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Attorney-Client Privilege and Work Product in Tax Controversies: Latest Developments

Protecting Confidentiality in IRS Summonses, Taxpayer Accrual Work Papers, FIN 48 Disclosures, and Litigation

WEDNESDAY, DECEMBER 12, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Attorney Client Privilege and Work Product in Tax Controversies

Strafford Publications Webinar

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December 12, 2012

Basics of Document Protection

- In What Circumstances Do You Encounter Requests for Documents?
  - In litigation
  - In administrative proceedings
  - In acquisitions
  - Financial audits
  - Privileges and work product can apply in each of these contexts
- Administrative Proceedings
  - Tax Audit
  - Summons and summons enforcement
  - *United States v. Powell,* 379 U.S. 48 (1964) (establishing four factors to test legitimacy of summons)

Elements of Attorney-Client Privilege

- Communications made for the purpose of receiving legal advice
- From a legal adviser
- Which are made in confidence
- The substance of which has not been disclosed to strangers, i.e., third persons who are outside the privileged scope. (Ministerial agents, and *Kovel* agents are examples of third parties who can be privy to privileged communications without waiver.)
- Crime/fraud exception
- Return preparation “exception”
- Fiduciary “exception”

Attorney-Client Privilege Applied

- Potentially Applicable to Internal Workpapers/Tax Opinions
  - Have the workpapers or opinions been provided, shown or otherwise substantively disclosed to third parties such as outside auditors?
  - Generally speaking, attorney-client privilege is waived if the communication was disclosed to outside auditor.
  - What if instead of disclosing the actual workpapers to the outside auditors, the companies had provided similar analysis but independently of the documents?
  - Short form/long form tax opinion

Basics – Section 7525

- Statutory privilege enacted by Congress in 1997
- Intended to protect communications regarding Federal tax advice between non-attorney tax advisors and taxpayers as if the tax advisor was an attorney
- Incorporates the Federal common law of attorney-client privilege into the non-attorney tax advisor context
  - In-house tax advisors can provide section 7525 privileged advice to corporation. *See United States v. Eaton Corp.*, 110 AFTR 2d 2012-5638 (N.D. Ohio 2012).
  - Same waiver rules apply
- Limitations
  - No application in criminal proceedings.
  - No application to written communications in connection with the promotion of a section 6662 tax shelter.
    - *Countryside Limited Partnership v. Commissioner of Internal Revenue*, 132 T.C. 347 (2009).
    - *Valero Energy Corp. v. United States* 569 F.3d 626 (7th Cir. 2009).

Privilege in the Corporate Setting

- *Upjohn Co. v. United States,* 449 U.S. 383 (1981) -- attorney-client privilege can extend beyond communications with individuals capable of controlling a corporation to communications of lower- and middle-level employees.
  - "Control group" test rejected.
  - Instead focus is on (i) employees necessary to facilitate legal advice to corporation and (ii) communications with employees being made pursuant to directions from corporate officials.
- *Upjohn* focused on communications between counsel and employees, but what about prior privileged communications being distributed to others within a corporation?
  - Later courts have generally viewed *Upjohn* as supporting the general rule that "distribution within a corporation of legal advice received from its counsel does not, by itself, vitiate the privilege." *In re: Buspirone Antitrust Litigation*, 211 F.R.D. 249, 255 (S.D.N.Y. 2002) (citing *Upjohn*).

McDermott Will & Emery

Establishing and Maintaining Work Product Privilege

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December 12, 2012

Work Product Protection

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- Established by the U.S. Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1947).

- Held that attorney's interview notes were protected from discovery.

Federal Rule of Civil Procedure 26(b)(3)

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- Partially codified *Hickman v. Taylor*.
- "Ordinarily, a party may not discover documents or tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent)."
  - Exception: "[P]arty shows that it has a substantial need for the materials to prepare for its case and cannot, without undue hardship, obtain their substantial equivalent by other means."
  - But there is almost absolute protection from disclosure of so-called "opinion work product"
    - Court "must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation." Fed. R. Civ. P. 26(b)(3)(B).

Elements of Work Product

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- Provides protection for documents or testimony;
- Prepared in "anticipation of litigation" or for trial;
- By or for another party;
- Or for that other party's representation;
- Unless the opposing party demonstrates a substantial need.

