Tax Executives Institute
May 23, 2008

How to Preserve the Work Product Protection in the Current Environment

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Contents

- Why Protecting Documents Matters
- Difference Between Attorney-Client Privilege and Work Product Protections
- Specific Issues
  - Formal Tax Opinions
  - Tax Accrual Workpapers
  - *Textron* Litigation
  - FIN 48
- Recommendations

Why Does Protecting Documents Matter?

- Encourage employees to be forthcoming and candid with their attorneys so that the attorney is sufficiently well-informed to provide sound legal advice.
- *See Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

Why Does Protecting Documents Matter?

- Avoid disclosure of comprehensive internal and external legal analyses of transactions/issues subject to audit that will create a road map for the Service.
- Avoid disclosure of sensitive tax reserve analyses to the Service to prevent these from being the starting point of negotiations during an audit.
- Avoid disclosure of strategic communications with your outside advisors.
- Allow full and frank communications on a going forward basis with your tax advisors during the course of the audit and any future litigation, without fear of undermining the position.

Two Different Protections

- There are three different doctrines that protect documents from disclosure.
  - Attorney-client privilege
  - Statutory accountant-client privilege
  - Work product protection
- Attorney-client privilege and attorney work product differ in how they are created and when they are waived.
- It is important to understand the distinctions to protect documents to which one or both may apply.

Attorney-Client Privilege

- What is it?
  (1) Where legal advice of any kind is sought
  (2) from a professional legal adviser in his capacity as such,
  (3) the communications relating to that purpose,
  (4) made with an expectation of confidentiality
  (5) by the client, or by the legal advisor containing such communications by the client,
  (6) are at his instance permanently protected
  (7) from compelled disclosure by himself or by the legal adviser,
  (8) unless the protection is waived

Attorney-Client Privilege

- What decides whether a document is privileged?
  - The document must contain a privileged communication.
  - Giving a document to your lawyer does not make the document privileged.

Attorney-Client Privilege

- Communications with external legal advisors includes:
  - Direct communications with lawyer
  - Communications with law firm employees who assist attorneys in providing legal advice
- Attorneys employed by accounting firms are generally not considered to be functioning as attorneys for purposes of the attorney-client privilege.

Attorney-Client Privilege

- Communications involving in-house counsel
  - Communications with employees for purposes of providing legal advice are privileged.
  - Tax advice provided by in-house counsel with respect to the legal consequences of transactions is privileged.
  - The mere funneling of tax work done by non-attorneys through in-house counsel does not attach attorney-client privilege to documents.
  - Practically speaking, courts will examine assertions of privilege with respect to in-house counsel more closely because of the dual business/legal roles common to company lawyers.

Attorney-Client Privilege

- How is the privilege waived?
  - Actual Waiver
    - The privilege is waived when a privileged communication is voluntarily disclosed to a party not covered by the privilege.
    - The privilege may be waived when a privileged communication is involuntarily disclosed to a party not covered by the privilege.
    - The courts are also split as to whether an inadvertent disclosure is treated as an actual waiver or not a waiver of the privilege.
      - Alternative 1--An inadvertent disclosure is treated the same as a voluntary disclosure, without exception.
      - Alternative 2--To determine if an inadvertent disclosure should be treated as a waiver, a balancing test is applied, weighing the following factors: (1) whether the disclosing party took reasonable precautions to prevent disclosure; (2) the speed at which the party acted to correct its mistake; (3) the overall volume of documents provided; (4) the number of inadvertent disclosures; and (5) fairness.

Attorney-Client Privilege

- How is the privilege waived?
  - Implied Waiver
    - An implied waiver of the privilege occurs when a privilege holder makes an assertion of fact that in fairness requires examination of protected communications.
    - The Tax Court applies a three-part balancing test to determine if an implied waiver occurs:
      - Whether the assertion of the privilege was the result of an affirmative act by the asserting party;
      - Whether the asserting party put the protected information at issue through an affirmative act by making it relevant to the case; and
      - Whether application of the privilege would deny the opposing party access to information "vital" to its defense.

Attorney-Client Privilege

- Scope of Waiver
  - The waiver generally applies to all communications of the same "subject matter," but the scope of how to define "subject matter" differs significantly among courts.
    - Some courts limit the scope of the waived "subject matter" to material actually disclosed to an uncovered party.
    - Other courts take a much broader approach and treat the waiver as including any privileged material with the same general subject matter of the disclosed communications (e.g., all communications related to a particular transaction).
  - Disclosure of a privileged opinion letter to the Service for penalty protection purposes may be seen as an actual waiver of the attorney-client privilege and, depending upon the application of the "subject matter" test, could result in the waiver of privilege with respect to a much broader set of communications.

