PRIVILEGES
IN TAX CONTROVERSIES

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I. The Attorney-Client Privilege

A. Definition

1. The hornbook definition of the attorney-client privilege is as follows: "(1) Where legal advice of any kind is sought (2) from a professional legal advisor in his capacity as such, (3) the communications relating to that purpose, (4) are made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or the legal advisor, (8) except the protection be waived." 8 J. Wigmore, Evidence § 2292.

2. The definition provided in U.S. v. United Shoe Machinery Corp., 89 F. Supp. 357 (D. Mass. 1950), is often cited: The attorney-client privilege applies where "(1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client."

B. Source of Privilege

1. The attorney-client privilege, the oldest of all testimonial privileges, was first recognized during the reign of Elizabeth I. Its purpose was to prevent the lawyer from having to testify against the client. The lawyer, rather than the client, had the privilege.

2. The privilege has developed over the years as a matter of common law. Today, however, the privilege belongs to the client. It is the client's right to assert or waive the privilege, not the lawyer's.

3. In federal court, the privilege is recognized under Rule 501 of the Federal Rules of Evidence, which provides that common law privileges shall be recognized except as modified by the Constitution, federal statute, or Supreme Court rule.

C. Duration of the Privilege

1. The privilege continues indefinitely unless there is a waiver. The Supreme Court held that the privilege survives the client's death. Swidler & Berlin v. U.S., 118 S.Ct. 2081 (1998).

D. Communications from and to the Client

1. For the attorney-client privilege to apply, there must be a communication (which may be either oral or written) **from the client to the lawyer**. The privilege protects the communication from disclosure – but note that the information is not privileged if it can be obtained from another source.

2. Communications **from the lawyer to the client** generally are also privileged.

a. Where the nature of the lawyer's communication to the client would reveal the substance of the client's communication to the lawyer, the privilege will apply. Alexander v. Fed. Bureau of Investigation, 198 F.R.D. 306, 309 (D.D.C. 2000) ("The attorney-client privilege must protect 'a client's disclosures to an attorney,' and the federal courts extend the privilege also to an attorney's . . . communications to a client, to ensure against inadvertent disclosure, either directly or by implication, of information which the client has previously confided to the attorney's trust").

b. In some cases, however, the lawyer's communication will not reveal the client's communication; for example, where the lawyer sends unsolicited legal advice to the client. Here, some courts apply the privilege, but others do not. American Standard, Inc. v. Pfizer, Inc., 828 F.2d 734 (Fed. Cir. 1987) (no privilege where lawyer's letter to client did not reveal substance of confidential communications); In re LTV Sec. Litig., 89 F.R.D. 595 (N.D. Tex. 1981) (upholding broad privilege).

c. *Important Point: Never assume that unsolicited or generic communications are privileged simply because they emanate from a lawyer*.

E. Corporations and Partnerships as Clients

1. The attorney-client privilege may be invoked by a corporation. (In this respect, it differs from the Fifth Amendment privilege, which is inapplicable to corporations.)

2. However, there is sometimes an issue as to which individuals within a corporation can speak on behalf of the corporation so that the privilege applies.

a. Under prior law, a "control group" test applied. Only confidential communications made by employees who were in a decision-making or "control group" capacity were privileged. Alternatively, under prior law, communication from any corporate employee was privileged only if made: (1) at the direction of a superior; (2) within the scope of the employee's duties; and (3) for the purpose of obtaining legal advise.

b. In Upjohn Co. v. U.S., 449 U.S. 383 (1981), the Supreme Court rejected these prior law tests as too narrow. Without laying down a definitive test, the Court said that the following factors were relevant: whether communications were made to the lawyer by employees, at the direction of their superiors, in order to obtain legal advice; whether the information communicated to the lawyer was not available from upper echelon management; whether the communications concerned matters within the scope of the employee's corporate duties; and whether the employee was aware that the purpose of the communication was to obtain legal advice.

3. After Upjohn, communications between counsel and employees of the corporate client are generally privileged. Communications between counsel and former employees of a corporate client are generally treated as privileged. In re Allen, 106 F.3d 582, 605-606 (4th Cir. 1997). Communications between counsel for a corporate parent and counsel for its subsidiary are also generally privileged. In re Westinghouse Elec. Corp. Uranium Contracts Litig., 76 F.R.D. 47, 58 (W.D. Pa. 1977). However, communications between counsel and the corporation's shareholders may not be privileged. Garner v. Wolfinbarger, 430 F.2d 1093, 1103-1104 (5th Cir. 1970).

