

Tax Executives Institute

**Recent Developments in
Tax Litigation**

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Overview of Recent Cases

- Intermountain Insurance Service of Vail v. Commissioner and Mayo Foundation for Medical Education and Research v. United States
 - Deference to regulations under Chevron standards after these recent cases
- Consolidated Edison Company of NY v. U.S.
 - Document Retention (and Destruction)
 - Spoliation
- Canal Corporation & Subsidiaries v. United States
 - Role of opinions in tax litigation
 - Trends after Long-Term Capital Holdings and Canal
 - Recommendations for obtaining opinions
- Xilinx
 - Transfer pricing and stock-based compensation
- Veritas Software Corp. & Subsidiaries v. Commissioner
 - Buy-in transfer pricing
- United States v. Deloitte
 - Impact on Work Product Doctrine
 - Recommendations for Protecting Documents after Deloitte

JUDICIAL DEFERENCE

**Intermountain Insurance Service of Vail v.
Commissioner
and
Mayo Foundation for Medical Education
and Research v. United States**

JUDICIAL DEFERENCE

- Intermountain Insurance Service of Vail v. Commissioner, 134 T.C. 11 (2010), and Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011), are two important opinions that discuss judicial deference to agency regulations.

Intermountain Ins. Svc. of Vail v. Commissioner, 134 T.C. 11 (2010)

- The Tax Court granted the Taxpayer's motion for summary judgment on the basis that the IRS issued the related FPAA to Taxpayer beyond the general 3-year period of limitations for assessing tax against Taxpayer's partners.
- Less than one month after the decision, IRS issued temporary regulations extending the 6-year period of limitations to income tax deficiencies resulting from basis overstatements.
- The IRS filed motions to vacate the decision and to reconsider in light of the temporary regulations.
 - The Taxpayer argued the temporary regulations were either inapplicable, invalid, or otherwise not entitled to deference.

Intermountain Ins. Svc. of Vail v. Commissioner, 134 T.C. 11 (2010)

- The Tax Court denied the motions to vacate and to reconsider, refusing to accord the IRS's interpretation deferential treatment.
 - There were three different opinions in support of the result.

Intermountain Ins. Svc. of Vail v. Commissioner, 134 T.C. 11 (2010)

- The majority found that the same statutory language at issue had been examined by the Supreme Court in Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), and concluded that the Colony Court had found the statutory language unambiguous. Thus, Colony foreclosed interpretation of the statutory provisions.
 - In fact, Colony had interpreted section 275 of a prior version of the Code.
 - Other courts had chosen not to apply Colony to Section 6501.
 - The majority accepted the controversial position that a court may look to legislative history to decide if a statute is unambiguous.

Intermountain Ins. Svc. of Vail v. Commissioner, 134 T.C. 11 (2010)

- Some courts have found that Colony does not apply and an overstatement of basis can be an omission from gross income. See, e.g., Phinney v. Chambers, 392 F.2d 680 (5th Cir. 1968); Home Concrete & Supply, LLC v. United States, 599 F. Supp. 2d 678 (E.D. N.C. 2008); Burks v. United States, 2009 WL 2600358 (N.D. Tex. June 13, 2008); Brandon Ridge Partners v. United States, 100 A.F.T.R. 2d 2007-5347, 2007 WL 2209129 (M.D. Fla. Jul. 30, 2007).
- Others courts have found that Colony does apply and an overstatement of basis is not an omission of gross income. See, e.g., Salman Ranch Ltd. v. United States, 573 F.3d 1362 (Fed. Cir. 2009); Bakersfield Energy Partners LP v. Commissioner of Internal Revenue, 568 F.3d 767 (9th Cir. 2009); Grapevine Imports, Ltd. v. United States, 77 Fed. Cl. 505 (2007).
- The earlier Tax Court decision in Intermountain relied on Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. 207 (2007), aff'd 568 F.3d 767 (9th Cir. 2009).

Intermountain Ins. Svc. of Vail v. Commissioner, 134 T.C. 11 (2010)

- The majority also found the plain meaning of the effective/applicability date of the temporary regulations indicated that the regulations were not applicable because the applicable statutes of limitations had expired before they were issued.
 - The majority found the IRS's interpretation of the effective/applicability date was "irreparably marred by circular, result-driven logic and the wishful notion that the temporary regulations should apply to this case because [Taxpayer] was involved in what [the IRS] believes was an abusive tax transaction."
 - The majority gave no deference to the agency's interpretation of its own rule because it was "plainly erroneous."