Federal Statutory Accountant-Client Privilege

- Applies to communications
  - After July 22, 1998
  - Between "federally authorized tax practitioners" and client
- Intended to apply the same common law protections as the attorney-client privilege
- Only applies to the extent that the communication would be considered a privileged communication if it were between a taxpayer and an attorney
- Does not apply to certain "tax shelter" transactions (i.e., transaction with a "significant" purpose of tax avoidance or evasion)
  - For communications prior to October 22, 2004, does not apply to "corporate" tax shelters
  - For communications after October 22, 2004, does not apply to any tax shelters
- The privilege may only be asserted by a taxpayer or accountant in any noncriminal proceeding before the Service or any noncriminal tax proceeding brought in Federal court.

Federal Statutory Accountant-Client Privilege

- Based upon one court's analysis, tax opinion letters prepared by accountants may not be protected from disclosure by the accountant-client privilege.
  - *United States v. KPMG, LLP*, 237 F. Supp. 2d 35 (D.D.C. 2003)
    - Tax opinion prepared by accountants is not protected by the accountant-client privilege because the analysis in the opinion letter was "prepared in connection with preparation of a tax return" as the opinion related to a transaction to be disclosed on the taxpayer's tax return.
- Tax opinion letters prepared by accountants may be protected from disclosure to the Service by the work product doctrine. *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998) (see discussion in following slides).

Work Product Doctrine

- What is this protection?
  - Documents prepared "in anticipation of litigation" or for trial by or for another party, or by or for that other party's representative, are protected from disclosure.
  - Mental impressions of attorneys/other representatives are protected.
  - Substantial need exception may be asserted to overcome the work product protection, but a heightened standard is generally applied by the courts to protect mental impressions as opposed to factual information.

Work Product Doctrine

- What is "in anticipation of litigation"?
  - Because of Litigation Test—Majority Test
    - If in light of the nature of the document and the factual situation in a particular case, the document can be said to have been prepared or obtained at least in significant part because of the prospect of litigation. *See Adlman*, 134 F.3d at 1202.
  - "Primarily to Assist In Litigation" Test—Minority Test
    - The primary motivating purpose behind the creation of the document must be to aid in possible future litigation.
    - Applied by the Fifth Circuit Court of Appeals. *See United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981).

Work Product Doctrine

- What is “in anticipation of litigation”?
  - Need to be already thinking about and anticipating potential litigation.
  - Helpful if litigation is in fact likely and not just a possibility.
  - Mere risk of challenge by IRS on audit may not be enough without actual anticipation of litigation.

Work Product Doctrine

- How is work product protection waived?
  - Voluntary disclosure to an adversary in litigation automatically waives work-product protection with respect to the items disclosed. *See In re Steinhard Partners, L.P.*, 9 F.3d 230 (2d Cir. 1993).
  - However, voluntary disclosure of work product to a third-party who is not an adversary does not necessarily waive the protection for other materials unless the disclosure "substantially increases the opportunity for potential adversaries to obtain the information." *In re Grand Jury*, 561 F. Supp. 1247 (E.D.N.Y. 1982).
  - Some courts have also limited a waiver of the work-product protection to only factual materials disclosed, maintaining the protection with respect to documents involving "core attorney mental processes." *In re Kidder Peabody Security Litigation*, 168 F.R.D. 459 (S.D.N.Y. 1996).

Work Product Doctrine

- Courts have reached different conclusions with respect to whether disclosures to outside auditors waive work product protection
  - *Medinol, Ltd. v. Boston Scientific Corp.*, 2002 U.S. Dist. LEXIS 20611, at * 10 (S.D.N.Y. 2002) (work product protection waived)
  - *In re Pfizer Inc. Sec. Litig.*, 1993 U.S. Dist LEXIS 18215, at *21 (S.D.N.Y. 1993) (work product protection not waived)
  - *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004) (work product protection not waived)
  - *United States v. Textron, Inc.*, 507 F. Supp.2d 138(D.R.I. Aug. 28, 2007) (work product protection not waived).

Concerns Regarding Formal Tax Opinions

Are Tax Opinion Letters Privileged?

- Opinion letters prepared by attorneys are generally privileged
- Opinion letters prepared for the specific purpose of disclosure to the Service to avoid potential tax penalties are not privileged

How Can Privileged Opinion Letters Be Protected from Disclosure to the Service?

- If you want a privileged opinion letter, but also need penalty protection, make sure you obtain separate opinions.
  - It would be prudent to engage separate firms to prepare opinion letters for each purpose.
- If possible, avoid providing opinion letters to independent auditors as part of your audit workpapers (e.g., in support of reserve analyses) as this will immediately waive the privilege and potentially result in a subject matter waiver.
  - See more detailed discussion below regarding this issue.
- Keep opinion letters separate from non-privileged documents to avoid the possibility that they will be inadvertently disclosed to third parties, resulting in a waiver of privilege/work-product protection.
  - May waive protection by orally disclosing conclusions in audit.