4. Communications with the general partners of a partnership client are generally privileged. Abbott v. Equity Group, 1988 WL 86 826 (E.D. La. 1988).

5. Although communications between an employee and corporate counsel may be privileged, the privilege may belong to the corporation, not the employee. Thus, if the corporation waives the privilege, the employee may have no defense to the publication to an adversary of his statements to corporate counsel. U.S. v. Stein, Docket No. S1 05 Crim. 0888 (S.D.N.Y. 2006) (in a criminal prosecution, former KPMG partner could not prevent disclosure to Government of her statements to KPMG counsel after KPMG waived the privilege).

F. Exceptions – Non-Privileged Communications

1. The identity of the client and fee arrangements generally are not privileged. Alexiou v. U.S., 39 F.3d 973 (9th Cir. 1994); U.S. v. Jones, 517 F.2d 666 (5th Cir. 1975).

   a. However, there is an exception if disclosing the identity of the client, or a fee arrangement, will necessarily disclose a privileged communication, or if the disclosure would be the "last link" in a chain of evidence incriminating the client. U.S. v. Sindel, 53 F.3d 874 (8th Cir. 1995); U.S. v. Blackman, 72 F.3d 1418 (9th Cir. 1995); U.S. v. Liebman, 742 F.2d 807 (3rd Cir. 1984).

2. Billing statements and timesheets generally are not privileged. However, redaction may be permissible if client communications are reflected on the bills or timesheets. Bieter Co. v. Blomquist, 156 F.R.D. 173 (D. Minn. 1994).

   a. *Important Point: The trend has been for legal bills to include more and more detail as to the services rendered. However, care should be taken so that the detail does not reveal client confidences. A time entry for "research into tax fraud issue," for example, would certainly pique an IRS examiner's curiosity*.

3. In general, documents provided by the client to the lawyer are not privileged (although communications about the documents would be). For example, providing all copies of accounting records to a lawyer will not prevent them from being discovered. U.S. v. Fisher, 425 U.S. 391 (1976). On the other hand, if a Fifth Amendment privilege against self-incrimination would apply to the documents, that privilege would not be lost if the documents were given to the lawyer.

4. The communication must be for legal advice – not business, accounting or other advice. Diversified Industries, Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1978); Sedco International, S.A. v. Cory, 683 F.2d 1201 (8th Cir. 1982). If a communication has a dual purpose to communicate business and legal advice, some courts may hold there is no privilege, but most courts will allow the privilege if the legal advice is the primary purpose for the communication. See, e.g., Neuder v. Battelle Pac. Northwest Nat'l Lab., 194 F.R.D. 289, 292 (D.D.C. 2000) ("Where business and legal advice are intertwined, the legal advice must predominate for the communication to be protected."); Pippenger v. Gruppe, 883 F. Supp. 1201, 1207 (S.D. Ind. 1994) (also applying primary purpose test).

5. It is well settled that communications relating to tax return preparation are not privileged. U.S. v. Frederick, 83 AFTR 2d ¶ 98-2644 (7th Cir. 1999); U.S. v. Lawless, 709 F.2d 485 (7th Cir. 1983); U.S. v. Davis, 636 F.2d 1028 (5th Cir. 1981); Bernardo v. Commissioner, 104 T.C. 677 (1995); U.S. v. Bell, 74 AFTR 2d 94-7271 (N.D. Cal. 1994).

6. The privilege does not apply when the communications to the attorney relate to a continuing or future crime or fraud.

G. Confidentiality

1. For the attorney-client privilege to apply, the communication must have been made with the expectation that it would remain confidential. U.S. v. Jones, 696 F.2d 1069 (4th Cir. 1982) (no attorney-client privilege for opinion letter in tax scheme where letter was circulated in offering brochures); U.S. v. Bohonnon, 628 F. Supp. 1026 (D. Conn. 1985), aff'd, 795 F.2d 79 (2d Cir. 1986) (no attorney-client privilege for communication to attorney with expectation that information would be included in tax return).

2. The privilege does not apply if the communication was made in the presence of nonclients. U.S. v. Gann, 732 F.2d 714 (9th Cir.), cert. denied, 469 U.S. 1034 (1984).

a. *Important Point: Lawyers are frequently invited to meetings with the client and other professionals. It should be borne in mind that the attorney-client privilege will not apply to such discussions. For example, there would be no attorney-client privilege for communications at a meeting at which the client was present with his investment banker*.