Chief Counsel Position

McDermott Will & Emery

- With respect to the assertion of work product for Chief Counsel Advice, the IRS has takes the position in a Chief Counsel Notice CC-2002-026, Q&A (37) that the work product doctrine requires a "litigation predicate," but is not limited to documents prepared in connection with docketed cases or cases in litigation.
- Chief Counsel Notice CC- 2004-012, Q&A (21) provides that an assertion of attorney work product is not limited to documents prepared in connection with docketed cases or cases designated for litigation, but assertion outside of this context should be coordinated with the Associate Chief Counsel.
  - The Notice identifies two examples in which litigation might reasonably be anticipated: (1) when the taxpayer's representative states an intention to litigate the matter; and (2) the taxpayer has litigated the same issue in prior audit cycles.

Substantial Need Exception

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- To overcome the work product doctrine, party must show a particularized need beyond a desire to learn what kind of a case the adversary has.
- The classic example of a "substantial need" sufficient to overcome a work product claim is where a party has withheld an interview memorandum for a witness that is dead or unavailable. See e.g., *In re Grand Jury Investigation*, 599 F.2d 1224 (3d Cir. 1979).
- In *Hartz Mountain Indus., Inc. v. Comr.*, 93 T.C. 521, 527-28 (1989), the Tax Court ordered the taxpayer to produce work product materials prepared by counsel during settlement negotiations in a prior antitrust litigation, because: (1) there was no "substantial equivalent" of the materials in showing the taxpayer's intent regarding the settlement; and (2) because the work product was prepared a decade before in a different litigation.

Tax Court Amends Rules to Adopt Substantial Need Exception

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- On July 6, 2012, the United States Tax Court ("Tax Court") amended Rule 70 to adopt the "substantial need and undue hardship exception."
- The Tax Court had previously rejected the exception. See e.g., *P.T. & L Const. Co. v. Commissioner*, 63 T.C. 404, 408 (1974); *see also Dvorak v. Commissioner*, 64 T.C. 846, 850-51 (1975) (refusing to "incorporate into this Court's discovery procedure the requirements of rule 26(b)(3) of the [FRCP], under which 'work product' materials are discoverable if 'the substantial equivalent of the materials' is unavailable").

Tax Court's Changing View

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- Over the years, several Tax Court opinions chipped away at the absolute protection for work product reflected in the Notes and prior cases.

Sterling Trading Opportunities, L.L.C. v. Commissioner

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- In *Sterling Trading Opportunities, L.L.C. v. Commissioner*, T.C. Memo. 2007-339, the Tax Court addressed whether documents containing notes by an individual and his attorney made during meetings with tax advisers were work product subject to discovery under the exception. The Court assumed, without deciding, that the documents contained fact-based work product.
- It framed the remaining issue as whether the IRS had substantial need for the information contained in the documents and the inability to obtain the substantial equivalent from other sources.

Tax Court Rule 70(c)(3)

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The amendment added a new paragraph (c)(3) under Rule 70, which closely tracks FRCP 26(b)(3)(A) and (B):

"(3) *Documents and Tangible Things:*

(A) A party generally may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent), unless, subject to Rule 70(c)(4),

(i) they are otherwise discoverable under Rule 70(b); and

(ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.

(B) If the Court orders discovery of those materials, it must protect against disclosure of mental impressions, conclusions, opinions, or legal theories of a party's counsel or other representative concerning the litigation."

Tax Court Amends Rules to Protect Expert Witness Work Product

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- On July 6, 2012, the United States Tax Court ("Tax Court") also amended Rule 70 to limit the discoverability of draft expert witness reports and certain communications between counsel and expert witnesses.

Tax Court Rule 143(g): Expert Reports

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- In the Tax Court, Rule 143(g) provides that an expert witness's report is treated as his or her direct testimony, and additional direct testimony may be allowed only "to clarify or emphasize matters in the report, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court."
- The report must contain "the qualifications of the expert witness and shall state the witness's opinion and the facts or data on which the opinion is based" and must "set forth in detail the reasons for the conclusion."
- The parties are required to exchange copies of any expert witness reports expected to be submitted into evidence at trial.

Protection of Drafts and Expert/Counsel Communications

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- In 2010, FRCP 26(b)(4) was amended to provide that drafts of expert witness reports and certain pretrial communications between experts and counsel were not subject to discovery.
- In the recent amendments to its Rules, the Tax Court amended Rule 70 to provide the same discovery protection in its proceedings.