How Can Privileged Opinion Letters Be Protected from Disclosure to the Service?

- If an opinion letter has been prepared for penalty protection purposes and you intend to disclose it to the Service, do not treat the opinion as a privileged document in your files and do not claim the document as privileged in response to IDRs, as this will reduce the possibility that the production of the document may be treated as a waiver of privilege.

- At a minimum, if you decide to produce opinion letters to the Service for penalty avoidance purposes for which you have previously asserted a privilege, try to obtain an agreement with the Service that it will not assert in the future that the production of the opinion constituted a subject matter waiver.

U.S. v. Roxworthy

- In *U.S. v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006) the Sixth Circuit held that two memoranda prepared by KPMG for Yum! Brands, Inc. were protected from disclosure to the IRS under the work product doctrine
- The memoranda were addressed to in-house "corporate counsel" at Yum's predecessor company, Tricon Global Restaurants, Inc. The memoranda analyzed the tax consequences of certain transactions entered into by Yum pertaining to the creation of a captive insurance company and related stock transfers. The memoranda discussed possible arguments the IRS might raise against the transactions and potential counterarguments.
- The magistrate judge ruled that the documents were not protected because they were prepared irrespective of the prospect of litigation to support Yum's tax return and avoid penalties. The district court agreed with the magistrate judge, even after Yum filed supplemental affidavits describing the purpose of the memoranda to prepare for likely litigation with the IRS over the tax consequences of the controversial transactions.

U.S. v. Roxworthy

- The Sixth Circuit reversed and held that the memoranda were protected by the work product doctrine.
- In particular, the Sixth Circuit ruled that the memoranda were prepared in anticipation of litigation and that the anticipation of litigation was objectively reasonable given the nature of the transactions.
  - "In the absence of any evidence to the contrary, the affidavits and deposition testimony supplied by Yum are adequate to demonstrate that Yum did not commission the memoranda as part of the ordinary course of business of completing the transactions and that Yum in fact anticipated litigation because of the certainty of an IRS audit, the conspicuousness of the $112 million discrepancy between tax and book loss, and the unsettled law surrounding captive insurance."
  - The Sixth Circuit applied the "because of" standard and stated, "the documents do not lose their work product privilege 'merely because [they were] created in order to assist with a business decision,' unless the documents 'would have been created in essentially similar form irrespective of the litigation.'"

Concerns Regarding Tax Accrual Workpapers

Tax Accrual Workpapers – In General

- Tax accrual workpapers include documentation of the company's analysis of tax contingencies and reserves reported on financial statements, including roll-forwards of changes to the reserves.
- The workpapers may include memoranda, analyses and schedules that reflect the company's hazards-of-litigation determinations.
- The workpapers may be prepared by company attorneys, company accountants, and other company personnel, and by outside legal or accounting advisers.
- The workpapers may be reviewed by or provided to various persons, both inside and outside the company.

Outside Auditor's Interest in Tax Accrual Workpapers

Outside Auditor's Interest in Tax Accrual Workpapers

- AICPA Audit Standards
  - Outside auditors will seek to review tax accrual workpapers.
  - AICPA Professional Standards require that "sufficient competent evidential matter" be obtained "to afford a reasonable basis for an opinion regarding the financial statements under audit." AICPA Professional Standards, AU section 9326, *Evidential Matter: Auditing Interpretations of Section 362.*
  - The Standards specifically require that audit documentation include "sufficient competent evidential matter about the significant elements of the client's tax liability contingency analysis." AICPA Professional Standards, AU section 9326, *Evidential Matter: Auditing Interpretations of Section 362.*

Outside Auditor's Interest in Tax Accrual Workpapers

- PCAOB Audit Standards
  - Sarbanes-Oxley created the Public Company Accounting Oversight Board (PCAOB). PCAOB has adopted audit documentation requirements in Auditing Standard No. 3 - Audit Documentation.
  - That Standard requires documentation that:
    - Demonstrates that the audit complied with PCAOB standards
    - Supports the auditor's conclusions regarding every relevant financial statement assertion
    - Demonstrates that the underlying accounting records agreed or reconciled with the financial statement
  - All significant findings are required to be documented, including "uncertainties as well as related management assumptions."

IRS Interest in Tax Accrual Workpapers

The Service's General Policy

- In *United States v. Arthur Young & Co.*, the Supreme Court held that tax accrual workpapers enjoy no special protection against disclosure to the Service.
- Nevertheless, in Announcement 84-46, the Service stated that it would demonstrate "administrative sensitivity" and generally would not request tax accrual workpapers.
- Until 2002, the Service would request tax accrual workpapers only in unusual circumstances.