Intermountain Ins. Svc. of Vail v. Commissioner, 134 T.C. 11 (2010)

- A concurring opinion found the temporary regulations were procedurally invalid under the Administrative Procedure Act ("APA"); the regulations were legislative, not "interpretive," because they were meant to bind the public.
 - Legislative regulations must go through "notice and comment."
 - These were legislative regulations because they were meant to bind the public and were issued pursuant to the power to promulgate rules for the enforcement of the Code.
 - Interpretative rules merely advise the public of the agency's view of a statute.
 - *Nb.* A regulation is not interpretive for purposes of the APA simply if issued under Section 7805.

Intermountain Ins. Svc. of Vail v. Commissioner, 134 T.C. 11 (2010)

- Another concurring opinion agreed the motions should be denied, but argued that examination of the substantive issues was not necessary.
 - A regulation promulgated after a final decision is not grounds to reopen a case.
 - It is not fair to allow an agency to redesign the playing field after losing.

Beard v. Comm'r, No. 13372-06 (Jan. 26, 2011)

- Note that the Seventh Circuit recently reversed the Tax Court in Beard v. Comm'r, No. 13372-06 (Jan. 26, 2011) with respect to a different taxpayer with a similar issue regarding whether a basis overstatement constitutes an omission from gross income for purposes of section 6501(e).
- The Seventh Circuit concluded that Colony did not apply because the basis overstatement of the taxpayers in Colony was in the course of a trade or business and the basis overstatement of the taxpayers in Beard was not. The Seventh Circuit found this distinction significant because section 6501(e)(1)(B)(i) provides a definition of “gross income” in the case of a trade or business. This definition was not included in old section 275, which was the statute interpreted by the court in Colony.
- The Seventh Circuit concluded that “a plain reading of Section 6501(e)(1)(A) would include an inflation of basis as an omission of gross income in non-trade or business situations.”

Beard v. Comm’r, No. 13372-06 (Jan. 26, 2011)

- The Seventh Circuit in Beard did not base its decision on the validity of the temporary regulation.
- However, the court, in dicta, commented that had it addressed this question, it would have been inclined to grant deference to the regulation. The court stated:
 - “Because we find that Colony is not controlling, we need not reach this issue. However, we would have been inclined to grant the temporary regulation Chevron deference, just as we would be inclined to grant such deference to T.D. 9511. We have previously given deference to interpretive Treasury regulations issued with notice-and-comment procedures, see Kikalos v. Commissioner of Internal Revenue, 190 F.3d 791, 795 (7th Cir. 1999); Bankers Life and Casualty Co. v. United States, 142 F.3d 973, 979-84 (7th Cir. 1998), and the Supreme Court has stated that the absence of notice-and-comment procedures is not dispositive to the finding of Chevron deference. Barnhart v. Walton, 535 U.S. 212, 222 (2002).”

Conclusions

- Where a statute is clear and unambiguous, the IRS may not be allowed to interpret it differently and seek deference for that interpretation.
- It is troubling that the court in Intermountain felt the need to analyze required deference and did not just reject applicability of the regulation on the basis that it was enacted to bolster the IRS's litigation position.
- The Seventh Circuit's decision in Beard arguably makes the Tax Court's discussion of deference in Intermountain less important.

Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011)

- The Supreme Court examined whether medical school graduates in residency programs were “students,” and, therefore, whether their income qualified for an exemption from FICA taxes.
- The Treasury Department had applied the student exception to exempt from taxation students who work for their schools “as an incident to and for the purpose of pursuing a course of study” there.
 - Until 2005, the Department determined whether an individual's work was “incident to” his studies by performing a case-by-case analysis. The primary considerations in that analysis were the number of hours worked and the course load taken.
 - The Social Security Administration (SSA) also articulated in its regulations a case-by-case approach to the corresponding student exception in the Social Security Act.
- In 1998, the Court of Appeals for the Eighth Circuit held that the SSA could not categorically exclude residents from student status, given that its regulations provided for a case-by-case approach.

Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011)

- Treasury regulations adopted in 2004 stated that the services of a full-time employee normally scheduled to work 40 or more hours a week are not incident to or for the purpose of pursuing a course of study, thus making residents, who typically spend between 50 and 80 hours a week caring for patients, ineligible for the student exemption.
- The Taxpayer sued for a refund of FICA taxes it had paid on residents' stipends in 2005, arguing that the full-time employee rule was invalid because it addressed something that was clearly spelled out in the statute.

Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011)

- The key issue before the Court was what level of deference should be afforded to regulations. There was conflicting precedent-
 - Chevron's two-step analysis:
 - Has Congress directly addressed the question at issue - is the statute clear and unambiguous?
 - If the statute is ambiguous, is the agency rule "arbitrary or capricious in substance, or manifestly contrary to the statute?"

Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011)

- ❑ The multi-factor analysis of National Muffler Dealers Association, Inc. v. U.S. 440 U.S. 472 (1979)
 - What is the history of the promulgation of the regulation? Is the regulation a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent? If not, how did the regulation evolve?
 - How long has the regulation been in effect? What reliance has been placed on the regulation?
 - Has the Commissioner interpreted the regulation consistently?
 - What degree of scrutiny has Congress devoted to the regulation during subsequent reenactments of the statute?

Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011)

- The Court chose to apply Chevron and upheld the regulation, finding that the statute did not define the term “student” and “does not otherwise attend to the precise question whether medical residents are subject to FICA.”
 - The Court found there was no justification for applying a less deferential standard than Chevron.

Deference to Regulations After Mayo

- Augurs a period of great deference to Treasury and the IRS.
- Regulations in response to litigation may not be suspect.
- It is irrelevant whether a regulation is promulgated pursuant to a general or specific grant of authority.
- Should not lead to increased deference to litigating positions generally, but will in practice, when they are promulgated as regulations.

Consolidated Edison Co. v. U.S. (Fed. Cl. 2009)

- Spoliation: obligation to preserve documents that may be relevant to future litigation
 - No clear standards between circuits
- Document Retention (and Destruction)
 - Advise careful attention to retention policies

Consolidated Edison Co. v. U.S. (Fed. Cl. 2009)

■ FACTS

- Part I: Lease-In, Lease-Out (LILO) transaction
 - Valid business purpose beyond its tax benefits
 - Unusual victory for taxpayer
- Part II: Spoliation of evidence
 - Government:
 - ConEd destroyed emails in tech migration
 - ConEd should have anticipated litigation at that time
 - Court:
 - There was spoliation of evidence
 - No sanctions appropriate

Spoliation: Preventing (or Seeking) Sanctions

- No clear standard (circuit split)
- Differences
 - Culpability: carelessness or bad faith required?
 - Adverse inferences: negligence or willfulness?

Spoliation: Preventing (or Seeking) Sanctions

- Do NOT destroy documents when:
 - Relevant in pending litigation
 - Relevant in pending agency or congressional proceeding
 - Reasonably foreseeable litigation/proceeding
- What to do: litigation commenced or imminent
 - Consider suspending document destruction altogether
 - Impose selective “litigation hold”
 - Preserve records of relevant departments
 - Preserve “key players” documents

Spoliation: Preventing (or Seeking) Sanctions

- FACTORS: “reasonable” document retention
 - Length of retention time
 - Distinguish between important and unimportant documents
 - Involvement in earlier litigation as well?
 - Bad faith in creating retention system
 - Bad faith in implementing retention system

Spoliation: Preventing (or Seeking) Sanctions

- Rebutting an adverse inference from spoliation:
 - Other evidence disproves adverse inference
 - Destroying evidence was accidental
 - Destroyed for reasons not related to lawsuit
 - Destroyed pursuant to normal retention plan
 - Destroyed privileged documents
 - Adverse party failed to use discovery measures
 - Government agency allowed document destruction

Spoliation: Preventing (or Seeking) Sanctions

- Seeking an adverse inference from spoliation:
 - Notice: be sure adverse party reasonably foresees litigation
 - Use discovery devices to reveal internal retention policies, electronic information systems
 - Reveal sources of relevant items and whether and when adverse party has destroyed items.

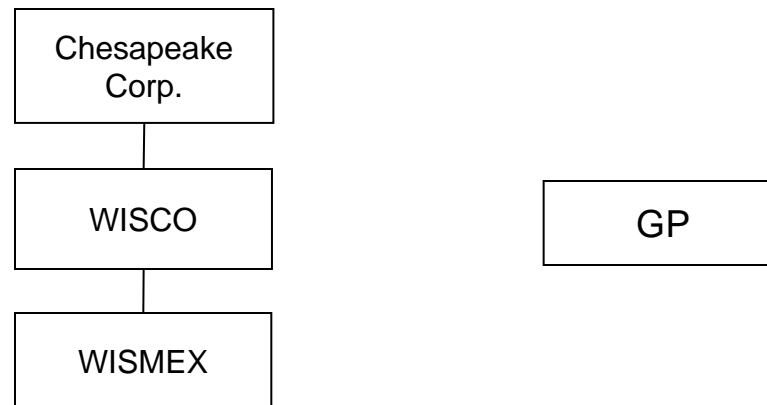
Validity of Opinions

Canal Corporation & Subsidiaries v. Commissioner

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)