Tax Court Rule 70(c)(4)

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- Rule 70(c)(4) now provides:

"(4) *Experts:*

(A) Rule 70(c)(3) protects drafts of any expert witness report required under Rule 143(g), regardless of the form in which the draft is recorded.

(B) Rule 70(c)(3) protects communications between a party's counsel and any witness required to provide a report under Rule 143(g), regardless of the form of the communications, except to the extent the communications:

(i) relate to compensation for the expert's study or testimony;

(ii) identify facts or data that the party's counsel provided and that the expert considered in forming the opinions to be expressed; or

(iii) identify assumptions that the party's counsel provided and that the expert relied on in forming the opinions to be expressed."

Timeline For “Anticipation of Litigation”

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- Moving target or continuum.
  - Planning stage
  - Analysis of litigating hazards in order to prepare
    - Tax reserve
    - Schedule UTP
  - Commencement of Audit
  - Receipt of IDR
  - Receipt of NOPA
  - Receipt of RAR
  - Appeals

Anticipation of Litigation: Documents Prepared During the Planning Stage

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United States v. Adlman,134 F.3d 1194 (2nd Cir. 1998).

- Accounting firm tax advisor prepared memorandum assessing litigating hazards if proposed transaction was undertaken.
- The memorandum assists in the business decision.
- Satisfies the "because of" standard.
  - Whether a document is prepared because of the prospect of litigation turns on whether the substantially same document would have been prepared irrespective of the expected litigation.

Planning Stage – Cont'd.

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- *U.S. v. ChevronTexaco,* 241 F. Supp. 2d 1065 (N.D. Cal. 2002).
  - VP of Tax's declaration supported finding that corporation reasonably believed that it was a certainty that the IRS would challenge the proposed transaction.

Anticipation of Litigation: Documents Prepared After the Close of the Transaction

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- *US v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006).
  - *Two memoranda prepared by KPMG Tax Advisor analyzing the consequences of certain transactions entered by Yum.*
  - *Establishes subjective and objective test for anticipation of litigation.*

Anticipation of Litigation: Documents Prepared During the IRS Audit

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- *Deseret Management Corp. v. U.S. 99 AFTR 2d 2007-1891* (Fed. Cl. 2007).
  - Taxpayer sought documents prepared by the IRS during the audit.
  - Government claimed work product protection.
    - "Government reasonably anticipated litigation on this issue almost from the inception of the audit."
    - Because "once the audit has begun, the likelihood of litigation increases."
  - "The court believes that, due to the size of the corporation and the significance of the transaction, both plaintiff and defendant knew or should have known that the auditing process could lead to litigation."

During the IRS Audit-Cont'd.

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U.S. v. Eaton Corp., 110 AFTR2d 2012 – 5638 (N.D. Ohio 2012).

- *4 summonses issued to the taxpayer and executives.*
  - *Emails and correspondence – 61 documents*
  - *Redacted documents from APA binder*
  - *Notes taken during employee interviews – no privilege log provided*
  - *Performance evaluations of former employees responsible for managing compliance with Advanced Pricing Agreement*

U.S. v. Eaton Corp.

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- Work product protection upheld.
  - Eaton demonstrated that the IRS audit was adversarial and contentious.
  - Court rejected IRS argument that work product did not protect documents prepared during the course of an IRS audit or in anticipation of an administrative dispute with the IRS.

Anticipation of Litigation: Tax Court Case Law

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- The Tax Court generally holds the view that "the audit or examination process is not conducted in anticipation of litigation" unless a matter has been "singled out for litigation." *See, e.g., Bennett v. Comr.*, T.C. Memo. 1997-505.
- And, as a corollary principle, the Tax Court has held that revenue agent's reports, audit workpapers, and district and appellate conference reports are only subject to work product protection if the agent's work was supervised by counsel or the agent consulted with counsel to support the proposed adjustment. See e.g., *Branerton Corp. v. Comr.*, 64 T.C. 191, 198-99 (1975).

Textron: District Court

- 507 F. Supp. 2d 138 (D.R.I. 2007)
- In June 2005, the IRS issued a summons to Textron seeking its tax accrual workpapers for the 2001 tax year.
- Textron's workpapers, which were created after the corporate tax returns were filed, consisted of two parts.
  - A spreadsheet that listed (i) each tax position considered by Textron's counsel to be arguable, (ii) estimates of litigation risks with respect to these position, and (iii) tax reserve amounts for each position.
  - Backup documents including the prior year spreadsheet, a draft spreadsheet, and accompanying memos from Textron's in-house counsel reflecting opinions regarding litigation risks.