3. However, there is a "common interest" exception to the no-third-party rule. Under the common interest exception, a communication is considered confidential even if shared with another party if there is a joint defense effort between one party and another. U.S. v. Schwimmer, 892 F.2d 237 (2d Cir. 1989); Bank Brussels Lambert v. Credit Lyonnais (Suisse) S.A., 160 F.R.D. 437 (S.D.N.Y. 1995).

a. The parties must share a common interest about a legal matter – not merely a common business plan – and there must be a concern about litigation. See U.S. v. United Technologies Corp., 979 F. Supp. 108 (D. Conn. 1997) (documents resulting from negotiations among five consortium members sought by the IRS in audit of one member were privileged because the documents discussed a common legal strategy, i.e., the tax structure of the consortium); but see SCM Corp. v. Xerox Corp., 70 F.R.D. 508 (D. Conn. 1976) (negotiations between parties regarding sale of business were not privileged because they were not directed at advancing the joint interests of the parties against a third party in litigation).

b. It is advisable to enter into a joint defense agreement where it is anticipated that the "common interest" exception may be invoked.

H. Waiver of Privilege

1. Although disclosure to certain persons assisting an attorney – secretaries, interpreters, etc. – is not a waiver of the attorney-client privilege, the general rule is that disclosure of the confidential communication is a waiver. (A significant exception exists, however, under the Kovel doctrine, discussed below.)

a. Voluntary disclosure – for example, by turning over confidential documents in litigation or in an audit – generally results in waiver. Moreover, if any substantial part of a communication is revealed, there is a waiver of the entire communication. SCM Corp. v. Xerox Corp., 70 F.R.D. 508 (D. Conn. 1976).

i. A voluntary disclosure to one federal agency may result in a waiver for other federal agencies. U.S. v. Massachusetts Institute of Technology, 957 F. Supp. 301 (D. Mass.) (voluntary disclosure of privileged communication to Defense Department resulted in waiver; IRS could obtain previously confidential documents), aff'd in part and vac'd in part on other grounds, 129 F.3d 681 (1st Cir. 1997). Note: This is the general rule; the Eighth Circuit, however, may recognize an exception. See Diversified Industries, Inc. v. Meredith, 572 F.2d 596 (8^{th} Cir.), rev'd on reh'g en banc, 572 F.2d 609 (8^{th} Cir. 1978).

b. Compelled disclosure – for example, turning over confidential documents pursuant to a court order – may also result in a waiver, although the law is unsettled. See Transamerica Computer Co. v. International Business Machines Corp., 573 F.2d 646 (9^{th} Cir. 1978).

c. The law is also unsettled with respect to inadvertent disclosures. Some courts hold that an inadvertent disclosure is a waiver. In re Sealed Case, 877 F.2d 976 (D.C. Cir. 1989) (legal advice to the finance vice president included in a memorandum to the chief accounting officer; the latter's files were reviewed by government auditors). Other courts have held that an inadvertent waiver by an attorney is not a waiver, either because the client did not authorize it or, in cases where vast quantities of documents are produced, because errors are inevitable. Westinghouse Elec. Corp. v. Republic of Philippines, 951 F.2d 1414 (3d Cir. 1991).

2. Subject matter waiver. A party cannot selectively reveal confidential communications. If one is revealed, then there is a subject matter waiver for all communications relating to the same issue. In re: G-I Holdings, Inc., et al., No. 02-3082 (D. N.J. 2003).

3. Reliance on legal advice. Courts will usually find a waiver of the attorney-client privilege if the client relies on the communication in litigation. For example, if an accuracy-related penalty is proposed under I.R.C. § 6662, and if the client's defense is that he relied upon the opinion of a lawyer, then there is a waiver of the privilege. In re: G-I Holdings, Inc., et al., No. 02-3082 (D. N.J. 2003) (privilege waived not just for opinion, but for all communications; depositions of attorneys who gave opinion permitted).

4. *Important Point: If an attorney provides a client with an anti-penalty opinion, then the IRS may be able to convince a court that the attorney-client privilege has been waived for all communications relating to the transaction.*

I. The Kovel Doctrine

1. Under the so-called Kovel doctrine, an attorney may disclose a client confidence to a person retained by the attorney to assist the attorney in the rendering of legal advice. Disclosure in this situation is not a waiver of the privilege. U.S. v. Kovel, 296 F.2d 918 (2d Cir. 1961) (no waiver where confidential information provided by attorney to accountant retained by the attorney to assist in rendering of legal services).

