

Recent Developments in Tax Litigation and Document Retention

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Overview

- **Judicial Deference: Deference to regulations under *Chevron* standards after recent cases**
 - Intermountain Insurance Service of Vail v. Commissioner, 134 T.C. 11 (2010)
 - Beard v. Commissioner, 107 AFTR 2d 2011-552 (7th Cir. 2011)
 - Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011)
 - *Post Mayo cases*
 - Burks v. United States, 107 AFTR 2d 2011-824 (5th Cir. 2011)
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 - Carpenter Family Investments, LLC v. Commissioner, 136 T.C. 17 (2011)
- **Validity of Opinions: The role of opinions in tax litigation after recent case law**
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 - Long Term Capital Management v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004) and 96 AFTR 2d 2005-6344 (2d Cir. 2005)
 - Recommendations for obtaining opinions
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 - Zubulake v. UBS Warburg LLC (“Zubulake V”), 229 F.R.D. 422 (S.D.N.Y. 2004)
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 - The Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, 685 F.Supp.2d 456 (S.D.N.Y. 2010)

JUDICIAL DEFERENCE

**Intermountain Insurance Service of Vail v.
Commissioner,**

Beard v. Commissioner,

**Mayo Foundation for Medical Education
and Research v. United States, and**

The Post Mayo cases

JUDICIAL DEFERENCE

- Intermountain Insurance Service of Vail v. Commissioner, 134 T.C. 11 (2010), Beard v. Commissioner, 107 AFTR 2d 2011-552 (7th Cir. 2011), and Mayo Foundation for Medical Education and Research v. United States, No. 09-837 (S. Ct. Jan. 11, 2011), are three important opinions that discuss judicial deference to agency regulations.

Intermountain (T.C. 2010)

- The Tax Court granted Taxpayer's motion for summary judgment on the basis that the IRS issued the related FPAA to Taxpayer beyond the general three-year period of limitations for assessing tax against Taxpayer's partners.
- Less than one month after the decision, the IRS issued temporary regulations extending the six-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.
 - Taxpayer argued the temporary regulations were either inapplicable, invalid, or otherwise not entitled to deference.

Intermountain (T.C. 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 (T.C. 2010)

- The majority found 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 (T.C. 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); 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).
- 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 (T.C. 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 (T.C. 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 (T.C. 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 (7th Cir. 2011)

- Note that the Seventh Circuit reversed the Tax Court in Beard v. Comm’r, 107 AFTR 2d 2011-552 (7th Cir. 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 (7th Cir. 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 (Sup.Ct. 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, Treasury 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 (Sup.Ct. 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.
- 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 (Sup.Ct. 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 (Sup.Ct. 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 (Sup.Ct. 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 are not suspect
- 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

Post Mayo Decisions: Home Concrete (4th Cir. 2/7/2011)

- Following the Ninth Circuit (Bakersfield Energy) and Federal Circuit (Salman Ranch), the Fourth Circuit held that Colony foreclosed the argument that the taxpayer's overstatement of basis resulted in an omission from its reported gross income. Thus, the period for assessments was limited to three years, and could not be extended under the six-year statute.
 - The court found that nothing in Colony suggested that the Supreme Court intended to limit its application to cases in which the taxpayer is a trade or business selling goods or services.
 - Furthermore, the court stated "[it] will not defer to Treasury Regulation § 301.6501(e)-1(e), which was promulgated during this litigation and, by its own terms, does not apply to the tax year at issue."

Post Mayo Decisions: Home Concrete (4th Cir. 2/7/2011)

- Citing to Mayo, the court stated that “Chevron deference is warranted only when a treasury regulation interprets an ambiguous statute.”
 - The court found stated that “the Supreme Court's reference to ‘the *unambiguous* language of section 6501(e)(1)(A)’ cannot be ignored.” (emphasis in original)
- Because the court found section 6501(e)(1)(A) unambiguous, it considered the regulation a change in the law, not a mere clarification.
 - Thus, the court declined to apply the regulation retroactively because applying the regulation would “subject the taxpayers to liability to which they would not have been subject under pre-regulation law.”
- Additionally, the court rejected the IRS’s argument that the period for assessing tax is open, or may be-re-opened, so long as litigation is pending is invalid, stating that “Congress specifically listed circumstances, such as fraud, in which the assessment window remains open without limitation.”

