Federal litigation and state tax systems

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Summons power

- IRS may examine any books, papers, records, or other data “relevant and material” to a tax inquiry section 7602
- enforced in federal district court sections 7402, 7604
- can suspend statute of limitations section 6503(j)
- higher standard to summons tax-related computer software source code section 7612

Morton Salt Co.

338 U.S. 632 (1950)

summons power like “grand jury” power

standards for administrative summons

1. within agency’s authority
2. not indefinite
3. information sought “reasonably relevant”

United States v. Powell

379 U.S. 48 (1964)

"probable cause" not required under § 7602

four requirements for summons

1. legitimate purpose
2. inquiry relevant to purpose — "throw light upon"
3. new information
4. administrative steps followed

But not while Justice Department referral for criminal prosecution is in effect. § *7602(d)*

But not to harass taxpayer, coerce settlement of another dispute, or otherwise act in bad faith

Tax accrual workpapers

- documents about tax reserve for current, deferred, and potential or contingent tax liabilities
- analysis of
  - tax pool
  - tax liability contingency
  - tax cushion
  - tax contingent reserve

Arthur Young & Co.

465 U.S. 805 (1984)

HOLDING – Tax accrual workpapers prepared by corporation's independent CPA in course of regular audit are "highly relevant" and may be summoned.

OBSERVATIONS – Independent auditor has "a *public* responsibility," "public trust."

– "§ 7602 is subject to traditional privileges and limitations"

IRS policy

- “restraint” in summonsing tax accrual workpapers
- no restraint, can routinely request tax reconciliation workpapers, or the existence/amount of total tax reserve
- *Arthur Young* case commends the IRS’s “administrative sensitivity” for its internal requirements for issuing summonses

El Paso Co. – 5th circuit

682 F.2d 530 (1982)

- "tax pool analysis" of contingent liability for more taxes than on return, holding company with 67 subsidiaries — 4-5 pages long

Not used to prepare returns

Not source document of actual transaction

Not made for "primary motivating purpose" of litigation

- Summons meets 4-part *Powell* test.
- Summons enforced.

FASB Interpretation No. 48 (2006)

Accounting for Uncertainty in Income Taxes

previously, FASB 5 - “probable and reasonably estimated,” “reasonably possible and disclosed,” **or** “remotely possible”

now, FIN48 - “more likely than not” success for taxpayer must be recognized and measured.

http://www.fasb.org/pdf/aop_FIN48.pdf

Textron – 1st circuit (2007-now)

- ongoing disputes, three other court cases, annual audits, *sale-in, lease-out* transactions
- Summons issued for tax accrual workpapers
- *really* spreadsheets with tax items that counsel says IRS may challenge, percent estimates of hazards of litigation, dollar amounts in tax reserve (if lose to IRS), and previous years' spreadsheets, notes, memos

Textron – arguments by taxpayer

o concedes papers are relevant and material

- attorney-client privilege
- section 7525 (a) privilege – taxpayer has privilege for (noncriminal) tax-advice communication with any federally authorized tax practitioner, like attorney-client privilege

- work product doctrine

Work-product doctrine

Adversary may not see documents and tangible things "prepared in anticipation of litigation."

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

derived from *Hickman v. Taylor*, 329 U.S. 495 (1947)

- qualified protection only – "substantial need" and "undue hardship" allows discovery
- applicant's burden to show need/hardship
- legal opinions most protected

Textron – district court, and court of appeals panel

507 F.Supp.2d 138 (D.R.I. 2007), 553 F.3d 87 (1st Cir. 2009)

District court (07): workpapers are protected by attorney-client/7525 privilege, **but** Textron waived privilege.

Court of appeals Panel (09): Work-product doctrine defeats the summons of Textron's — **but not the auditor's** — workpapers.

appealed to *en banc* court ; argued June 2

now awaiting decision

Commissioner v. Comcast Corp.

901 N.E.2d 1185 (Mass. March 3, 2009)

- 16-page memos between in-house lawyer and outside accountant as to structure of stock sale; capital gains not on state return
- Attorney-client privilege does **not** apply to advice about state tax law from CPA.
- Work-product doctrine does protect memos that were prepared "because of" anticipated litigation, citing *Textron* panel.

Preemption

Article VI, U.S. Constitution

U.S. Constitution, U.S. laws, and treaties are the "Supreme Law of the Land."

- If state or local law conflicts with federal law, then the state or local law is preempted.
- Two types of preemption
  - express
  - implied

Express preemption (plain)

- when Congress expressly says so
- plain – *All States Tax Guide*, ¶¶ 831-915
- U.S. government, U.S. bonds, Direct-to-home satellite service, interstate bus tickets, Indians, nonresidents' pensions, mobile phone, credit unions, non-home-office national bank, 4-R law, air fares, military/transportation-worker nonresidents, (only) direct solicitation, internet access

Express preemption (ambiguous)

Congress says "preempt" (or similar words)

but meaning is ambiguous

- "[ERISA] shall supersede any and all State laws insofar as they may now or hereafter **relate to** any employee benefit plan."

29 U.S.C. 1144(a)

- ERISA does **NOT** preempt gross-receipts tax on hospitals run by ERISA plans. *DeBuono v. NYSA-ILA Med. Fund*, 520 U.S. 806 (1997)

Preemption (Constitution)

- Commerce clause – negative/dormant
  - State tax may not prohibit or discriminate against interstate commerce.
- Due process clause
  - State may not tax out-of-state property, misapportioned income, twice ("double tax"), without notice, without chance for hearing.
- Equal protection clause
- Privileges and immunities clauses
  - Protects only real people, not corporations

Implied preemption

key is Congress's intent about state law

two types:

1. **field** preemption – federal regulation is so pervasive that Congress left no room for the states

2. **conflict** preemption – complying with both federal and state rules is impossible, or state law obstructs Congress's purposes

Presumption against implied preemption

- generally true in all preemption cases
- but particularly so in areas traditionally occupied by states
- “historic police powers of the States”
- state power to tax is often equated with police powers of state.

Tax Injunction Act

"The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." *28 U.S.C. § 1341*

Also barred in federal court are declaratory-relief suits, and § 1983 damages suits as to validity of state tax systems. *FAIR v. McNary*, 454 U.S. 100 (1981).

Tax injunction act does not bar suits by:

- ✓ railroads (under 4-R act). *49 U.S.C. § 11501*
- ✓ U.S. government to protect itself or agencies. *Dep't of Employment*, 385 U.S. 355 (1966).
- ✓ Indian tribe on a federal question. *Moe v. Confederated Tribes*, 425 U.S. 463 (1976).
- ✓ state tax collectors that end up in federal court (**when** taxpayer can raise defenses). *Jefferson County v. Acker*, 527 U.S. 423 (1999).