2. Although attorneys often rely upon "Kovel" when they hire outside experts such as accountants, the recent trend has been to read Kovel narrowly. See In re: G-I Holdings, Inc., et al., No. 02-3082 (D. N.J. 2003) (Kovel applies only where the accountant functions as a "translator" or "facilitator" who merely helps the attorney understand the client, as contrasted with situations where the accountant is providing his own tax advice).

3. The following are important steps that should be followed if Kovel is to be relied upon:

a. When the lawyer retains the agent-consultant (accountant, appraiser, etc.), the agreement should be in writing and should make clear that the consultant is being hired to assist the lawyer in providing **legal** services.

b. The retainer agreement should be between the consultant and the lawyer (not the client). The consultant's bills should be sent to the lawyer for payment. The engagement should be separate from any other engagement that the consultant may have with the client.

c. The consultant must work under the supervision, direction and control of the lawyer. The consultant's advice should go to the lawyer, not directly to the client.

d. The consultant should agree in writing to maintain the confidentiality of all the information he receives.

e. All documents prepared by the accountant should be the property of the attorney.

4. If the above steps are not followed, Kovel may not be applicable. See, e.g., U.S. v. Adlman, 68 F.3d 1495 (2d Cir. 1995) ("Adlman I"). In Adlman I, Sequa Corporation's general counsel (Mr. Adlman) asked an Arthur Andersen CPA to draft a memorandum outlining the tax consequences of a proposed sale of a wholly-owned subsidiary. The merger was expected to produce a loss for tax purposes. The CPA prepared a 58-page memo outlining the transaction, discussing various legal issues relating to taxation, and predicting the outcome of possible litigation. The IRS summonsed the memo. Sequa argued that the attorney-client privilege applied, citing Kovel. The Second Circuit held that the attorney-client privilege was inapplicable.

a. The court noted: "… the evidence supports the conclusion that Sequa consulted an accounting firm for tax advice, rather than that Adlman, as Sequa's counsel, consulted AA to help him reach the understanding he needed to furnish legal advice." (Under Kovel, the accountant must provide advice to, and be under the control of, the lawyer.)

b. The court also observed that there was "no contemporaneous documentation supporting the view that AA, in this task alone, was working under a different arrangement from that which governed the rest of its work for Sequa." Andersen's "billing statements lump the work done in this consultation together with its other accounting and advisory services to Sequa."

c. Also, Andersen "sent a summary of its recommendations and conclusions directly to Sequa's management," instead of providing it to Sequa's attorney.

d. The court noted, however, that the work-product doctrine might protect the memo. See Adlman II, discussed below.

e. *Important Point: Adlman I demonstrates that it is important to structure a Kovel arrangement with some care. Where Kovel has to be argued as an afterthought, as it was in Adlman I, it is much more difficult to prevail*.

5. The Second Circuit also rejected the application of the attorney-client privilege in another recent case, U.S. v. Ackert, 169 F.3d 136 (2d Cir. 1999). Ackert was employed as an investment banker by Goldman Sachs. Ackert "pitched" a tax-oriented investment proposal to Paramount Corporation. (The proposal was similar to that at issue in the ACM case.) Myers, Paramount's senior vice president/tax counsel (an attorney), contacted Ackert regarding the tax implications of the investment so that he could advise Paramount. The IRS summonsed Ackert to appear and answer questions regarding his conversations with Myers. Relying upon Kovel, Paramount argued that the attorney-client privilege applied. The court held that it did not.

a. Although Ackert was a licensed attorney, he was employed as an investment banker. An attorney not acting as such is not a provider of legal advice; thus, the privilege did not arise.

b. The Second Circuit held that Kovel was inapplicable even though Myers interviewed Ackert in order to obtain information and better advise his client, Paramount. Kovel recognized that a lawyer could rely upon a non-lawyer to improve the comprehension of communications between the attorney and the client. However, Myers sought out information that Paramount did not have about the proposed transaction and its tax consequences.

c. Ackert was selling an investment "product." He was not helping Myers understand his client's communications.

II. The Work-Product Doctrine

A. Definition

1. The work-product doctrine protects documents, interviews, statements, memoranda, correspondence, briefs, mental impressions, and tangible things prepared by an attorney in anticipation of litigation. See U.S. v. Nobles, 422 U.S. 225 (1975); Hickman v. Taylor, 329 U.S. 495 (1947).