Post Mayo Decisions: Burks (5th Cir. 2/9/2011)

- The Fifth Circuit joined with the Fourth Circuit (Home Concrete), concluding that Colony foreclosed the argument that the taxpayer's overstatement of basis resulted in an omission from its reported gross income. Thus, the period for assessments was limited to three years and could not be extended under the six-year statute.
- The Court also distinguished this case from Phinney v. Chambers, 392 F.2d 680 (5th Cir. 1968).
 - In Phinney, the taxpayer misrepresented the nature of the item reported, thereby putting the IRS at a disadvantage in detecting the error.
 - But in this case, the disclosure of the item on the tax return, despite its incorrect amount, gave the IRS "sufficient notice to inquire into the correctness and validity of the item being reported." Thus, the extended limitations period was not appropriate.

Post Mayo Decisions: Burks (5th Cir. 2/9/2011)

- In a footnote, the court referenced Mayo, stating that “even if the statute was ambiguous and Colony was inapplicable, it is unclear whether the Regulations would be entitled to Chevron deference under [Mayo].”
 - The court distinguished this case from Mayo because in this case the regulations were issued during the suit, following adverse judicial decisions on the identical legal issue. The court indicated that deference to regulations issued to bolster litigation positions would be inappropriate.
 - Also, the Temporary Regulations considered in this case were issued without notice and comment procedures. The court stated “That the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for pre-promulgation notice and comment.”

Post Mayo Decisions: *Grapevine Imports* (Fed. Cir. 3/11/2011)

- Unlike the Fourth Circuit (Home Concrete) and Fifth Circuit (Burks), and Ninth Circuit (Bakersfield Energy), the Federal Circuit recently found that Colony does not apply and an overstatement of basis can be an omission from gross income.
- The court stated it was not bound by the is previous Salman Ranch decision because Treasury had issued regulations since that opinion, which had to be considered.
- Following Mayo, the court applied the Cheveron test to the Treasury regulations.

Post Mayo Decisions: *Grapevine Imports* (Fed. Cir. 3/11/2011)

- Applying Chevron step one, the court found that the statute was ambiguous.
 - The Colony Court found that the predecessor statute was ambiguous.
 - Though the Colony Court stated that the updated statute was unambiguous, that court “did not rely or elaborate on that statement, nor was the updated statute at issue in that case.”
 - This case did not involve trade or business income, and the statutory language that applies outside of the trade or business context is the same as the ambiguous predecessor statute.
 - The plain language did not foreclose Treasury’s interpretation.
 - The Salman Ranch decision “made no separate holding that the statute was unambiguous for purposes of Chevron step one”
 - The statute’s legislative history, as examined in Colony and Salman Ranch, did not specifically address the language at issue.

Post Mayo Decisions: *Grapevine Imports* (Fed. Cir. 3/11/2011)

- Applying Chevron step two, the court found that the new Treasury Regulations were within the bounds of reason; therefore, they deserved deference.
 - The court also found that the regulation's retroactivity was not so burdensome as to be an abuse of Treasury's discretion.
 - Also, because the regulations were reasonable, it was irrelevant that they were issued after adverse judicial decisions.

Post Mayo Decisions:

Carpenter Family Investments (T.C. 4/25/2011)

- The Tax Court recently affirmed Intermountain, holding, in accordance with the Fourth and Fifth Circuits, that an overstatement of basis is not an omission from gross income.
- The court stated that neither Mayo nor issuance of the final form of regulations at issue warrants a revision of the Intermountain holding.
- The court stated that it must follow the precedent of the case's appellate venues. According to the Ninth Circuit Court of Appeals' Bakersfield Energy opinion, Colony controls the meaning of the phrase "omits from gross income"; and the Supreme Court's Colony opinion states that phrase does not include an overstatement of basis.