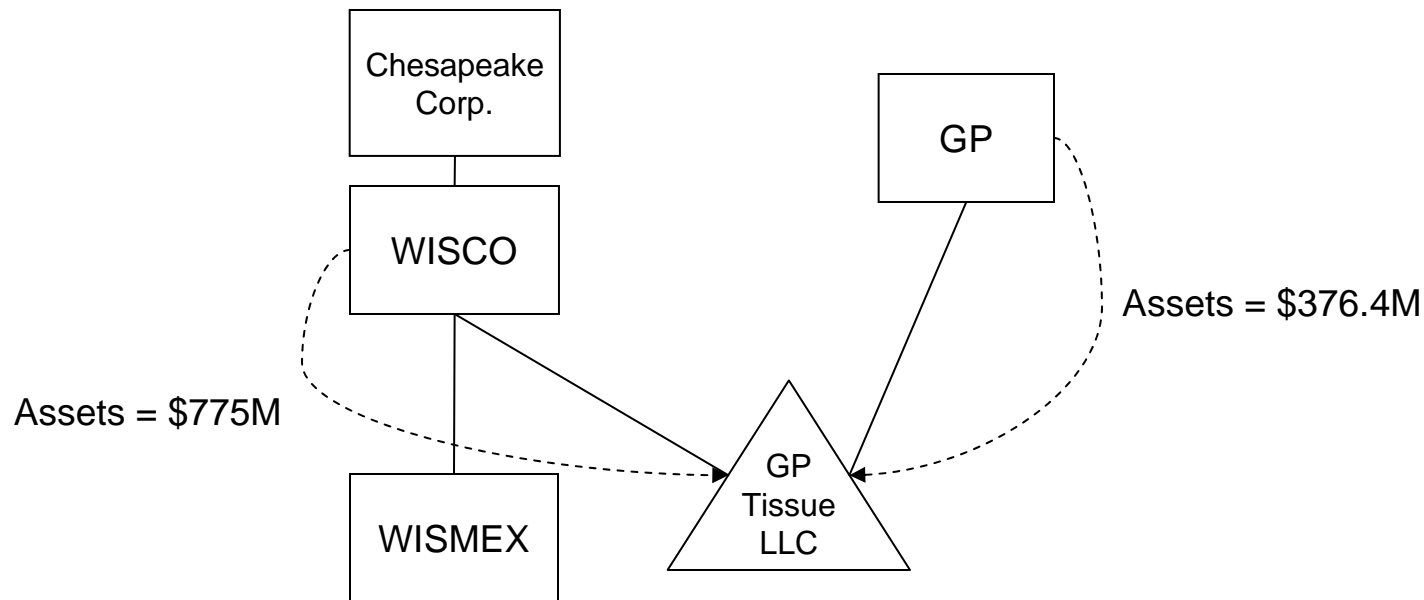
- The IRS challenged the treatment of a leveraged partnership transaction, claiming that the parties' contributions to a newly formed joint venture in exchange for partnership interests constituted a disguised sale.
- The IRS asserted that the transaction should be treated as a disguised sale because one party did not bear any economic risk of loss for the partnership debt when it entered the joint venture. The IRS asserted that the anti-abuse rule in Treas. Reg. § 1.752-2(j) causes this party's interest to be disregarded because there was no more than a remote possibility the party would actually be liable for payment.