2. The work-product doctrine is incorporated in Rule 26(b)(3) of the Federal Rules of Civil Procedure, which provides: "… a party may obtain discovery of documents and tangible things otherwise discoverable … prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall

protect against disclosure of the mental conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation."

3. Rule 26(b)(3) addresses tangible evidence (e.g., documents). However, the work-product doctrine more broadly means that an attorney generally cannot be compelled to testify regarding work product, whether tangible or not. For example, in general an attorney cannot be forced to reveal the substance of witness interviews. Hickman v. Taylor, 329 U.S. 495 (1947); In re Grand Jury Proceedings, 473 F.2d 840 (8th Cir. 1973).

4. It should be noted that the work-product doctrine may apply to documents prepared by non-attorneys, provided they are prepared in anticipation of litigation. U.S. v. Bornstein, 977 F.2d 112 (4th Cir. 1992).

5. However, the work-product doctrine is a qualified privilege, as discussed below. The privilege can be overcome if the party seeking disclosure makes an adequate showing of substantial need and unavailability.

B. "In Anticipation of Litigation"

1. The work-product doctrine extends to documents, etc., prepared by attorneys and non-attorneys; however, it is critical that the documents be prepared "in anticipation of litigation."

a. The term "litigation" is undefined. It is usually understood to mean proceedings in court or administrative tribunals "in which the parties have the right to cross-examine witnesses or to subject an opposing party's presentation of proof to equivalent disputation." U.S. v. American Tel. & Tel. Co., No. 74-1698 (D.D.C. Feb. 28, 1979). Under this definition, an IRS examination would not be litigation; however, documents prepared in the course of an examination might well be characterized as "in anticipation" of future Tax Court, Claims Court or District Court litigation.

b. Some courts have stated that the work-product doctrine applies only if the **primary** purpose behind the creation of the document is to aid in litigation that may arise. U.S. v. Davis, 636 F.2d 1038 (5th Cir. 1981) (holding the work-product doctrine inapplicable to work papers prepared to aid in filing tax returns); U.S. v. El Paso Co., 682 F.2d 530 (5th Cir. 1982) (holding the work-product doctrine inapplicable to a tax pool analysis disclosing the "soft spots on the corporation's tax returns"); U.S. v. Bell, 74 AFTR 2d 94-7271 (N.D. Cal. 1994). Under this formulation, a document prepared primarily to facilitate a business decision would not be protected.

c. However, in U.S. v. Adlman, 134 F.3d 1194 (2d Cir. 1998) ("Adlman II"), the Second Circuit held that a CPA's memorandum outlining the tax consequences of a proposed sale of a corporate subsidiary was work product. The Second Circuit rejected the "primary purpose" test, and held that even if a document was prepared to facilitate a business decision it could still be work product if the document "can fairly be said to have been prepared or obtained **because of** the prospect of litigation."

i. The Second Circuit sent the case back to the district court for a determination of whether the memorandum "would have been prepared irrespective of the anticipated litigation and therefore was not prepared because of it."

ii. The Second Circuit also noted that the IRS could obtain the memorandum if it could show "substantial need for the document and an inability to obtain its contents elsewhere without undue hardship."

iii. There was a dissenting opinion in the case. The dissenting judge believed that the majority "extended the work-product privilege to a stage that precedes any possible 'anticipation' of litigation."

d. On remand of the Ackert case, the taxpayer relied upon Adlman II in raising the work-product doctrine as a defense. The court held it did not apply because the "conversations took place in connection with a proposed investment, not an impending lawsuit." It noted that "no litigation was on the horizon" and an IRS audit did not begin for 7 years. U.S. v. Ackert, 84 AFTR 2d ¶ 99-7527 (D. Conn. 1999) ("Ackert II").

i. Given the nature of the tax-oriented investment at issue, the court's conclusion that there was no anticipation of litigation seems naïve.

ii. Ackert II, which seems at odds with Adlman II, may indicate a judicial reluctance to extend a work-product privilege to the testimony and documents of those pitching tax "products."

e. In U.S. v. Roxworthy, 457 F.3d 590 (6th Cir. 2006), the court held that two "more likely than not" memoranda prepared by KPMG regarding the creation of a captive insurance company and related stock transfers were work product. The court held that the "anticipation of litigation" requirement was met because the taxpayer (Yum Brands) had an objectively reasonable belief there could be litigation, based on the fact that it was audited annually, the dollars at issue were significant, and there was a large discrepancy between a tax loss and a book loss.