Post Mayo Decisions:

Carpenter Family Investments (T.C. 4/25/2011)

- The Tax Court acknowledged Treasury's authority to promulgate regulations of an ambiguous statute that do not accord with the Supreme Court's opinion of the "best reading" of the statute.
- But the court refused to agree that *any* regulations would trump the Supreme Court's prior construction. The court stated:
 - "[R]espondent is asking us to defer to his determination of whether that Supreme Court decision [Colony] is on point However we know of no authority . . . that requires us to defer to the Commissioner's determination of the applicability of Supreme Court precedent."
 - "When Congress speaks in muffled tones, the Commissioner presumably enjoys an advantage in deciphering the message. And though we are respectful of the Commissioner's experience in reviewing court opinions, we decline to surrender our prerogative of interpreting judicial pronouncements – ambiguous or otherwise."

Post Mayo Decisions:

Carpenter Family Investments (T.C. 4/25/2011)

- The Tax Court commented that the Mayo decisions implies Chevron step one should be limited to the plain text of the statute but is silent on whether the Brand X holding applies to Supreme Court precedence.
 - Under Brand X, the Supreme Court allowed a court's prior interpretation of a statute to override an agency's contrary interpretation because the court's prior decision found the statute to be unambiguous. Nat'l Cable & Telecomms. Assoc. v. Brand X Internet Servs., 545 U.S. 967, 984 (2005).
- Furthermore, if Mayo was to be understood as categorizing most judicial constructions that discuss legislative history as Chevron step two decisions, the Commissioner's "hands must remain tied" until he "issues[s] regulations that unequivocally repudiate the Colony holding." (Citing SEC v. Chenery Corp., 332 U.S. 194 (1947).)

Post Mayo Decisions:

Carpenter Family Investments (T.C. 4/25/2011)

- A concurring opinion agreed with the result because Intermountain held the temporary regulations invalid.
 - The concurrence states that it would not find Colony to be a Chevron step one decision.
 - The concurrence agrees with the majority that Treasury's intent to limit Colony to a trade or business circumstance was an attempt to "usurp the courts' function of interpreting the Supreme Court's opinion."
 - But the concurrence rejects the majority's application of Chenery, finding it "reasonably clear" that Treasury believed it could derive a different meaning of the statute, following Brand X.

Post Mayo Decisions:

Carpenter Family Investments (T.C. 4/25/2011)

- Another concurring opinion found that “there is no compelling reason for this Court to abandon its precedents in this case.” Unless and until the Ninth Circuit or the Supreme Court address the final regulations, “the regulations do not trump.”

Deference to Regulations After Mayo

- The Department of Justice recently issued a statement that it will no longer argue for Cheveron deference for revenue rulings and revenue procedures. (May 10, 2011)
 - DOJ will argue that temporary regulations are entitled to Chevron deference, but will not argue that proposed regulations should also be accorded deference.

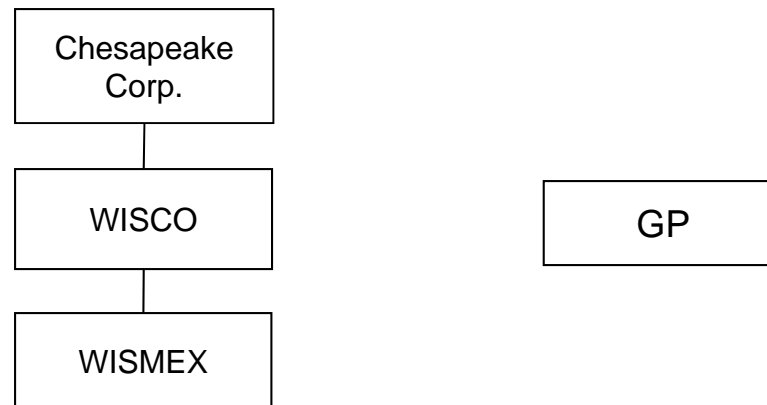
Validity of Opinions

**Canal Corporation & Subsidiaries v.
Commissioner**

Canal Corp. (T.C. 2010)