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)



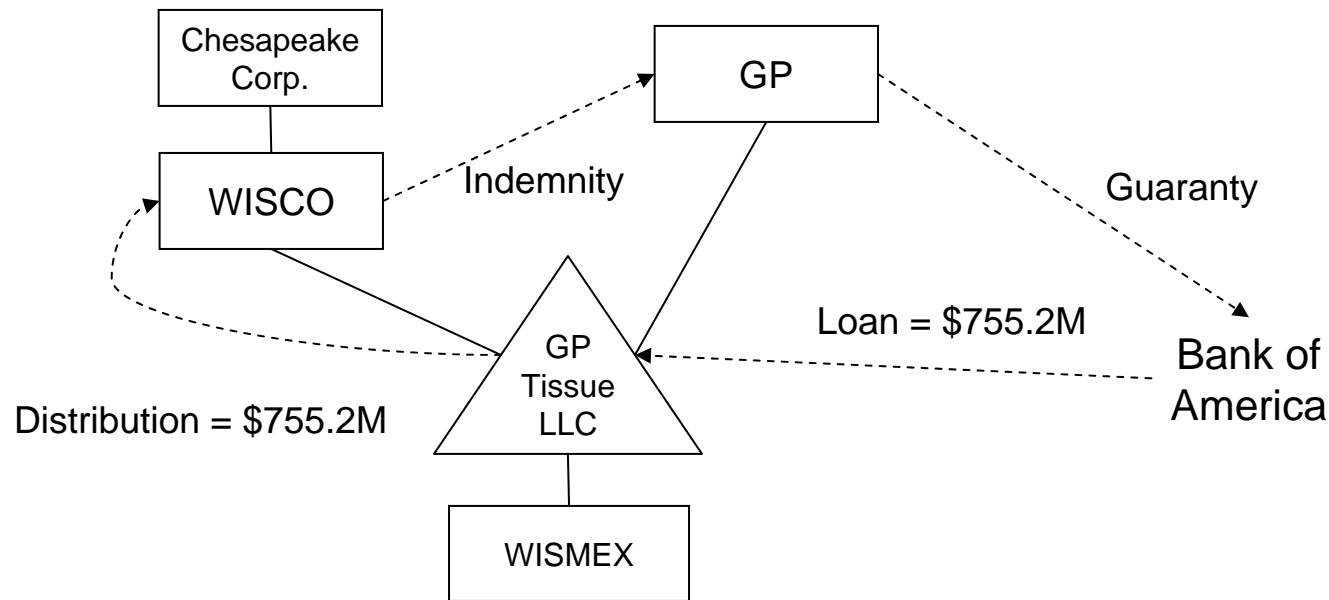
- Chesapeake wanted to sell WISCO to generate capital for a new strategic expansion of its specialty packaging business.
- However, Chesapeake had a low basis in WISCO and did not want to pursue a direct sale.
- Salomon Smith Barney ("Salomon") recommended a leveraged partnership structure with Georgia-Pacific Corporation ("GP"). Pursuant to the structure, WISCO and GP would contribute assets to a partnership, the partnership would borrow cash from a third party, and then the partnership would distribute the cash to WISCO as a special distribution. The structure was designed to allow Chesapeake to get cash out of the business while deferring the related tax gain.
- To avoid the recognition of gain as a result of the special distribution, PwC recommended GP guarantee the debt of the partnership and that WISCO indemnify GP for any payments made on the guarantee.

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)



- On October 4, 1999, WISCO and Georgia Pacific ("GP") formed GP Tissue LLC and contributed the following assets:
 - WISCO: (i) shares of WISMEX (ii) shares of Wisconsin Tissue Management LLC; (iii) an interest in Alsip Condominium Association; (iv) working capital; (v) land; (vi) building; (vii) equipment. Total value = \$775,000,000.
 - GP: (i) Working capital; (ii) land; (iii) buildings; (iv) equipment; (v) inventory; (vi) goodwill. Total value = \$376,400,000.
- GP Tissue LLC assumed most of WISCO's liabilities but did not assume WISCO's Fox River liability.

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)



- GP Tissue LLC then borrowed \$755.2M from Bank of America and immediately transferred that \$755.2M to a WISCO bank account maintained by Chesapeake.
- GP guaranteed payment of the Bank of America loan, and WISCO agreed to indemnify GP for any principal payments actually made by GP under its guaranty (but not any interest payments).
- This structure was intended to allow WISCO to defer gain on the WISCO assets contributed to GP Tissue LLC.

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)

- The parties to the transaction had received a “should” level opinion from PriceWaterhouseCoopers (“PWC”) regarding the transaction’s federal tax implications (i.e., that the partnership transaction should be respected and should not be a disguised sale).
- The Tax Court agreed with the IRS and held that the transaction was a disguised sale.
- The court also held that the Taxpayer was liable for accuracy-related penalties because (i) PWC based its advice on unreasonable assumptions, and (ii) the Taxpayer did not act with reasonable cause because it lacked good faith in relying on the opinion.