Textron: District Court

- The workpapers were prepared by in-house attorneys or accountants under the ultimate supervision of in-house counsel. The workpaper files did not contain any "factual" materials, such as transaction documents and the like.
- Textron objected to the summons on the grounds that the workpapers were protected from disclosure under the attorney-client privilege, the section 7525 tax practitioner privilege and the work product doctrine.
- The IRS thereupon brought a summons enforcement action in the District Court in Rhode Island.

Textron: District Court

- The workpapers prepared by in-house attorneys were privileged communications under the attorney-client and those prepared by in-house accountants were privileged communications under the section 7525 tax practitioner privilege.
- Disclosure of the workpapers to the outside auditor caused a waiver of the privileges.
- The district court followed the majority view (adopted by the First Circuit) regarding the scope of work product and held that the workpapers were work product even though they might have also served a financial reporting purpose.
- Disclosure did not waive work product.

Textron: District Court

- The court rejected the IRS's characterization of the services provided by the in-house professionals as "an accounting function." The court analogized to the advice of tax planning attorneys, which, even though rendered in connection with the preparation of a tax return, can still be legal advice protected by the attorney-client privilege.
- The court distinguished *United States v. Arthur Young & Co.*, 465 U.S. 805 (1976) (finding no an accountant-client privilege-like protection applicable to workpapers created by outside auditors) on the grounds that *Arthur Young* did not address:
  - (i) internal tax accrual workpapers,
  - (ii) whether the attorney-client privilege could apply to such workpapers,
  - (iii) the section 7525 tax practitioner privilege, which was enacted in 1998.

Textron: District Court

- Based on supporting affidavits and other evidence regarding the nature and purpose of the workpapers, the court found
  - that Textron created the workpapers to determine adequate reserves in case of later controversy or litigation.
  - that Textron reasonably believed based on uncertainty in the law and its prior audit and litigation experience with the IRS that the positions identified in the workpapers that there was a likelihood of litigation.
  - that the workpapers served the purpose of showing Textron's outside auditors, that its reserves were appropriate and thereby facilitating the auditor's approval of the audited financial statements.

Textron: District Court

- The key analytical step of the court is summed up in the following quote: "[I]t is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared *at all* 'but for' the fact that Textron anticipated the possibility of litigation with the IRS." 507 F. Supp. 2d at 150 (emphasis added).
- Court rejected Government's waiver argument finding that disclosure to financial auditor is not disclosure to an adversary or conduit to an adversary.

Textron: First Circuit Panel

- The First Circuit, in a 2-1 panel decision affirmed in large part
  - Key proposition: workpapers would not have been created but for the possibility of litigation
  - Anticipation of tax audit should be treated as anticipation of litigation for work product purposes
  - Prior controversy experience is not relevant because any taxpayer can anticipate in good faith a dispute with the IRS: "A company with a history of challenging the IRS creates these documents 'because of' the same reason as any other company without such a history: the possibility of a dispute compels them to anticipate litigation so as to prepare and assess their tax reserve funds."
- Panel decision vacated when the First Circuit granted rehearing *en banc*.

Textron: *En Banc* Decision

- *United States v. Textron,* 577 F.3d 21 (1st Cir. 2009)
- **Holding**: Textron's internal tax accrual workpapers are not protected work product.
- Rationale: Tax accrual workpapers are not protected by the work product doctrine because they were not "prepared for use in possible litigation."
  - Appeal to a trial lawyer's sensibilities
  - Appeal to IRS complaint of wasting resources hunting through complex return
  - Potential scope of holding: FIN 48 workpapers, GAAP workpapers (internal or external) cannot be work product
- Observations
  - Binding only in courts in the First Circuit
  - *Deloitte* shows that other "majority view" circuits are unlikely to follow

Textron: *En Banc* Decision

- The decision did not squarely address the question whether anticipation of a tax audit should be deemed anticipation of litigation.
  - One view of decision is that the court believed that the taxpayer had no other purpose in creating its workpapers than to obtain a clean financial audit. Another view suggests a strict standard for work product, namely that the document must be useful for trial and the kind of document that a trial attorney would create. Such a standard likely would not support a ruling that a document created in anticipation of a tax audit is work product.
- The original, now vacated, panel decision held that anticipation of a tax audit should be treated as anticipation of litigation.
- *See also Santander Holdings USA, Inc. v. United States*, 110 AFTR 2d 2012-5481 (D. Mass. 2012) (following *Textron*).