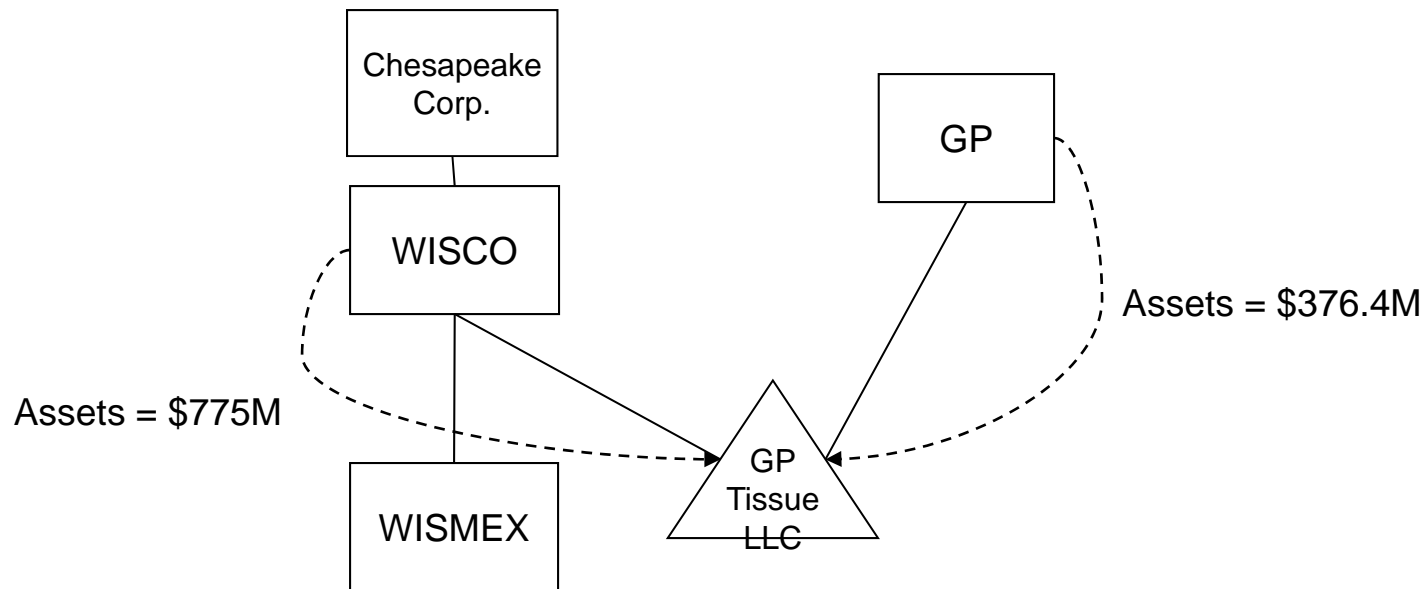
- The IRS challenged the treatment of a leveraged partnership transaction, claiming that the parties' contributions to a newly formed joint venture in exchange for partnership interests constituted a disguised sale.
- The IRS asserted that the transaction should be treated as a disguised sale because 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 Corp. (T.C. 2010)