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)

- The court's disguised sale analysis is troubling and raises many questions. It has been reported that the case is unlikely to be appealed because Canal is in bankruptcy.
- The case may cause leveraged partnership transactions to be more heavily scrutinized.
- Taxpayers may want to consider additional steps to demonstrate that parties providing indemnities in such transactions are adequately capitalized:
 - Contribute more assets to subsidiary;
 - Have the indemnity be from the parent company rather than the subsidiary;
 - Enter into "keepwell" agreements or guarantees to require the parent company to ensure that the subsidiary is adequately capitalized.

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)

- Regarding the unreasonableness of PWC's assumptions, the court made the following conclusions:
 - The draft opinion submitted into evidence was disorganized and incomplete.
 - The opinion was filled with questionable conclusions and unreasonable assumptions. The opinion assumed the indemnity would be effective and that the indemnitor would hold assets sufficient to avoid the anti-abuse rule, failing to consider whether the indemnity lacked substance.
 - The rendering of a "should" level opinion was unreasonable given the dubious legal reasoning provided in the opinion.
 - It was unreasonable for the taxpayer to have relied on an analysis based on erroneous legal assumptions.

Canal Corporation & Subsidiaries v. Commissioner, 135 T.C. 9 (2010)

- Regarding the Taxpayer's lack of reasonable cause or good faith in relying on PWC's advice, the court found any advice received was tainted by an inherent conflict of interest because a member of the PWC team helped plan the transaction.
 - ❑ The court also noted the opinion was issued for a fixed fee of \$800,000, which was contingent on the closing of the transaction.
 - ❑ The court viewed this fee as excessive.

Comparison to Prior Case Law: Mandelbaum v. Commissioner

- Mandelbaum v. Commissioner, T.C. Memo. 1995-225
 - The Tax Court found the taxpayers “were not required to second-guess their [accountants’ and long time advisors’] advice.”
 - The taxpayers made a “reasonable attempt to assess their proper tax liability,” retaining their advisors because they lacked sophistication in valuation and tax matters.
 - The advisors’ manner, education, and legal experience demonstrated an apparent expertise.
 - Prior IRS challenge to the taxpayers’ valuation method was not a reason for the taxpayer to assume the valuations were unreasonable.

Comparison to Prior Case Law: Long Term Capital Holdings v. United States

- Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004)
 - The District Court of Connecticut held that Taxpayer was liable for accuracy related penalties because:
 - Taxpayer did not receive the written opinion it purported to rely on until over nine months after Taxpayer claimed the related deductions;
 - Oral advice Taxpayer claimed to have received before the deductions were claimed covered only one of three issues;
 - The opinion was not based on “all pertinent facts and circumstances”;
 - Taxpayer provided assumptions it knew to be false;
 - The tax opinion writers made no effort to demonstrate why it was reasonable to rely on the assumptions and representations provided by Taxpayer and,
 - The opinion contained minimal legal analysis.

Comparison to Prior Case Law: Long Term Capital Holdings v. United States

- Long Term Capital Holdings v. United States, 96 AFTR 2d 2005-6344 (2d Cir. 2005)
 - The Second Circuit Court of Appeals affirmed the Tax Court's opinion.
 - The court stated the Tax Court did not require Taxpayer to detect legal deficiencies in the opinion, nor was Taxpayer expected to "engage in sophisticated questioning of its expert's advice." Instead, the inadequate legal analysis indicated the advice was "general superficial pronouncements based almost entirely on the flawed and out-come determinative assumptions [Taxpayer] asked it to make."

Recommendations for Obtaining an Opinion After Recent Case Law Developments

- Your level of sophistication matters: companies with large, well-trained tax departments will be required to evaluate opinions more closely.

Recommendations for Obtaining an Opinion After Recent Case Law Developments

- Review representations and assumptions
 - Make sure that they are well supported and well reasoned
 - Make sure that they are credible given the facts

Recommendations for Obtaining an Opinion After Recent Case Law Developments

- Keep support for all representations and assumptions
 - Maintain a file of everything that the opinion writer examines
 - Make sure what the opinion writer reviews is detailed and not conclusory
 - Make sure that the opinion writer reviews analyses of business purposes and expected benefits of tax favored transactions
 - If financial wherewithal matters, make sure it is documented
 - If bearing risks matters, make sure that documents demonstrate that the risks are real

Recommendations for Obtaining an Opinion After Recent Case Law Developments

- Consider fee arrangements, so as not to shock the court's conscience
 - Consider hourly billing
 - Avoid contingent fees