2. The Supreme Court has held that the work-product doctrine does not protect an accountant's tax accrual workpapers. The rationale underlying the decision is that such workpapers are not prepared in anticipation of litigation, but rather are prepared in the ordinary course of business and as an accounting

necessity. U.S. v. Arthur Young & Co., 465 U.S. 805 (1984). For additional discussion on tax accrual workpapers, see Section VI, below.

C. Qualifications and Exceptions

1. The work-product doctrine, as stated in FRCP 26(b)(3), states that a "court shall protect against disclosure of the mental conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation." Thus, there is an **absolute** privilege for so-called "opinion work product."

2. On the other hand, "fact work product" is entitled to only a **qualified** privilege. It must be disclosed if "the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means."

3. The work-product doctrine is applicable in the Tax Court, but there too it is a qualified privilege. See Hartz Mountain Industries Inc. v. Commissioner, 93 T.C. 521 (1989).

4. The exceptions applicable to the attorney-client privilege are also applicable to the work-product doctrine.

D. Waiver

1. A waiver of the work-product doctrine may occur because of a disclosure, but the courts have been less strict than they have been with respect to the attorney-client privilege. Only disclosures that are inconsistent with the adversary system are deemed waivers of the work-product doctrine.

   a. A disclosure to an adversary will waive the work-product doctrine, because the purpose of the work-product doctrine is to protect information against opposing parties, rather than to promote confidentiality generally. U.S. v. AT&T, 642 F.2d 1285, 1299 (D.C. Cir. 1980).

   b. In Salomon Bros. Treasury Litig. v. Steinhardt Partners, LP, 9 F.3d 230 (2d Cir. 1993), disclosure of work product to the SEC was held a waiver of the privilege where the SEC was in an adverse position at the time of disclosure, and where a subsequent suit was brought by a private party.

   c. As with the attorney-client privilege, there is a "common interest" exception for disclosures.

2. If a person relies upon work product as a basis for a claim or defense, there is a waiver of the privilege. This may occur, for example, where a legal opinion is relied upon to defend against a penalty, or where a lawyer acts as an expert witness. The Black & Decker Corp. v. United States, 92 AFTR 2d 2003-6426 (D. Md. 2003); In re: G-I Holdings, Inc., et al., 92 AFTR 2d 2003-6451 (D.N.J. 2003).

3. In contrast to the law applicable to the attorney-client privilege, the disclosure of one document protected by the work-product doctrine does not result in a wholesale subject matter waiver for all such documents. The Black & Decker Corp. v. United States, 92 AFTR 2d 2003-6426 (D. Md. 2003).

III. The Federally Authorized Tax Practitioner Privilege

A. I.R.C. § 7525

1. Section 3411 of the 1998 IRS Reform Act (P.L. 105-206) created a new privilege (codified at I.R.C. § 7525) for federally authorized tax practitioners ("FATPs"). The privilege is effective for communications on or after July 22, 1998.

2. I.R.C. § 7525 provides: "With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney."

3. The FATP privilege is analogous to, but narrower than, the attorney-client privilege. However, it appears that there is no FATP work-product privilege created by I.R.C. § 7525. See U.S. v. Frederick, 83 AFTR 2d ¶ 98-2644 (7th Cir. 1999). (However, the work-product doctrine applicable under the rules of civil procedure may well protect FATP documents prepared in anticipation of litigation. See Adlman II.)

B. FATPs

1. A FATP is "any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code." Practices subject to such Federal regulation are set out in so-called Circular 230. Title 31, Part 10, Code of Federal Regulations.

a. The following persons are authorized to practice before the IRS by Circular 230: attorneys, CPAs, enrolled agents, and enrolled actuaries.

b. Insofar as attorneys practicing law is concerned, I.R.C. § 7525 adds nothing to the common law privilege that currently exists. However, the statute does add protection for attorneys who are not practicing law (for example, those working for accounting firms).

c. The statute does not require that a FATP primarily be engaged in providing tax services. Presumably, therefore, the privilege will apply to FATPs employed by non-tax organizations (such as banks and brokerage firms) to the extent they provide tax advice.

d. *Important Point: It would seem that in-house CPAs are FATPs under the statute*.