The Service's New "Tax Shelter" Policy

- In 2002, responding to tax shelter developments, the Service adopted a new tax accrual workpaper policy, under which workpapers will be requested from taxpayers that engage in "listed transactions."

- The Service's goal was to reduce the corporate appetite for tax shelters by telling companies that, if they engage in "listed" tax shelter transactions, they will be required to disclose their tax accrual workpapers.

- The new policy was initially set forth in Announcement 2002-63, was augmented in LMSB Questions & Answers and in Chief Counsel Notice 2004-010, and was finally memorialized in Internal Revenue Manual section 4.10.20.

The Service's New "Tax Shelter" Policy

- If a taxpayer engages in one listed transaction, and properly discloses that transaction, the Service will request only the portion of the tax accrual workpapers concerning that transaction.

- However, the Service will request all tax accrual workpapers if:
  - The listed transaction is not properly disclosed, or
  - The taxpayer engages in multiple listed transactions, or
  - There are reported financial irregularities regarding the taxpayer

- This new policy applies to tax returns filed after July 1, 2002 (some returns filed earlier also may trigger a request, if listed transactions were not disclosed).

Conflicts Between Taxpayers and the IRS Over Disclosure of Tax Accrual Workpapers

The Tug-of-War Over Tax Accrual Workpapers

- Because of the increasing number of "listed transactions" identified by the Service, the chance that a taxpayer's tax accrual workpapers will be requested by the Service has increased significantly.
- "Listed transactions" also include transactions that are "substantially similar" to an expressly listed transaction.
- Regulations state that the "substantially similar" standard is to be broadly construed in favor of treating transactions as within the scope of the expressly listed transactions.
- Disclosure is required even for transactions that become listed transactions at a subsequent time

The Tug-of-War Over Tax Accrual Workpapers

- As noted above, there is no special, blanket protection that can be claimed for tax accrual workpapers.
- However, when the Service requests tax accrual workpapers, a taxpayer may be able to assert three potential defenses:
  - Attorney-client privilege
  - Work product protection
  - The section 7525 tax practitioner-client privilege
- These defenses cannot be asserted as blanket protections, but must be asserted and established on a document-by-document basis.

The Tug-of-War Over Tax Accrual Workpapers

- To prevail, the taxpayer first must prove that, given the circumstances in which each workpaper was created, the asserted privilege or protection initially applied to the document.
- This involves an analysis of:
  - What is the document?
  - Why was the document created?
  - Who created the document?
  - What are the contents of the document?
  - Was the document intended to be kept confidential?

The Tug-of-War Over Tax Accrual Workpapers

- To prevail, the taxpayer also must prove that, given the circumstances in which the workpapers were thereafter maintained, the asserted privilege or protection was not waived.

- This involves an analysis of:
  - Who within the company had access to the document?
  - Was the document stored in secure file?
  - Was the document disclosed outside the company?

- The privilege can be waived for a single document. Also, the disclosure of one document can waive the privilege for all documents that concern the same subject matter.

The Tug-of-War Over Tax Accrual Workpapers

- Tax accrual workpapers may not be privileged or protected if:
  - They are not created by or at the direction of persons who can create privileged or protected documents;
  - They contain solely business advice;
  - They were not intended to remain confidential.
- Tax accrual workpapers may lose any existing privileged status if:
  - They are widely distributed within the company;
  - They are not maintained in a secure fashion; or
  - They are turned over to a third party, including outside auditors.
- In either case, they may become subject to disclosure to the Service.

Can Tax Accrual Workpapers Be Privileged?

- In *El Paso Co.*, the Fifth Circuit said "we would be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of litigation on it are not legal advice."
  - The court held that disclosure to outside auditors waived any privilege.
  - The case was decided before the enactment of section 7525.
- In *Rockwell International*, the Third Circuit held that the determination of whether a tax reserve analysis is protected by the attorney-client privilege is dependent on several factors:
  - Does it represent legal advice, or business advice, of an attorney?
  - Who was involved in its preparation?
  - Who has control of the file?
  - Was it intended to be disclosed to third parties, such as an independent auditor?
  - Was it actually disclosed to a third party?
  - The court remanded to the trial court for factual findings on these factors
- The Service's position is that a company's auditor is a third party so that disclosure to the auditor waives privilege.
- As discussed later, in *U.S. v. Textron* the District of Rhode Island agreed that disclosure to an independent auditor waives privilege.

Can Workpapers Be Protected As Work Product?

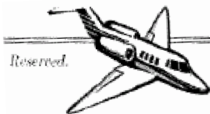
- A tie to anticipated litigation must be firmly established.
  - The author of the document should be involved with tax litigation.
  - The document should be created, at least in part, because of the expectation of litigation.
  - The analysis should be used in making litigation decisions.
- Whether "dual purpose" documents are protected varies:
  - In "because of" jurisdictions, having a "dual" litigation and business purpose for creating a document does not prevent work product protection.
  - In "primary motivation" jurisdictions, the litigation purpose for creating the document must be primary (or even exclusive).
- Work product protection for legal analyses generally is not waived by disclosure (such as to outside auditors) because work product is usually waived only if disclosed to an "adversary".