Recommendations for Obtaining an Opinion After Recent Case Law Developments

- Consider obtaining an opinion from someone with no other role in the transaction
 - If the deal is a promoted deal, select your own counsel

Recommendations for Obtaining an Opinion After Recent Case Law Developments

- Know for what purpose the opinion is being obtained and treat it appropriately
 - If obtained for penalty avoidance, it is not privileged
 - If obtained for internal advice, it may be privileged

**XILINX, INC., & CONSOLIDATED SUBS. v.
COMM'R**
and
**VERIAS SOFTWARE CORP. & SUBSIDIARIES v.
COMM'R**

Transfer Pricing Activity: Xilinx

- Since the 1990s, IRS has argued that stock-based compensation (SBC) must be included in the cost-sharing pool of intangible development costs.
- “Xilinx I”: The Tax Court (Judge Foley) held that inclusion of stock-based compensation is contrary to arm’s length standard because unrelated parties would not share costs in joint development arrangements.
- “Xilinx II”: May 2009, 9th Circuit reversed 2 (Fisher, Reinhard) to 1 (Noonan), on the basis that the “all costs” provision of Reg. § 1.482-7(d)(1) trump the arm’s length standard.

Xilinx, revisited

- Jan. 13, 2010: 9th Circuit withdrew the May 29, 2009 opinion.
- "Xilinx III": the same three-judge panel affirmed Tax Court. Again 2 (Noonan, Fisher concurring) to 1 (Reinhard).
- Rejected earlier reasoning based upon canons of construction in favor of analysis based on the purpose of the regulations.

Xilinx III → the final stand?

- Update on IRS reaction.
- Will the IRS continue to litigate in cases outside the 9th Circuit decision?
- Implication for 2003 SBC regulations?
- 2008 Stock Option Coordinated Issue Paper (“CIP”): requires inclusion of stock-based compensation in cost-sharing.
- 2003 and 2009 cost-sharing regulations require inclusion of stock-based compensation for grants made in years beginning on or after August 26, 2003.

Buy-in Payment Transfer Pricing Litigation: VERITAS

- First Tax Court trial (T.C. No. 12075-06, J. Foley again) determining cost-sharing buy-in under section 482 (July 2008).
- Tax Court Opinion (133 T.C. No. 14) issued on Dec. 10, 2009.
- Unequivocal taxpayer victory→TC held that IRS' \$1.68 billion income §482 adjustment to the buy-in payment due to VERITAS from its Irish affiliate was arbitrary, capricious & unreasonable.
- Taxpayer's CUT method, with adjustments to inexact CUTs, was best method.

VERITAS

- IRS relied on Foregone Profits Method (“FPM”) payable in perpetuity.
- Aggregation of all intangibles rather than enumerated intangibles.
- TC opinion, based upon 1996 cost-sharing regs, focused heavily on lack of credible evidence to support the IRS’ economic theories.
 - Admissions by IRS’s economic expert
 - Lack of credibility of remaining IRS experts
 - Strength of taxpayer’s factual evidence and witnesses

Transfer Pricing: Appeals Trends

- Appeals Settlement Guidelines on Stock Option Cost-Sharing
- Appeals Settlement Guidelines on Buy-In and Acquisition Buy-In Issues
- Appeals Trends in other transfer pricing cases
 - “Services” regulation cases under Treas. Reg. §1.482-2 and §1.482-9T

Penalties → What to expect

- Have penalties become Exam's default position?
- Appeals' approach to penalties.
- IRS Exam takes a different approach to penalties relating to the following categories that do Appeals and the Courts.
 - Transfer Pricing: Taxpayers need only be compliant, not prescient
 - R&E Credit
 - Alignment of the courts with the IRS position applying penalties to "Tax Shelters":
 - Schering Plough
 - Jade Trading

WORK PRODUCT AFTER *TEXTRON*

United States v. Deloitte

United States v. Deloitte, 623 F. Supp. 2d 39 (D. D.C. 2009) – District Court Decision

- The United States sought to compel Deloitte to produce two categories of documents related to a civil tax refund case brought by partnerships formed by subsidiaries of the Dow Chemical Company (referred to as the Chemtech partnerships or “Chemtech”).