Regions Financial Corp. – Background

- *Regions Financial Corporation and Subsidiaries v. United States,* 2008 WL 2139008,101 AFTR 2d 2008-2179 (N.D. Ala. 2008)
- The IRS began an audit of the 2002-2003 tax years of Regions Financial Corporation and Subsidiaries (RFC), a consolidated group.
- During the course of the audit, the IRS had determined that RFC had participated in two listed transactions during the audited tax years, and, pursuant to its modified tax accrual workpaper policy, the IRS sought all the workpapers relating to the 2002 and 2003 tax years.
- In April 2006, the IRS issued a summons to RFC's outside auditor requesting all tax accrual workpapers that it had created or assembled in connection with its audit of RFC.

Regions Financial Corp. – Background

- RFC moved to quash the summons on grounds of work product.
- Eventually the dispute narrowed to four tax opinions from RFC's tax advisors that were in the auditor's files: three authored by its outside tax counsel, Alston & Bird; and one authored by tax professionals at the auditor who were separate from the audit team.
- The tax opinions discussed a transaction in which an existing REIT subsidiary of RFC issued new preferred stock that was subsequently acquired by the European Reconstruction and Development Bank (the "ERDB Transaction")

Regions Financial Corp. – Holding

- The district court ruled that the documents at issue were protected work product and, like the judge in *Textron*, suggested that the preparation of analyses with respect to contingent tax liabilities is fundamentally an action carried out in anticipation of litigation.
- The court did not resolve the uncertainty as to the standard for application of work product in the 11th Circuit (to which the case would be appealed). Instead the court said that under either the more restrictive "primary purpose" test or the less restrictive "because of litigation" test the documents met the requirements for work product protection.

Regions Financial Corp. – Analysis

- Content of Opinions Was Quintessential Work Product
  - There was no dispute between the parties that the opinions at issue contained RFC's advisors' analyses regarding the merits of the ERBD Transaction. Thus, the *content* of the documents was consistent with RFC's claim of work product protection. Indeed, the IRS did not attempt to argue that its need for the information and facts contained in the opinions should overcome RFC's claim of work product (as it was entitled to do under Fed. R. Civ. Pr. 26(b)(3)).
  - Based on its *in camera* review in which the court found that the documents contained "the mental impressions and opinions of RFC's lawyers" the court noted that: "the contested documents contain precisely the kind of legal analysis that the work product doctrine exists to protect." Slip Op. at 13. The court cited *United States v. Roxworthy* for the statement that this factor weighed in favor of recognizing the documents as protected.

Regions Financial Corp. – Analysis

- Key testimony provided in affidavits established the purpose for the creation of the opinions, namely to prepare for potential litigation with the IRS. The affidavits provided evidence that:
  - RFC's General Counsel solicited the tax opinions,
  - The General Counsel was concerned with the prospect of litigation regarding the ERBD Transaction,
  - RFC solicited the tax opinions from outside tax advisors because of the anticipated conflict with the IRS, and
  - RFC, outside counsel, and the auditor agreed to maintain the confidentiality of the documents.

Regions Financial Corp. – Analysis

- The court characterized the IRS's main argument that in order for work product to apply the *only* reason for the creation of the document must be litigation preparation. In rejecting this argument, the court implicitly embraced the "because of" test. A document can be created because of litigation while satisfying other legitimate purposes, e.g., financial reporting or penalty protection.
- The court went further in its rejection of the IRS argument by turning it on its head – the only reason the tax position regarding the EBRD transaction was necessary to disclose for financial reporting purposes was because RFC anticipated litigation.
- Government dismissed its notice of appeal to the 11th Circuit.