Can Workpapers Be Section 7525 Privileged?

- The workpaper must be prepared by a qualifying "tax practitioner."
- The tax practitioner must be giving tax advice.
- The Service and the courts may presume that a tax practitioner is giving business advice, tax return advice, or financial statement advice.
- However, if the tax advice is similar to legal advice that would be attorney-client privileged, then the section 7525 privilege should apply.
- But, tax advice from non-lawyers regarding tax shelters is not protected.
- Also, the privilege can be waived through disclosure.

Textron Litigation

United States v. Textron



THE WALL STREET JOURNAL.

Tax Battle: IRS vs. Textron

The Maker of Aircraft and Golf Carts Tries to Keep Uncle Sam Out of Its Files

By Jesse Drucker

TEXTRON INC., AN AEROSPACE and defense contractor, is in an uphill legal battle with the Internal Revenue Service that could win U.S. corporations a significant new weapon in tax disputes.

The conglomerate is resisting demands by the IRS for internal documents about its use of allegedly abusive tax shelters. Tax collectors have become more aggressive in recent years in demanding such records, and most companies comply. Textron is the first company that the federal government has taken to court over the issue, the IRS says. Legal experts say the IRS has the upper hand in the fight, but tax lawyers are watching to see if the case alters the balance of power in corporate tax disputes.

It's unclear how much money is at stake. Textron makes Cessna Aircraft, Bell Helicopters, golf carts, lawn mowers and other products. It had revenue of about $10 billion in 2005, nearly a third of that from its Bell segment, which makes combat helicopters, armored vehicles, munitions and other defense products. Textron's stock, which closed yesterday at $86.67 on the New York Stock Exchange, has risen fairly steadily since the beginning of the Iraq war in early 2003, when it traded near $30.

In 2001, Textron bought several telephone networks and a railroad system overseas and then leased them back to their owners, according to a Justice Department court filing. Such arrangements can produce big tax benefits because depreciation can be claimed on the assets to reduce taxable income.

Some leasing transactions that reduce taxes are legitimate, but the IRS has tried to crack down on aggressive ones it calls "sale in, lease out" deals. In 2004, Congress outlawed future so-called SILOs, and the IRS ...

to SILOs. Toward that end, last year it ...

United States v. Textron: Facts

- IRS requests Textron's tax accrual workpapers: First reported case since *Arthur Young*.
- Presence of more than one listed transaction.
- Facts:
  - Attorneys prepared workpapers
  - Kept confidential
  - Content shared with accounting firm

United States v. Textron: Facts

- Content of tax accrual workpapers
  - List of issues (uncertain tax positions)
  - List of "hazards of litigation" conclusions, expressed as percentage chance of losing each issue in court
  - List of monetary value of each issue and reserve

United States v. Textron: Facts

- Attorneys involved: Different facts, different rules

  - Attorney/client privilege

  - FRCP 26(b)(3): Protection for work product

United States v. Textron: Issues

- Issues
  - Do workpapers include "legal advice?" If so,
    - Was attorney/client privilege waived by communication to accounting firm?
    - *See* IRC 7525 privilege for accountants providing tax advice.
    - Are auditors providing "tax advice" with respect to the items contained in tax accrual work papers?
  - Were workpapers (all or portion) prepared in anticipation of litigation? FRCP 26(b)(3) (rules relating to protected "work product.")
    - Are workpapers entitled to "super" protection because they contain "mental impressions and conclusions of attorneys?"
    - Was "work product" protection forfeited when papers were shared with accounting firm?

United States v. Textron: Issues

- Issues (continued)
  - Circuit courts have two different standards for work product protection; Fifth Circuit is most restrictive. To be work product, papers must be primarily prepared for litigation.
  - In *El Paso* (1982), Fifth Circuit rejected taxpayer's "work product" argument.
  - Most other circuits reject this rule and follow what is called "dual purpose" rule.
  - Under the "dual purpose" rule, work product can be "in anticipation of litigation" even if in the first instance it was prepared for non-litigation business purpose. *See State of Maine* (C.A.1).

United States v. Textron: Decision

- Court denied IRS petition to enforce summons
- Court reached the following conclusions:
  - Privilege
    - Tax accrual work papers were initially protected by attorney-client privilege and sec. 7525 tax practitioner-client privilege
    - However, the privileges were waived when the workpapers were disclosed to Textron's independent auditors
  - Work Product
    - Tax accrual work papers were protected by work product because they would not have been prepared "but for" the fact that Textron anticipated the possibility of litigation with the IRS.
      - *El Paso* case distinguished because it applied a "primary purpose" test. "Because of" or "But for" test controls in the First Circuit.
    - Work product protection was not waived because disclosure to independent auditors did not substantially increase the opportunity for potential adversaries (i.e., the IRS) to obtain the information.