United States v. Deloitte, 623 F. Supp. 2d 39 (D. D.C. 2009) – District Court Decision

- First Category. Three documents Deloitte USA was withholding on the basis of privileges asserted by Dow, including:
 - June 2005 tax opinion related to Chemtech
 - September 1998 legal and tax analysis provided by an in-house attorney at Dow
 - July 1993 internal Deloitte USA memorandum recording thoughts and impressions of Dow's attorneys concerning tax issues related to Chemtech

United States v. Deloitte, 623 F. Supp. 2d 39 (D. D.C. 2009) – District Court Decision

- Second Category. All responsive documents maintained at Deloitte USA's affiliate in Zurich, Switzerland (referred to as "Deloitte Switzerland")

United States v. Deloitte, 623 F. Supp. 2d 39 (D. D.C. 2009) – District Court Decision

- First Category

- The District Court for the District of Columbia held that the three documents in the first category were protected from disclosure by the work product doctrine because they were prepared in anticipation of future litigation over the tax treatment of Chemtech.
- The court held that the protection was not waived by disclosure to Deloitte USA because Deloitte USA, as Dow's independent auditor, was not a potential adversary, and no evidence suggested it was unreasonable for Dow to expect Deloitte USA to maintain confidentiality.

United States v. Deloitte, 623 F. Supp. 2d 39 (D. D.C. 2009) – District Court Decision

■ Second Category

- ❑ The court also denied the motion to compel with respect to the second category of documents. The court held Deloitte USA did not have sufficient control over the documents maintained at Deloitte Switzerland to enable their production. The court stated the government failed to establish Deloitte USA had the “legal right, authority or ability to obtain documents upon demand” from Deloitte Switzerland.
- ❑ The court determined, “Close cooperation on a specific project does not, per se, establish an ability, let alone a legal right or authority, on Deloitte USA’s part to acquire documents maintained solely by a legally distinct entity.”

United States v. Deloitte, 106 AFTR 2d 2010-5053 (D.C. Cir 2010) – Appeals Court Decision

- The United States appealed the District Court's decision with respect to the First Category of documents.
- The government argued that the July 1993 internal Deloitte memorandum recording thoughts and impressions of Dow's attorneys concerning tax issues related to Chemtech was not work product because (i) it was prepared by Deloitte, not Dow or Dow's counsel; and (ii) it was generated as part of the audit process, not in anticipation of litigation.

United States v. Deloitte, 106 AFTR 2d 2010-5053 (D.C. Cir 2010) – Appeals Court Decision

- The D.C. Circuit rejected the government's categorical arguments with respect to the first document prepared by Deloitte. The court stated that Deloitte's preparation of the document does not exclude the possibility that it contains Dow's work product.
- The court also stated a document can contain protected work product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation.
- However, the court determined that the District Court did not have sufficient evidentiary foundation for its holding that the memorandum was purely work product.
- The court, therefore, remanded so the District Court could conduct an *in camera* review of the document and determine whether it was entirely work product, or whether a partial or redacted version of the document could be disclosed.

United States v. Deloitte, 106 AFTR 2d 2010-5053 (D.C. Cir 2010) – Appeals Court Decision

- The government also argued that the other two documents--(i) the September 1998 legal and tax analysis provided by an in-house attorney at Dow and (ii) the June 2005 tax opinion related to Chemtech--were not protected from disclosure because Dow waived work product protection by disclosing the documents to Deloitte.
 - The D.C. Circuit rejected this argument and concluded (i) Deloitte was not a potential adversary with respect to the litigation that the documents address and (ii) Deloitte was not a conduit to potential adversaries because Dow had a reasonable expectation of privacy as a result of Deloitte's obligation to refrain from disclosing confidential information.

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?

- Communications between your independent auditors and your tax advisors may not be privileged; negotiate with auditors to try to limit scope of documents reviewed, where possible.
- Part 22 of AU 326 states “the auditor should obtain the access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege.”
- Be aware 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 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.
 - The Group does not necessarily need to consist of separate employees. The employees should clearly delineate 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.
- Secondly, the Company may use 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 they are providing legal advice to be used for litigation purposes.
- Documents should be labeled, as appropriate, to state 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 guidelines that certain counsel must be involved in issues expected to result in litigation, and then include such counsel only when litigation is expected.

Working with Your Auditors to Protect Work Product

- Enter into a confidentiality agreement with the auditors.
- Enter into a common interest agreement with the auditors, specifying the Company is providing access to documents solely for the purpose of the parties' common interest in performing the audit, confidentiality will be maintained, and 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.
 - Try to avoid disclosure of the documents most clearly prepared in anticipation of litigation if auditor's rules so permit.