C. Tax Advice and Communications

1. The statute defines the term "tax advice" to mean "advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice" before the IRS. This definition is rather ambiguous, but clearly the privilege is no broader than that applying under the attorney-client privilege, since the statutory privilege arises only "to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney."

a. For example, privileged tax advice probably does not include advice in connection with the preparation of a tax return or business advice.

b. *Important Point: Care should be taken by FATPs to separate, to the extent possible, privileged tax advice from return preparation*.

i. However, this is easier said than done. Where a FATP (or his firm) acts in a dual capacity as return preparer and tax adviser, the privilege may easily be lost.

ii. This point is illustrated by <u>U.S. v. Frederick</u>, 83 AFTR 2d ¶ 98-2644 (7th Cir. 1999). The case involved an attorney/CPA who prepared his client's tax return and also represented him in an audit.

iii. The court said that a "dual purpose document – a document prepared for use in preparing tax returns and for use in litigation – is not privileged."

iv. The court also indicated that the privilege did not apply where *during the audit* the attorney/CPA prepared memoranda relating to the numbers that were on the return, as contrasted with memoranda addressing legal theories.

v. Although the case technically involved the attorney-client privilege rather than the FATP privilege, Frederick suggests that the FATP privilege will be narrowly construed.

vi. *Important Point: While Frederick arguably goes too far, both the attorney-client privilege and the FATP privilege may be at risk if the professional preparing the return also handles subsequent tax controversies*.

2. The privilege protects "a communication between a taxpayer and any federally authorized tax practitioner."

a. Presumably, the "communications" protected will be similar to those protected by the attorney-client privilege.

b. Communications from the client to the FATP in connection with tax advice should be protected, as should communications from the FATP to the client to the extent they pertain to tax advice.

c. However, the courts may not consider unsolicited advice from FATPs to be protected. See American Standard, Inc. v. Pfizer, Inc., 828 F.2d 734 (Fed. Cir. 1987). For example, in a case like Ackert I, where an investment product is being pitched, a court might hold the FATP privilege to be inapplicable.

d. Fee arrangements, billing statements and timesheets presumably are not privileged.

D. Confidentiality and Waiver

1. As with the attorney-client privilege, it is essential that the privileged communication be kept confidential.

2. Cases decided under the attorney-client privilege have established that there is no breach of confidentiality (and hence waiver) where a communication is disclosed to persons assisting an attorney, including secretaries and paralegals. Presumably these cases will be followed with respect to FATPs.

a. However, the FATP privilege may raise new issues. For example, many accounting firms have on staff employees who are not FATPs and who do not assist in the rendering of tax advice. Networked documents may be available to non-privileged persons. If privileged tax advice is not in some manner protected from disclosure to such persons, it remains to be seen whether the privilege will survive.

3. The Kovel doctrine presumably will be applicable under I.R.C. § 7525.

4. Waiver will also occur if the tax advice communication is placed in issue (for example, if it is relied upon to defend against a penalty).

E. Proceedings in Which the Privilege Applies

1. Unlike the attorney-client privilege, the forums in which the FATP privilege may be asserted are limited.

2. The privilege applies in "any noncriminal tax matter before the Internal Revenue Service," and in "any noncriminal tax proceeding in Federal court brought by or against the United States."

3. The privilege does not apply in: nontax civil litigation; proceedings before administrative agencies other than the IRS; state tax proceedings; or criminal proceedings. Further, it may not apply to tax matters in bankruptcy proceedings (which are not brought by or against the United States). For an example of a case where the court held the privilege was inapplicable, see John Doe #1 v. Wachovia Corp., 92 AFTR 2d 2003-5125 (W.D.N.C. 2003) (action by bank customer against bank to prevent disclosure of taxpayer's identity to IRS).

4. This limitation creates a significant risk that a waiver will occur. As noted previously, a disclosure in one forum may result in a waiver for all other forums. U.S. v. Massachusetts Institute of Technology, 957 F. Supp. 301 (D. Mass.), aff'd in part and vac'd in part on other grounds, 129 F.3d 681 (1st Cir. 1997).

5. Moreover, it is unfortunate that Congress chose to restrict the FATP privilege to civil proceedings, since it is in criminal proceedings that the attorney-client privilege has its greatest importance. If there is any possibility that a civil investigation may turn into a criminal one, the FATP privilege should not be relied upon.