United States v. Textron: First Reactions

- *Textron* was a major victory for taxpayers
  - Established limits on IRS ability to obtain information
  - Determined that tax accrual workpapers were legal advice protected by privilege and work product
  - Determined that disclosure to independent auditors is not disclosure to an adversary that waives work product protection
- However, the full scope of the victory is yet to be determined.
- Important to remember:
  - Tax accrual workpapers at issue were prepared by counsel providing legal advice, not independent auditors
  - Circuit split on application of work product; First Circuit is a "because of" jurisdiction; Others require "primary purpose" for work product to apply
    - Textron court stated that even if the workpapers were needed to satisfy independent auditors for purposes of verifying reserves, the workpapers were still prepared "because of" anticipated litigation
    - Unclear how same question would be resolved in a "primary purpose" jurisdiction.
  - Confidentiality agreement in place between Textron and independent auditors

United States v. Textron: Future Implications

- *Textron* appeal currently in First Circuit.
- Financial Executives International ("FEI") has filed *amicus curiae* brief in support of taxpayer based on potential broad implications of case beyond tax accrual workpapers.
- Points emphasized in FEI *amicus curiae* brief:
  - Outcome of case could affect work product protection for evaluations of any pending or threatened claims given to auditors for purposes of establishing reserves.
  - Companies and their auditors are not adversaries; they share the same goal of presenting accurate financial statements to the investing public.
  - Auditors are bound by rules of professional conduct to keep information confidential. Accordingly, providing work product material to auditors should not waive the protection.

Regions Financial Corporation v. United States (N.D. AL 2008)

- The Northern District of Alabama also recently held in favor of the taxpayer and determined that documents were protected by work product from disclosure to the IRS.
- In *Regions*, the documents at issue contained legal opinions and analysis from a law firm and evaluations of that analysis by Regions' auditors. The documents at issue also included certain "derivative documents" that discussed conclusions in the "core documents."
- The court determined that all the documents were protected by work product and that disclosure of the legal analysis of the law firm to the auditors did not waive protection.

Regions Financial Corporation v. United States (N.D. AL 2008)

- The court determined that the primary purpose standard applicable in the Fifth Circuit did not apply in the Eleventh Circuit. The court adopted the majority "because of litigation" standard.
- The court criticized the IRS for misciting *United States v. El Paso*, 682 F.2d 530 (5th Cir. 1982) and claiming the opinion stated the standard as "primarily or exclusively to assist in future litigation" rather than "primarily to assist in future litigation."
- Regardless, the court determined that the documents at issue would be protected under either the "primary motivating purpose" test or the "because of litigation" test.
- The court noted that it "has found no support for the conclusion that a party must show that it was motivated by preparation for litigation and nothing else in order to claim that a document is protected work product."
- The court concluded that Regions met its burden of demonstrating that the documents were prepared in anticipation of litigation. The court stated, "[t]he fact that Regions undertook the time and expense of consulting outside firms to assess its potential liabilities shows that it believed litigation to be likely, and this court cannot say that Regions' subjective believe was objectively unreasonable."

Regions Financial Corporation v. United States

- The court concluded that the fact that Regions provided the documents to its auditors did not waive work product protection because the auditor was not a potential adversary.
- The court stated, "There is simply no conceivable scenario in which [the auditor] would file a lawsuit against Regions because of something [the auditor] learned from Regions' disclosures."

Does Work Product Protection extend to tax reserve numbers and calculations?

- The workpapers at issue in *Textron* contained attorney analysis and support for tax reserve numbers established by *Textron*.
- The taxpayer's case may have been more difficult if the information at issue was limited to the reserve numbers themselves and did not contain any attorney analysis.
- Arguably the reserve numbers are the result of the attorney analysis and therefore should also be protected. However, the reserve numbers themselves are reflected in financial statements and therefore may be difficult to protect as work product.
- The calculations to determine the reserves are arguably more similar to the "hazards of litigation" information at issue and ultimately protected in *Textron*.
- In *Regions*, the court mentioned in a footnote that "[t]he documents Regions seeks to withhold are less broad than those withheld in Textron because Regions has already disclosed the fact and amounts of its reserves."

