Complaint (Complaint) at ¶¶ 1-5).
5 Id.
8 Id.
10 SEC v. PriceWaterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992). Some court recite the formula as “those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure...
from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." See e.g., Goldstein v. MCI Worldcom, 340 F.3d 238, 245-246 (5th Cir.2003).

11 Complaint at ¶ 2.
13 Complaint at ¶¶ 80-84.
14 Id. at ¶¶ 19-22.
15 Id. at ¶¶ 80-84.
16 Id. at ¶¶ 85-91.
17 SAB 99, which requires both a quantitative and a qualitative analysis, should guide decisions on materiality.
18 Before releasing tax opinions and other types of advice from your lawyer, companies should consider the impact on Attorney Client Privilege if the disclosure is made.

Environmental Remediation Costs: To Deduct or to Capitalize?

The U.S. Court of Federal Claims recently denied Kerr-McGee Corporation’s motion for partial summary judgment in its claim for a deduction under Internal Revenue Code (IRC) Section 162 for environmental remediation costs incurred at an oil refinery site in 1995 and 1996. The Internal Revenue Service (IRS) argued that the remediation costs should be capitalized under IRC Section 263. The court concluded that a deduction may be appropriate; although, it could not reach a definitive conclusion with respect to the amount because of a lack of evidence that the contamination present prior to Kerr-McGee’s purchase was attributable to Kerr-McGee. The court indicated that a deduction may be appropriate for the pre-acquisition contamination, which is more generous than the result available under existing IRS guidance.

An interesting issue arises in this case because a substantial portion of the remediation costs were incurred to clean up environmental waste that was deposited at the refinery site prior to Kerr-McGee’s purchase of the site in 1956. Although the IRS has allowed Kerr-McGee to deduct certain remediation costs relating to the portion of the property that Kerr-McGee itself contaminated, the corporation claims that it is entitled to a deduction for cleaning up the property that was already contaminated prior to Kerr-McGee’s acquisition.

Background of Environmental Remediation Cost Treatment

Under IRC Section 162, corporations may deduct “ordinary and necessary expenses [that are] paid or incurred during the taxable year in carrying on a trade or business.” The IRS addressed the deduction of remediation costs in Revenue Ruling 94-38, 1994-1 C.B. 35, in which a deduction was allowed when the costs are not incurred for permanent improvements to the land and will not produce significant future benefits.1 Under the ruling, increased value is determined by comparing the value “of the asset after the expenditure with the status of the asset before the condition arose that necessitated the expenditure (i.e., before the land was contaminated by [the taxpayer’s] hazardous waste).”2 If value increases in this context, then the remediation costs must be capitalized. The ruling limits remediation deductions to amounts that are attributable to contamination caused by the taxpayer while the taxpayer owned the property. The IRS has allowed taxpayers to deduct the clean-up costs when there is a temporary break in ownership of the property, but deductions are not available for pre-acquisition contamination.3 Similarly, prior case law has focused on the nature of the improvement to the property as a result of the remediation as well as whether the party claiming the deduction was responsible for the contamination. For example, the Fourth Circuit Court of Appeals found that an improvement may be deductible if it only restores the property to its value prior to the deterioration and does not permit the property to be utilized in a different way.4 The Sixth Circuit Court of Appeals subsequently added the requirement that the taxpayer must have contaminated the property in the ordinary course of business and the deductible costs must not be attributable to defects present when the taxpayer acquired the property.5 Therefore, based on the previous case law and IRS rulings, the Court of Federal Claims in the present case stated that “expenditures incurred by a taxpayer in carrying on its trade or business to remediate property that it contaminated and that do not increase the value or change the use of the property may be classified by that taxpayer as ordinary and necessary business expenses instead of capital expenditures.”6

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Was the Liability to RemEDIATE Accounted for in the Acquisition?

Under Revenue Ruling 94-38, there would not be a question of deductibility if Kerr-McGee had owned the site during the entire period of contamination. However, Kerr-McGee argued that its purchase after significant contamination had already occurred does not change this result. This argument was based in large part on the assertion that the liability to remediate was not accounted for in the purchase price of the site because the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), requiring Kerr-McGee to disclose the possible presence of certain wastes to the EPA, was not passed until 1980. Therefore, the obligation to remediate did not exist in 1956 and there was no liability to assume as part of the purchase price.

Moreover, the corporation alternatively argued that under Cinergy Corp. v. United States, it is important to distinguish between cases in which the contamination is present and apparent at the time of purchase (or construction) and cases in which the contamination becomes apparent over a period of time. In Cinergy, the plaintiffs were able to deduct remediation costs for asbestos that existed when the plaintiff constructed a building. Since the asbestos was not a “full-blown problem” at the time of construction, the taxpayer did not assume the obligation until much later.