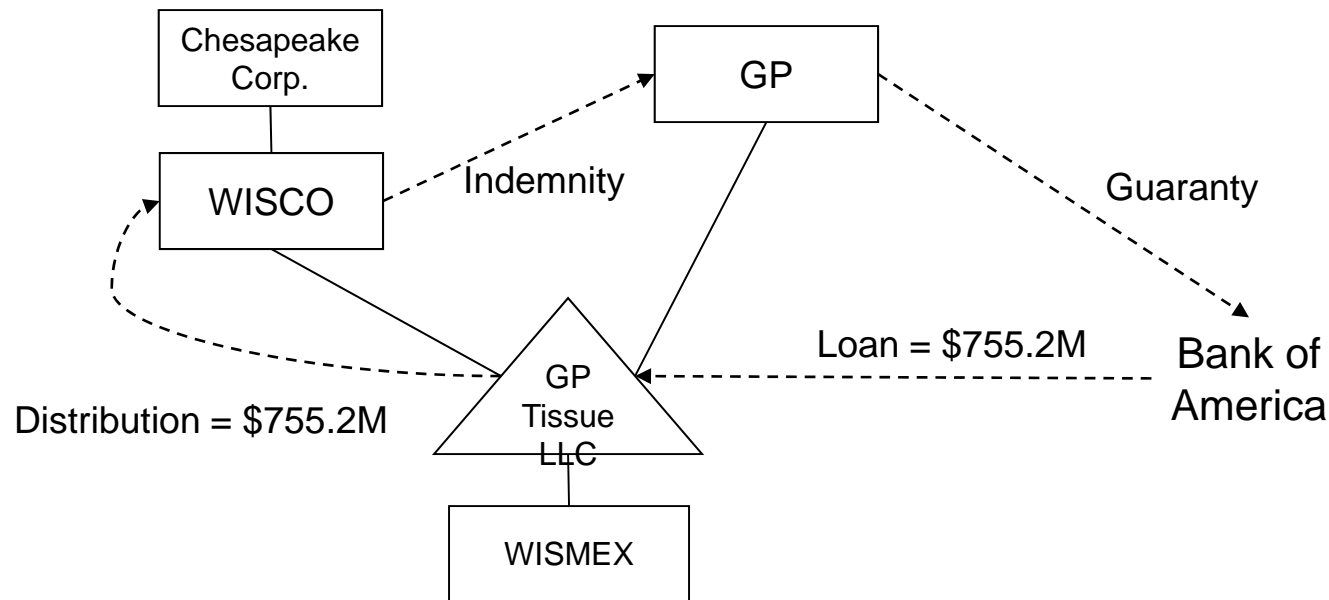
- Chesapeake wanted to sell WISCO to generate capital for a new strategic expansion of its specialty packaging business.
- However, Chesapeake had a low basis in WISCO and did not want to pursue a direct sale.
- Salomon Smith Barney ("Salomon") recommended a leveraged partnership structure with Georgia-Pacific 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 Corp. (T.C. 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 Corp. (T.C. 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 Corp. (T.C. 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 Corp. (T.C. 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 Corp. (T.C. 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 (T.C. 1995)

- In Mandelbaum, 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 (D. Conn. 2004)

- In Long Term Capital Holdings, the District Court of Connecticut held 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 (2d Cir. 2005)

- The Second Circuit Court of Appeals affirmed the Tax Court's Long Term Capital Holdings 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 your 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 for and treat it appropriately
 - If obtained for penalty avoidance, it is not privileged
 - If obtained for internal advice, it may be privileged

Spoliation

Zubulake v. UBS Warburg LLC (“Zubulake V”)

Consolidated Edison Co. of NY v. U.S.

The Pension Committee of the University of
Montreal Pension Plan v.

Banc of America Securities

SPOLIATION

■ Spoliation

- “[T]he destruction or significant alteration of evidence or failure to preserve property for another’s use as evidence in pending or reasonably foreseeable litigation.”
United Med. Supply Co. v. United States, 77 Fed. Cl. 257, 263 (2007).

SPOILIATION

- Spoliation is a serious issue in litigation. Failure to preserve both paper and electronic records properly can be detrimental to your case and could result in your case being dismissed.
- Recent cases address the practical realities of document retention, including-
 - What are counsel's duties in monitoring a client's document retention efforts?
 - When does the duty to preserve documents arise?
 - When are special measures required?
 - When are sanctions applicable?

Case Law

Zubulake v. UBS Warburg LLC (“Zubulake V”),
229 F.R.D. 422 (S.D.N.Y. 2004)

Judge Scheindlin of the Southern District of New York discusses counsel’s duty to monitor a client’s document preservation efforts.

Zubulake V (S.D.N.Y. 2004)

Facts

- Plaintiff Zubulake filed an employment discrimination suit against Defendant UBS Warburg LLC.
- The court considered Plaintiff's motion to sanction Defendant for failure to produce, and tardy production of, relevant information due to spoliation.
- There had been numerous prior opinions in the case setting forth what the parties had to do in order to comply with their discovery obligations

Zubulake V (S.D.N.Y. 2004)

Facts

- ❑ Counsel had not adequately questioned employees about their files and their compliance with the litigation hold.
- ❑ Defendant's personnel deleted relevant e-mails from their active files.
- ❑ Active files from some key players were not solicited.
- ❑ Backup tapes for the most relevant time periods were missing.