United States v. Deloitte

- 610 F.3d 129 (D.C. Cir. 2010) (D.C. Cir. 2010).
- Department of Justice subpoenaed Deloitte, Dow Chemical's outside auditor, to produce its files related to Deloitte's review and audit of Dow's reserves with respect to the tax treatment of certain Dow partnerships.
- Dow claimed work product regarding three documents:
  - A July 1993 draft memorandum created by Deloitte based on a meeting with Dow's attorneys regarding possible litigation of the tax treatment of the partnerships
  - A September 1998 analysis created by Dow's in-house counsel
  - A June 2005 tax opinion from Dow's outside counsel
- DOJ moved to compel in the District Court for the District of Columbia, which upheld the claims of work product.
- **Holding**: Following the majority view of the definition of work product, (i) the three documents contained protected work product and (ii) work product was not waived upon disclosure to Deloitte. Remand to the lower court to determine whether portion of the 1993 Deloitte memorandum contain non-work product information.

United States v. Deloitte

- The key analytical conclusions of the D.C. Circuit:
  - Work product protects intangible content
  - Work product is determined through an examination of the contents of a document
  - *Textron* is distinguishable and limited to its facts
  - Disclosing work product to outside auditors is not a waiver
- Observations
  - Affects rules of evidence in all proceedings before the U.S. Tax Court
  - Distinguishes and criticizes *Textron*
- Scope of holding: documents prepared with respect to financial audits, including workpapers, can contain protected work product.

Deloitte: Practical Considerations

- Keep a record regarding the purpose of meetings with outside auditors and their intention to discuss litigation evaluations as part of their meeting agenda
- Supplement existing ethical requirements of confidentiality for accountants regarding their attest client files with a specific agreement between the client and auditor setting forth conditions of confidentiality
- Request that the auditor segregate from its own audit workpapers work product documents received from the company
- Request that any use of such work product in the audit workpapers be specifically identified to the company

Tax Accrual Workpapers Redux

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- On September 1, 2010, Wells Fargo & Co. asked the federal district court in Minnesota to quash an IRS summons issued to its auditor seeking Tax Accrual Workpapers.
- In a related case, the government asked the same court to enforce summonses issued to Wells Fargo seeking the same documents.

Eighth Circuit's Legal Standards

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- The Eighth Circuit has adopted the majority "because of" test to determine if documents are prepared in anticipation of litigation.
- The Eighth Circuit's exception for obtaining opinion work product is "rare and extraordinary circumstances."

Parties' Positions

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- Government:
  - The tax accrual workpapers were prepared in the ordinary course of business as part of Wells Fargo's regulatory obligations.
  - The prospect of litigation was too remote because the procedural events of having to create tax reserves and being under IRS examination are not "tantamount to anticipated litigation."
  - Alternatively, if work product applies, the government has shown a substantial need.
  - Additionally, if work product applies, Wells Fargo has waived work product by disclosure to its independent auditor.

Parties' Position

McDermott Will & Emery

- Wells Fargo
  - Tax accrual workpapers are, by their very nature, prepared in anticipation of litigation because they are created because of the prospect of litigation.
  - But for the anticipated litigation with the IRS, Wells Fargo would have no need to create the tax accrual workpapers.
  - The government has failed to meet the substantial need exception which would only entitle the government to ordinary work product, because it relied on conclusory statements without concrete evidence.
  - There has been no waiver of work product protection because the independent auditor was not an adversary.

Status of the Case

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- Evidentiary hearing was held in July 2011.
- Post hearing briefings completed in September 2011.
- Awaiting decision by the district court.
- Expect appeal to the Eighth Circuit.
- Case may make its way to the Supreme Court.

Waiver of Work Product Protection

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- Clear case = intentional disclosure to adversary.
- Disclosure to a third party does not necessarily waive the privilege.
- Waiver occurs where disclosure of protected materials to third persons who are not adversaries substantially increases the opportunity for potential adversaries to obtain the information.
  - D.C. Court of Appeals held in *U.S. v. Deloitte LLP,* 610 F.3d 129 (D.C. Cir. 2010) that disclosure to independent auditor did not waive work product.

At Issue – Work Product Waiver

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- Work product cannot be used as a sword and a shield.
- "At Issue" waiver occurs when party relies on its work product to defend against penalties.

Salem Financial, Inc. v. U.S., 109 AFTR.2d 2012-604 (Ct. Fed. Cl. 2012).