Potential Impact of FIN 48

Issues Arising in IRS Audits in FIN 48 World

- FIN 48 workpapers are tax accrual workpapers.
- Former IRS Large and Mid-Size Business Commissioner Deborah Nolan, speaking at a DC Bar program April 12, 2007, said the IRS is currently considering whether its "policy of restraint" regarding tax accrual work papers should be changed.
- However, acting IRS commissioner Linda Stiff, speaking at a TEI event on October 22, 2007, stated that the IRS had no current plans to change the policy of restraint. Stiff did, however, note that IRS agents were being trained on financial statement analysis and FIN 48.
- It is unclear what affect, if any, the taxpayer win in *Textron* will have on IRS policy.

Issues Arising in IRS Audits in FIN 48 World

- Since the IRS treats FIN 48 workpapers as tax accrual workpapers, taxpayers without listed transactions should use IRS policy to protect these documents.
  - Restraint in asking for tax accrual workpapers is IRS policy. Accordingly, it should not be necessary to raise privilege to protect such documents in ordinary course; but, the policy could change.
  - Taxpayers should rely on the IRS "restraint policy" where appropriate.
  - If "unusual circumstances" are not present, taxpayers should be able to oppose a request for FIN 48 workpapers.

Issues Arising in IRS Audits in FIN 48 World

- Issues where taxpayers have listed transactions.
  - FIN 48 workpapers may contain very sensitive information concerning litigation/settlement "hazards" analysis.
    - Highly prejudicial if obtained by IRS.
    - Where FIN 48 workpapers are requested, taxpayer must examine facts and law to determine if documents are privileged or protected work product.

Subsequent Recognition – Proposed FASB Staff Position

- FSP FIN 48-a Exposure Draft released February 27, 2007
- Guidance on determining whether previously unrecognized tax position is "effectively settled;" term "ultimate settlement" dropped
  - Taxing authority completed all exam procedures it is required or expected to perform for the tax position
  - No appeal or litigation is intended for any aspect of the tax position
  - Based on taxing authority's "widely understood policy," enterprise considers it highly unlikely that the tax position would be subsequently examined or reexamined, presuming taxing authority has full knowledge of all relevant information
- Final FSP will be effective upon initial adoption of FIN 48; An entity that did not apply FIN 48 consistent with the final FSP FIN 48-a will be required to apply the provisions of FSP FIN 48-a retrospectively to the date of the initial adoption of FIN 48.

Recommendations

General Policies

What Steps Can be Taken to Protect Privileged Documents and Communications from Disclosure to the Service?

- Be certain to include counsel meaningfully in communications regarding legal issues, and document their substantive role.
- Coordinate with General Counsel with respect to privileged tax documents to avoid waiver of privilege in other litigation
- Avoid inappropriate claims of privilege on documents
  - Risk of waiver
  - Credibility issues
- Enter into written agreements through counsel with third-party consultants to whom you wish to disclose privileged information (e.g., *Kovel* arrangement).
- Be aware of the potential limitations of the accountant-client privilege, particularly when considering whether to disclose sensitive documents in the context of the preparation of an opinion letter.

What Steps Can be Taken to Protect Privileged Documents and Communications from Disclosure to the Service?

- Limit communications between your independent auditors and your tax advisors (both inside and outside), as these communications may not be privileged; Negotiate with auditors to limit scope of documents reviewed.

- Be aware that the disclosures of information or documents (e.g., tax opinions) to the Service pursuant to the taxpayer disclosure regulations (Treas. Reg. § 1.6011-4) may result in a subject matter waiver of the attorney-client privilege that could reach a wider range of privileged communications.

How Should Privileged, Sensitive Documents be Handled?

- Only disclose legal documents with respect to an issue to other employees/officers on a need-to-know basis.
  - The wider the distribution, the more likely it is that a court will find there has been a waiver.

- Separate and clearly mark legal documents to avoid an inadvertent waiver of privilege/work-product protection.
  - This not only protects against waiver, but can demonstrate intent.

- No privilege will attach to business documents, so store business documents in a separate location from the legal documents.

Formalize a Tax Litigation Group

- In general:
  - The Group advises the Company on the conduct of tax controversies and litigation, and advises the Company on the hazards of litigating tax issues.
    - In smaller companies, the Group does not necessarily need to consist of separate employees. However, the employees should be clearly delineated when functioning in the Group's role.
  - The Company relies on the Group's advice in deciding whether and how to proceed in litigation, whether to settle, and what settlement terms to propose or accept.
- The Group's primary purpose is handling tax controversies. In that role, it provides hazards-of-litigation analysis and legal advice regarding the Company's tax litigation.
- Secondarily, the Company uses the Group's hazards-of-litigation advice in establishing financial statement tax reserves.

Formalize a Tax Litigation Group

- The Group's leader should be an attorney, and:
  - Should be responsible for managing tax litigation
  - Should have at least a dotted line to the law department (to enjoy a presumption that the attorney-client privilege applies)
- The Group's work should be done under the leader's direction and control.
- Group members, to the extent possible, should be attorneys or act at the direction of attorneys.
- The Group should exclude persons whose responsibilities are solely the preparation of financial statements.