Similarly, Kerr-McGee argued the contamination at the oil refinery site was not a “full-blown problem” when it purchased the site because the health problems associated with refinery waste were not evident in 1956.

Pepper Perspective

It is important to note that the court did not deny Kerr-McGee’s argument outright, especially since the IRS had already allowed a deduction with respect to the post-acquisition clean-up costs. The court could have denied the motion arguing that no deduction was allowed because Kerr-McGee did not contaminate the property. Instead, the court found that a deduction may be appropriate provided that Kerr-McGee can substantiate the deduction.

This decision may be significant for other taxpayers seeking to deduct remediation expenses because it leaves a number of questions. Will the existence (or non-existence) of a purchase price adjustment tip the scales in future decisions? Assuming the evidence does attribute the pre-1956 contamination to Kerr-McGee, what quantity of evidence will the IRS require going forward to substantiate remediation deductions?

The regulations also state that to determine whether the expenditure materially increases the value of the unit of property, the taxpayer should compare “the condition of the property immediately after the expenditure with the condition of the property immediately prior to the event necessitating the expenditure.”

In thinking about substantiation, taxpayers should keep in mind the Cohan rule, which states that if it is clear that a taxpayer is entitled to some deduction, but the taxpayer cannot establish the full amount claimed, it is improper to deny the deduction in its entirety. Instead, the court should estimate to the best of its ability. Another consideration is that this case may raise questions for remediation deductions as well as other deductions. Specifically, what amount of substantiation is required to support a deduction? Generally, deductions have to be substantiated in accordance with the record-keeping requirements of IRC Section 6100. How will this court’s conclusions be applied in other contexts?

A final question presented by this decision is whether the IRS’s proposed repair regulations would change the result suggested by the Kerr-McGee court. The proposed regulations to IRC Section 263 provide five exclusive factors for determining whether an expenditure materially increases the value of a unit of property and therefore requires capitalization. An expenditure materially increases such value only if it:

- ameliorates a condition or defect that either existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production
- is for work performed prior to the date the property is placed in service by the taxpayer (without regard to any applicable convention under [IRC] Section 168(d))
- adapts the unit of property to a new or different use (including a permanent structural alteration to the unit of property)
- results in a betterment (including a material increase in quality or strength) or a material addition (including
an enlargement, expansion, or extension) to the unit of property or
• results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, or quality of output of the unit of property.\(^\text{12}\)

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Notable to Kerr-McGee’s case, an expenditure that repairs a defect that existed prior to acquisition would be capitalized under the proposed regulations. In contrast to Kerr-McGee’s argument, the treatment would not change even though Kerr-McGee was not aware of the defect at the time of purchase. However, under the standard for comparing the value of the property before and after the improvement, the low value of the refinery site even after the clean-up may not be any higher than the value immediately prior to when CERCLA required remediation. Therefore, the proposed regulations may not change the court’s suggested result.

Finally, it is important to note that the regulations have not been finalized. Originally, the IRS intended to issue final regulations this summer but after some public discussion from Treasury officials, the regulations will not be finalized as issued but re-proposed in the late fall.

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Endnotes

1 See Rev. Rul. 94-38, 1994-1 C.B. 35.
2 Id.
5 See United Dairy Farmers, Inc. v. United States, 267 F.3d 510, 518 (6th Cir. 2001).
6 Kerr-McGee Corp. v. United States, No. 05-5T (Fed. Cl. June 29, 2007).
8 Id.
9 Id.
10 Cohan v. CIR, 39 F.2d 540 (2d Cir. 1930).
11 See Prop. Treas. Reg. § 1.263(a)-3(e).
12 Id.
13 Id.

IRS Issues Proposed Regulations on CEO’s Entertainment Use of the Corporate Jet

On June 13, 2007, the Internal Revenue Service (IRS) released proposed regulations that affect corporate deductions for business aircraft used for entertainment travel by the company’s executives. The rules reflect efforts by Congress to limit corporate deductions attributable to entertainment travel on corporate aircraft for senior executives, which was added as part of the American Jobs Creation Act of 2004.

In particular, these rules affect companies that deduct entertainment expenses under Section 274(e)(2), which provides that certain expenses (e.g., expenses for goods, services and facilities that are used for entertainment, amusement or recreation) if treated as compensation, are eligible for deduction under Section 162. Section 274(e)(2) provides that an employer’s deduction for personal entertainment expenses are limited to the amount that an employer reports as income for certain executives (officers, directors and greater-than-10-percent owners, including partners), plus the amount that individuals reimburse the employer for entertainment travel. The regulations maintain the IRS’s position that entertainment travel should be reported in an employee’s income (e.g., W-2 and tax return). The regulations also maintain the IRS’s view that expenses associated with entertainment flights are
remuneration and, therefore count toward the $1 million salary expense limitation in Section 162.