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- Taxpayer claimed that tax reserve workpapers and related documents were protected by work product and tax practitioner privileges.
- Taxpayer waived work product protection by contending that it had reasonable cause for its tax reporting and putting the legal advice at issue.
- Post-transaction communications with accountants were protected by tax practitioner privilege and not subject to exception for communications in connection with the promotion of a tax shelter. However, the privilege was also waived because the taxpayers had indicated that it intended to rely on such advice as a defense to penalties. *But see Santander Holdings USA, Inc. v. U.S.*, No. 1:09-cv-11043-GAO (D.C. Mass. Aug. 6, 2012) (disagreeing with *Salem* and holding that post-transaction advice relating to effects of later changes in law was a different subject matter not covered by waiver of advice regarding whether to enter into transaction).
- Avoided debate over whether tax reserves and associated workpapers are prepared in anticipation of litigation, but noted that it is sympathetic to public policy considerations counseling toward application of the work product doctrine to tax reserve documents.

U.S. v. Eaton Corp. – "At Issue" Waiver

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- District Court rejected government's contention that Eaton had implicitly waived its claims of privilege by filing a petition in the Tax Court.
- "The IRS has not persuasively demonstrated that Eaton has affirmatively raised claims that can only be disproven through disclosure of privileged documents."

Summons Litigation Over Privilege Disputes

McDermott Will & Emery

- An IRS administrative summons is issued to taxpayer or third party.
- An administrative summons is not self enforcing.
- Court proceeding is commenced.
  - DOJ Tax Division brings a summons enforcement proceeding.
  - Third party institutes a proceeding to quash the summons.

Summons Litigation

McDermott Will & Emery

- Government bears the initial burden to show that the summons is valid.
  - *Issued for a legitimate purpose.*
  - *Information may be relevant – "throw light on the correctness of the return."*
  - *Not already in the possession of the IRS.*
  - *Meets all administrative requirements, i.e., service, notice, no referral to DOJ criminal.*

Summons Litigation

McDermott Will & Emery

- Burden shifts to the summoned party.
  - Must prove that each of the requested documents are protected by privilege, and the privilege has not been waived.
  - No blanket claim of privilege.
  - Summoned party produces privilege logs and affidavits.

U.S. v. Eaton Corp. – Privilege Log Requirement

McDermott Will & Emery

- Court required production of interview notes because Eaton had not provided a privilege log.
  - Rejected Eaton's contention that a privilege log was not required since the request on its face reflected the privileged nature of the documents.

Summons Litigation

McDermott Will & Emery

- Information to include in a privilege log.
  - Type of document withheld.
  - Authors and recipients, cc's of the document along with their capacities.
  - Indicated whether or not redacted.
  - Date (of document creation).
  - The nature of the privilege asserted (e.g., attorney-client privilege, work product, tax practitioner privilege).
  - The nature of the privilege asserted may differ for each email in a chain.
  - A summary of the document's subject matter without revealing the confidential communication.

Summons Litigation

McDermott Will & Emery

- The privilege log should provide a prima facie showing of the basis for privilege, however it is advisable to suggest an in camera review.
- Submit affidavits to establish the elements of work product protection.
  - Why it was subjectively and objectively reasonable to anticipate litigation.
  - Documents were prepared because of the prospect of litigation.
  - Documents would not have been created but for the prospect of litigation.

Schedule UTP Requirements

- What's supposed to be reported?
  - UTP number
  - Primary Code sections relating to the position
  - Whether the position is a "Major Tax Position"
  - Ranking of the tax position
  - The taxable year to which the position relates
  - Whether the position involves a permanent inclusion or exclusion of any item and/or the timing of that item
  - Pass-through entity EIN
  - Concise description

Schedule UTP

- What is a concise description?
  - "Provide a concise description of the tax position, including a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identify of the tax position and the nature of the issue."
  - Instructions specifically state that description is not to include an assessment of litigation hazards or other risk analysis.
  - This was a major change from the draft Schedule which requested a statement of the rationale for the position and the reasons for determining the position is uncertain.

Schedule UTP – Example 12

- The corporation investigated and negotiated several potential business acquisitions during the tax year. One of the transactions was completed during the tax year, but all other negotiations failed and the other potential transactions were abandoned during the tax year. The corporation deducted costs of investigating and partially negotiating potential business acquisitions that were not completed, and capitalized costs allocable to one business acquisition that was completed. The corporation established a reserve for financial accounting purposes in recognition of the possibility that the amount of costs allocated to the uncompleted acquisition attempts was excessive.
- Sample description: The corporation incurred costs of completing one business acquisition and also incurred costs investigating and partially negotiating potential business acquisitions that were not completed. The costs were allocated between the completed and uncompleted acquisitions. The issue is the whether the allocation of costs between uncompleted acquisitions and the completed acquisition is appropriate.