Zubulake V (S.D.N.Y. 2004)

Counsel's Duty to Monitor Retention Efforts

- Duty to Implement Litigation Hold at the Outset of Litigation or When Litigation is Reasonably Anticipated
 - Suspend routine document retention/destruction policy for all accessible information
 - Communicate the preservation duty to persons with relevant information; speak directly to key players in the litigation
- Duty to Take Affirmative Steps to Locate All Relevant Information
 - Become fully familiar with the client's document retention policies and document retention architecture and how key players individually store information
 - Consider running a system-wide keyword search and preserving a copy of each "hit"

Zubulake V (S.D.N.Y. 2004)

Counsel's Duty to Monitor Retention Efforts

- Duty to Ensure Preservation
 - Periodically re-issue the hold to inform new employees and remind existing employees, and periodically remind key players that the duty remains in place
 - Periodically recheck all interrogatories and canvass all new information
 - Have active files produced and make sure backup media are identified and safeguarded

Zubulake V (S.D.N.Y. 2004)

Willful Destruction Found and Sanctions Ordered

- Failings of Counsel
 - Failure to communicate the litigation hold to all key players.
 - Failure to ascertain each key players' document management habits.
- Failings of Defendant
 - Willful destruction of information in defiance of explicit instructions not to do so.
- Sanctions Ordered
 - Adverse Inference Jury Charge
 - Presumption that the lost information was relevant.
 - Monetary Sanctions
 - Pay for (1) necessary re-depositions of relevant personnel, (2) restoration of an additional existing backup tape, and (3) the costs related to the motion.

**Consolidated Edison Company of
New York v. United States,
90 Fed. Cl. 228 (2009)**

The Court of Federal Claims discusses
the duty to preserve documents in
relation to work product protection.

Consol. Edison Co. of NY (Fed. Cl. 2009)

Facts

- The court considered a refund claim for deductions related to a Lease-In, Lease-Out (LILO) transaction entered into in 1997.
- ConEd changed to a new email system in 2000. Old emails did not migrate to the new system and the old system was not backed-up.
 - Employees were instructed to save “important” emails on their own hard drive. When an employee’s computer was taken out of service, the hard drives were destroyed.
 - Email boxes of employees who left prior to the changeover were not preserved.
 - The president of ConEd’s leasing subsidiary, which entered transaction at issue, left the company in 1999; thus, his email box was not preserved.

Consol. Edison Co. of NY (Fed. Cl. 2009)

The IRS's Spoliation Argument

- The IRS claimed that ConEd destroyed emails relating to the development of the transaction during the email system changeover in 2000.
- The IRS claimed that ConEd had a duty to preserve evidence relating to the transaction in 2000 because ConEd anticipated litigation in either 1997 or 1999.
 - 1997: Three documents were created in 1997 by in-house and outside counsel that assessed the tax risk of the transaction. Prior to the spoliation claim, ConEd unsuccessfully claimed work product protection for these documents.
 - 1999: The IRS published Revenue Ruling 99-14, which the IRS claimed was a clear indication of its intent to litigate deductions related to LILOs.

Consol. Edison Co. of NY (Fed. Cl. 2009)

No Spoliation Because No Anticipation of Litigation

- The court held that there was no spoliation of evidence because ConEd did not anticipate litigation in either 1997 or 1999.
 - 1997: Even though ConEd tried to claim work product protection for the three documents created in 1997, it did not in fact anticipate litigation at that point.
 - ConEd was engaged in making an informed decision about whether to enter into the transaction at issue.
 - Assessing tax implications were a part of ConEd's due diligence efforts.
 - 1999: Revenue Ruling 99-14 was fact specific-based and did not provide any new information given existing case law. Therefore, it was reasonable for ConEd to continue to expect that a negotiated resolution was "a genuine possibility, if not probability"

Consol. Edison Co. of NY (Fed. Cl. 2009) No Sanctions Because Relevance Not Established

- The court stated that, even if litigation could have been expected in or before 1997 or 1999, no sanctions would be imposed.
 - The IRS did not establish that relevant emails or documents were in fact lost.
 - The IRS did not show it was prejudiced by ConEd's failure to preserve the emails during the change over.
 - The parties had ample opportunity to fully develop an extensive record.

**The Pension Committee of the
University of Montreal Pension Plan
v. Banc of America Securities, LLC,
685 F.Supp.2d 456 (S.D.N.Y. 2010)**

“Zubulake Revisited: Six Years Later”

Judge Scheindlin revisits document retention requirements and discusses the shifting burden of proof for spoliation claims.