The proposed regulations follow and clarify Notice 2005-45, providing that a company must include all of the expenses of operating corporate aircraft, including depreciation, to determine any deduction limitation. These costs include both fixed and variable costs such as fuel, pilot salaries, maintenance personnel, take-off and landing fees. However, the regulations provide an optional method for determining allocable depreciation. A taxpayer also may choose an additional method for allocating costs to entertainment travel, the flight-by-flight method. The IRS also indicated it is considering a safe harbor that would allow taxpayers to use a charter rate in lieu of calculating the total expenses for personal entertainment travel on the corporate aircraft.

While the proposed regulations are not effective until finalized by Treasury, taxpayers may rely on either these rules or those in the Notice.

The following are details of some of the additional options in the proposed regulations.

**Depreciation**

The proposed regulations clarify that the expenses subject to disallowance of maintaining and operating an aircraft includes all variable and fixed costs, including recognized depreciation. For taxpayers that elected to use bonus depreciation, this could lead to a somewhat draconian disallowance. In response to comments from taxpayers, and solely for purposes of determining the deduction limitation, a taxpayer may elect to treat the amount of depreciation that would result from using the straight-line method of depreciation over the class life of corporate aircraft. A taxpayer may use this convention even though depreciation is calculated under another method for other federal income tax purposes. Under the proposed regulations, if the taxpayer elects to use the straight-line method and class life for corporate aircraft, that method must be used for all aircraft. Under the proposed regulations, once this election is made, it may only be revoked for future years with compelling circumstances upon consent of the Commissioner by private letter ruling. As a bonus, the proposed regulations clarify that disallowed depreciation does not reduce basis in the aircraft so that when sold or otherwise disposed of, the disallowed portion of the depreciation is recovered.

**Flight-by-Flight Method**

The proposed regulations retained the occupied-seat-hour or occupied-seat-mile formulation to determine allocable expenses to certain executives flying in an employer’s aircraft for entertainment. In response to commentators’ concerns, the expenses may be calculated on a flight-by-flight basis as an alternative to using the occupied-seat-hour or mile formula. Under the flight-by-flight method, companies may aggregate aircraft expenses for the taxable year and divide the amount of total expenses by the number of flight hours or miles for the taxable year to determine the cost per hour or mile. Then expenses are allocated to each flight by multiplying the number of hour or mile for the flight by the expense per mile or hour and then allocate expenses for the flight to the passengers on the flight per capita. This convention would reduce the disproportionate effects if an entrainment flight had a larger than average capacity.

**Charter Rate Safe Harbor**

As an alternative to determining actual expenses, the IRS is considering whether the regulations should permit taxpayers to determine the amount of their expenses for entertainment flights by reference to charter rates. Under such a safe harbor, taxpayers could elect to treat as the amount of expenses for entertainment flights an undiscounted charter rate for each flight in lieu of calculating the actual expenses of each entertainment flight. The undiscounted charter rate for the flight would be allocated to the individuals on the flight in lieu of the occupied-seat, hour, mile or flight-by-flight allocation methods.

Under the charter-rate method being considered, an undiscounted charter rate would generally be based on the amount that a person would pay to charter a comparable aircraft for a comparable flight. The taxpayer will have to substantiate that the rate used is an actual, published, undiscounted charter rate charged to the general public within 10 days before or after the taxpayer’s flight by a qualified chartering company. A qualified chartering company would be a chartering company unrelated to the taxpayer that is in the trade or business of chartering aircraft and that operates and charters 10 or more aircraft to the general public during the taxable year. Leaseback arrangements or rates charged for off-peak usage, aircraft downtime, or by employers to their employees would not qualify under the safe harbor. If the taxpayer elects the safe
harbor, the taxpayer would have to use it for all entertainment flights on all of the taxpayer’s aircraft for the current and all subsequent taxable years, unless the taxpayer makes a proper revocation.

Pepper Perspective

With the release of the proposed regulations, it may be a good time to review your corporate aircraft use policy and any accompanying conventions in calculating any disallowed expenses attributable to entertainment. It also might be advantageous to begin using the straight-line depreciation convention to minimize any depreciation disallowance as well as recover some of any prior disallowed depreciation deductions.

Christian Wood, the author of this article is an associate at Pepper Hamilton. Prior to joining Pepper in 2006, he was one of the principal authors of the proposed regulations and can provide insight into the rules and their potential application. Also, anyone wishing to submit comments (i.e., support of the charter rate safe harbor convention) must do so by September 13, 2007. Requests to speak and outlines of topics must be received by October 4, 2007 for the public hearing scheduled for October 25, 2007.

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