Privilege and the UTP

- Schedule UTP does not contain the requirement to provide a rationale regarding the nature of the uncertainty of the reported position. This removes one significant area of privilege concern that was in the draft Schedule UTP.
  - Announcement 2010-75
- Announcement 2010-76 states that the IRS will not assert a waiver of privilege or work product during an examination for documents that are disclosed to an outside auditor in the course of a financial audit.
  - IRS is careful to note that this applies only to documents that are otherwise protected or privileged and for which such protection has not already been waived through some other disclosure.
  - What about assertion of waiver in subsequent litigation? Tax Court? Refund courts?

Duty to Preserve and Work Product

- The duty to preserve documents and the penalty for failure to do so, i.e., spoliation, are defined by the courts.
  - *Consolidated Edison Co. of N.Y. v. United States*, 90 Fed. Cl. 228 (Fed. Cl. 2009) ("Sanctions for spoliation arise out of the court's inherent power governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases.") (citations omitted).
- The duty to preserve arises when litigation is reasonably anticipated:
  - "While a litigant is under no duty to keep or retain every document in its possession, once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a litigation hold to ensure the preservation of relevant documents." *Adorno v. Port Auth. of New York and New Jersey*, 258 F.R.D. 217, 227 (S.D.N.Y.2009).

Duty to Preserve and Work Product

- Does the duty to preserve arise at the same time work product is created?
  - *Consolidated Edison* addressed whether the taxpayer failed in its duty to preserve potentially relevant emails in the migration of those emails from one server to another in 2000. At an earlier juncture the court had rejected the taxpayer's claim that a 1997 tax memorandum was work product. In moving for sanctions, the Government adopted the taxpayer's original argument that it had anticipated litigation in 1997 and so should have preserved the emails.
    - Court focuses on unique features of tax disputes where given the "elaborate structure set up to administratively resolve disputes" with the IRS, the point in the IRS administrative process at which it is reasonable to conclude that litigation should be anticipated will differ in each case.
    - Court holds that there was insufficient evidence indicating the taxpayer should have anticipated litigation prior to the email migration.
      - 1997 memorandum and a 1999 listed transaction notice did not "predetermine" litigation.

Duty to Preserve and Work Product

- *Samsung Electronics Co., Ltd. v. Rambus Inc.*, 439 F.Supp.2d 524 (E.D. Va. 2006)
  - The court found that defendant's document retention policy, which included the intentional destruction of discoverable documents as a part of the company's IP litigation strategy, constituted spoliation. The court looked to the anticipation of litigation in the work-product doctrine:
    - "The determination of when a party anticipated litigation is necessarily a fact intensive inquiry, and a precise definition of when a party anticipates litigation is elusive. One helpful analytical tool is the more widely developed standard for anticipation of litigation under the work product doctrine."
- *See also AAB Joint Venture v. United States,* 79 Fed. Cl. 432 (Fed. Cl. 2007)
  - "It would be incongruous for the Court to find that Defendant had a duty to preserve documents for discovery because of impending litigation, yet could not assert the work product doctrine to protect documents prepared in anticipation of that litigation."

Duty to Preserve and Work Product

- Special considerations in tax cases?
  - Burden of proof always on taxpayer
  - The Internal Revenue Code requires maintenance of relevant records supporting return positions. Failure to maintain such records can result in the imposition of a negligence penalty under IRC Section 6662.
  - The Government can ask for a finding that missing documents are adverse to the taxpayer.
- Intentional destruction of relevant documents outside the normal record retention policy raises other issues such as fraud, concealment and obstruction of justice.
- With respect to all significant transactions or large reported items, complete transactional documentation should be maintained, including key memoranda, notes etc. discussing such transactions and items, regardless of the requirements of the Code.

Best Practices and Strategies

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- Take “Precautions” – Be Disciplined to Protect the Jewels.
- Know your rules.
  - Understand and keep up with the laws and rules that apply.
  - Federal and state laws vary.
- Think about your role.
  - Consider the roles you perform and recognize that part of what you do may by protected by privilege.
  - Working at the direction of counsel.
- Preparation of documents.
  - Use business judgment on what and when documents need to be prepared.
  - Be label conscious.
  - Limit “dual purpose” documents by identifying purpose in opening paragraphs.