Pension Committee (S.D.N.Y. 2010)

Facts

- Investors in two hedge funds filed a suit to recover losses resulting from the funds' liquidation.
- A group of Defendants moved to sanction Plaintiffs for failure to produce documents and submitting false and misleading declarations regarding their document collection and preservation efforts.

Pension Committee (S.D.N.Y. 2010)

Framework of Analysis

- Duty to Preserve
 - When did the party reasonably anticipate litigation?
- Level of Culpability
 - Was the failure to produce or spoliation due to negligence, gross negligence, or willful action?
- Burden of Proof
 - If the conduct was **negligent**: Innocent party must show (1) the lost information was relevant and (2) the absence of the information is prejudicial.
 - If the conduct was **grossly negligent** or **willful**: Relevance and prejudice are presumed. Burden shifts to spoliating party to rebut the presumption.
- Appropriate Remedy
 - What is the least harsh sanction to alleviate the harm done to the innocent party?

Pension Committee (S.D.N.Y. 2010)

Distinguishing Between Negligent and Grossly Negligent Plaintiffs

Negligence	Gross Negligence
Failure to collect records from all employees	Failure to issue a written litigation hold Failure to issue a litigation hold in a timely manner
Failure specifically to direct all persons to not destroy records	Failure to take any action to collect or preserve records for four years after the duty arose
Failure of management or counsel to supervise the document collection	Failure to identify the key players and collect records from them
Failure to assess the accuracy and validity of selected search terms	Deletion of electronic documents after the duty to preserve arose
Failure to take all appropriate measures to preserve electronically stored information ("ESI")	Destruction of backup data potentially containing responsive documents of key players that were not otherwise available
	Failure to collect information from, or destruction of, the files of former employees that remain in a party's possession, custody, or control

Pension Committee (S.D.N.Y. 2010)

Sanctions Applied

- Grossly Negligent Plaintiffs
 - Adverse inference jury charge
- Grossly Negligent and Negligent Plaintiffs
 - Monetary sanctions
- Additional discovery ordered for two Plaintiffs who never searched backup tapes still in existence
- No terminating sanctions because conduct was not egregious
 - No perjury, tampering with evidence, or intentionally destroying evidence by burning, shredding, or wiping out computer hard drives

The Interplay Between Work Product and Document Retention

Work Product Does Not Require Attorneys...

- Work product protection is derived from Supreme Court precedent.
 - *See Hickman v. Taylor*, 329 U.S. 495 (1947).
- Work product may be broader in scope than the attorney-client privilege.
 - *See, e.g., In re Cendant Corp. Sec. Litig.*, 343 F.3d 658 (3d Cir. 2003) (holding that consultants retained to aid in witness preparation may qualify as non-attorneys protected by work-product).
- Work product is harder to waive than the attorney-client privilege.
- Disclosure of work product by a company to its auditor generally does not result in a waiver of work-product.
 - *United States v. Deloitte LLP*, 610 F.3d 129 (D.C. Cir. 2010).
 - *S.E.C. v. Roberts*, 254 F.R.D. 371 (N.D. Cal. 2008).
 - *In re Guidant*, Pre-trial Order No. 17, Doc. 05-1708 (D. Minn. August 16, 2006).
 - *Merrill Lynch v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004).
 - *In re Pfizer Securities Litig.*, No. 90-1260, 1993 WL 561124, at *6 (S.D.N.Y. 1993).

But Work Product Can Be A Double-Edged Sword

- Once litigation is anticipated, special document retention policies can apply, generally prohibiting destruction of related materials.
- Destroying documents after litigation is expected may be considered “spoliation.”
 - *PML North America, LLC v. Hartford Underwriters Ins. Co.*, No. 05-70404, 2006 WL 3759914 (not reported) (E.D. Mich. 2006) (reciting the “general duty of litigants to avoid spoliation of evidence from the moment that a party knows or should reasonably know that there is a potential for litigation”).
- Spoliation may result in sanctions, including dismissal.
 - *See, e.g., Leon v. IDX Systems Corp.*, 464 F.3d 951 (9th Cir. 2006) (spoliation resulted in \$65,000 sanction and dismissal).
- Arguably, any early claim of work-product should also result in a litigation hold over all related material.
 - *See Consol. Edison Co. of N.Y. v. United States*, 90 Fed. Cl. 228, 250-61 (2009).