Control Who Creates Documents

- Documents should be created at the direction of, and under the control and supervision of, the Group's leader.

- Documents should indicate that they are prepared by attorneys or tax practitioners.

- Documents should indicate that they are prepared at the request of the Group leader for litigation purposes.
    - Careful and discriminating use of such labels is imperative.

Create Only Defined Types of Documents

- In general:
  - Confine legal analysis to litigation-oriented documents that are most entitled to privilege and work product protection
  - When creating documents, separate legal analysis from:
    - Business advice
    - Tax reserve numbers and calculations
    - Other advice not intended to remain confidential
- Create documents for disclosure outside the Group that contain:
  - Only hazards-of-litigation percentages
  - Only aggregate reserve information

Control How Documents Are Labeled

- Documents should state that they are providing legal advice to be used for litigation purposes.
- Documents should be labeled, as appropriate, to state that they contain confidential legal advice, subject to privilege and protected by the work product doctrine.
- Do not label business advice, tax return advice, or other advice not intended to be confidential, as privileged or protected.
- Do not label documents containing legal analysis and advice as documents that relate to tax reserve analysis or tax contingency analysis.

Control Access to Documents Inside the Company

- Restrict access to confidential documents.
- In each instance, distribute the least confidential document possible.
- Establish a central storage file, and restrict access to it.
- Password protect electronic files.
- Discourage the keeping of personal files, paper and electronic.
- Avoid "broadcast" emails and limit email "chains."
- Do not place legal memoranda and analyses into tax accrual workpaper files.

Enact Policies to Identify Anticipated Litigation

- Make use of document hold requests to communicate that litigation is anticipated
- Consider formal guideline that certain counsel are involved only in issues expected to result in litigation

Handle Outside Auditor Requests for Information With Care

Negotiate Disclosures to Outside Auditors

- Does disclosure to outside auditors constitute a privilege waiver?
  - *El Paso* held "yes," but possibly only because there was then no accountant-client privilege (decision was pre-section 7525)
  - No waiver now due to I.R.C. section 7525?
  - Are the auditors providing protected tax advice?
  - Can disclosure be restricted to tax attorneys in the auditing firm, who could then be considered "specialists" under AICPA Professional Standards, AU section 336? Would such an arrangement be permitted under Sarbanes-Oxley standards?
  - Is the auditor's duty of confidentiality sufficient to avoid waiver?
  - Court in *Textron* held that disclosure to outside auditors did constitute a privilege waiver.
- Disclosure is not likely to compromise work product protection
  - Court in *Textron* held that disclosure to outside auditors did not constitute a work product waiver.

Negotiate Disclosures to Outside Auditors

- Negotiate with the auditors to disclose only the least confidential types of tax accrual workpapers.

- AU section 9326.22 allows:
  - Rather than the "actual advice," the disclosure of "other sufficient documentation"
  - "Redacted or modified opinions"
  - A summary analysis of an opinion
  - A representation that "the client has not received any advice or opinions that are contradictory to the client's support for the tax accrual"

- Consider giving the auditors only the list of issues reflected in the tax reserves, and the aggregate amount of the reserves.

Negotiate Disclosures to Outside Auditors

- Enter into a confidentiality agreement with the auditors.
- Enter into a common interest agreement with the auditors, specifying that the Company is providing access to documents solely for the purpose of the parties' common interest in performing the audit, that confidentiality will be maintained, and that no waiver of privilege is intended.
- Include in auditor engagement letters a representation regarding non-adversarial relationship.
- The general rule is that, with respect to an attorney's analysis and mental impressions, work product protection cannot be waived merely by disclosure.
  - Resist disclosure of the documents most clearly prepared in anticipation of litigation.

Handle IRS Requests for Information With Care

Negotiate Disclosures to the Service

- Require approval of the Group's leader before documents are disclosed to the Service.
- Establish a screening process to prevent disclosures that could result in a waiver of privilege.
- In tax accrual workpaper IDR responses, emphasize the litigation function of the Group, and emphasize the legal content and confidential nature of the documents.
- Prepare a detailed privilege log, stating the specific grounds that support the claim for privilege and protection.
- Be careful about representations to the Service when negotiating disclosure.

Negotiate Disclosures to the Service

- Consider disclosing the least confidential documents to the Service.
  - Do not seek protection for non-confidential documents.
  - Disclose to the Service those documents that contain no legal analysis or advice.
  - Beware of creating a subject matter waiver.

- Focus the controversy on the most protected documents.
  - Withhold those documents that contain legal analysis and advice.
  - Force the Service to determine whether it wishes to press the issue against a taxpayer that has cooperated, but that has taken careful steps to create and maintain confidential documents.