Contemporaneous Documents Are Critical to Winning A Tax Trial

- Without contemporaneous objective evidence, witness credibility is seriously compromised.
- Courts disregard “self-serving” testimony.
 - ❑ *See Trucks, Inc. v. United States*, 234 F.3d 1340 (11th Cir. 2000) (“[Taxpayer] must be able to corroborate its claim by evidence beyond ‘tax returns, uncorroborated oral testimony, or self-serving statements.’”).
 - ❑ *Han v. Comm’r*, 83 T.C.M. (CCH) 1824 (2002) (“We are not required to accept self-serving testimony, particularly where it is implausible and there is no persuasive corroborating evidence.”).
- Over 1000 Tax Court cases cite (and disregard) “self-serving testimony.”

Preservation May Be Required

- Arthur Andersen was convicted for “knowingly, intentionally and corruptly” persuading other persons to destroy documents.
- Supreme Court reversed.
 - It was not “corrupt” within meaning of statute cited in indictment merely to “impede” a regulatory proceeding.
- Sarbanes-Oxley
 - Directed at old “pending” or “imminent” requirement.
 - Knowledge is enough – no corruption required.
 - Influencing the investigation is enough – impeding or obstructing not required.

Preservation May Be Required

- Sarbanes-Oxley
 - It is a crime to alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry in any record, document, or tangible object knowingly with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or in relation to or contemplation of any such matter or case. 18 U.S.C. § 1519.
- Legislative history:
 - “This statute is specifically meant not to include any technical requirement, which some courts have read into other obstruction of justice statutes, to tie the obstructive conduct to a pending or imminent proceeding or matter by intent or otherwise.”

Recommendations for Implementing a Document Hold

Establishing an Effective Document Retention Policy

1. Establish company-wide policies.
2. Ensure litigation hold follows standards.
3. Establish tax-specific policies.
4. Think broadly about documents to be retained.

Establish Company-Wide Policies

- Develop a firm company-wide written policy for retention and destruction of documents, including specified time periods for particular types of documents based upon legal requirements.
- Develop a specific policy with respect to e-mail retention and destruction.
- Apply document retention policies consistently across business groups.
- Establish internal penalties for failure to follow policies.
- Generally, have policy managed by corporate legal department.

Ensure Litigation Hold Follows Standards

- Issued in writing
 - Meet with each key custodian and IT personnel
 - Require each employee to provide written certification of compliance
- Issued in a timely manner: when the party reasonably anticipates litigation
- Directs employees to preserve all relevant records- both paper and electronic
- Provides guidance regarding what records are responsive
- Creates a mechanism for collecting the preserved records so that they can be searched by someone other than the employee
- Specifically instructs employees not to destroy records

Establish Tax-Specific Policies

- Adjust corporate-wide policies to address tax specific issues.
 - Not limited to the tax department.
- Establish a standing hold policy for documents expected to be requested during every Federal (and state) audit.
- Issue a hold order for specific transactions or issues for which a dispute is clearly anticipated.
- Maintain records sufficient to support the return.
 - For “reportable transactions,” maintain records that “are material to an understanding of the tax treatment or tax structure of the transaction.”

Think Broadly About Documents To Be Retained

- Hard-copy correspondence (*e.g.*, letters, facsimiles)
- Electronic correspondence (*e.g.*, e-mails, other messaging)
- Records of oral communications (*e.g.*, phone messages, memos)
- Include third-party documents:
 - Business advisors
 - Tax advisors
 - Counterparties
 - Shareholders
 - Board members

Practical Tips for Core Document Preservation

- Preserve core transactional documents.
 - Consider how to handle drafts.
- Preserve intent-related documents.
 - If contained in informal communications, consider putting them in more formal documents.
- Segregate privileged documents up front.
- Consider interviewing key personnel who are involved in significant transactions.
 - Treasury Department
 - Chief Financial Officer
 - Business unit personnel