F. Inapplicability to Corporate Tax Shelters

1. The FATP privilege does "not apply to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii))."

2. A corporate tax shelter is defined as an entity, plan or arrangement having "as a significant purpose" the avoidance or evasion of Federal income tax. This definition is extremely broad.

3. However, the limitation only applies to the "promotion" of a tax shelter. Presumably, the FATP privilege will apply unless the FATP (or his firm) is involved in pitching a tax shelter to the client.

IV. Recent Tax Shelter Litigation – Promoter Cases

A. Background

1. I.R.C. § 6111 requires the registration of "tax shelters," as that term is defined in the statute.

2. I.R.C. § 6112 requires organizers and sellers of potentially abusive tax shelters to maintain lists of investors.

3. I.R.C. §§ 6707 and 6708 impose penalties for failure to register and maintain lists.

4. I.R.C. § 7602 permits the IRS to examine "books, papers, records, or other data" which may be relevant or material to determination of tax liability. It also permits the IRS to issue summonses to compel the production of such items.

5. In 2002, the Government began issuing summonses to accounting firms, law firms and others that it believed had failed to register tax shelters. The ensuing summons enforcement litigation has, to a large extent, concerned (a) whether the identity of the investors is privileged, and (b) whether certain documents are privileged.

B. Privilege for Taxpayer Identity

1. U.S. v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003). The IRS issued summonses to BDO as part of its investigation into BDO's compliance with I.R.C. §§ 6111 and 6112. Some BDO clients moved to intervene to prevent the disclosure of documents that would identify them to the IRS. They invoked the FATP privilege under I.R.C. § 7525. The motion was denied upon appeal because the Court ruled the taxpayer's did not have a protectible interest in keeping their identity confidential.

a. The taxpayers relied upon Tillotson v. Boughner, 350 F.2d 663 (7th Cir. 1965). In Tillotson, an unidentified taxpayer determined that he understated his tax liability on previously filed returns. His attorney delivered a cashier's check in the amount of $215,499.95 to the IRS on his behalf, but without identifying him. The IRS insisted that the attorney identify his client. The Seventh Circuit upheld the attorney-client privilege because revealing the taxpayer's identity would also reveal the content of the confidential communication (i.e., that the taxpayer had understated his tax).

b. The Seventh Circuit characterized Tillotson as an exception to the general rule that the identity of the client is not privileged. It rejected the taxpayers' argument that disclosure of their identities would reveal their "motive" for consulting BDO, and that disclosure of motive is privileged. The Court said that in BDO, in contrast to Tillotson, "the IRS knows relatively little about the interactions between BDO and the Does, the nature of their relationship, or the substance of their conversations."

c. It appears that the distinction is that, in Tillotson, the taxpayer's payment was a de facto acknowledgment of a past understatement. There was an admission of liability from the client to the lawyer. In BDO, there was no such admission. All the identity of the client would reveal was participation in a transaction.

d. The Seventh Circuit also said that, in light of I.R.C. §§ 6111 and 6112, "the [taxpayers] should have known that BDO was obligated to disclose the identity of clients engaging in such financial transaction" when they engaged BDO. Thus, they had no expectation of confidentiality. This analysis is questionable, however, since whether BDO had to comply with the registration and list requirements had not been established. Indeed, that was the whole point of the IRS examination.

2. U.S. v. Arthur Andersen LLP, 92 AFTR 2d 2003-5800 (N.D. Ill. 2003). This case was similar to the BDO case. The district court initially thought that whether identity would be privileged would depend upon the particular facts of each taxpayer's case, such as whether he engaged Andersen to prepare tax returns (no privilege) or to provide a tax opinion (privilege). However, the Court concluded that the Seventh Circuit's decision in BDO was very broad, and that client identities had to be disclosed.

3. John Doe #1 v. Wachovia Corp., 92 AFTR2d 2003-5125 (W.D.N.C. 2003). Wachovia entered into agreements with clients who wanted to participate in a "sophisticated investment strategy." Wachovia agreed to collect and analyze information, and to provide it to two other consultants, KPMG and Jenkens & Gilchrist, a law firm. The IRS summonsed documents from Wachovia, and several taxpayers sued seeking to enjoin Wachovia from complying. The Court ruled against the taxpayers on a number of grounds. It found there was no attorney-client relationship with Jenkens & Gilchrist because there was no individualized representation of the taxpayer (i.e., Jenkens & Gilchrist provided form documents and a "canned" opinion). Moreover, the documents and opinion were delivered to the taxpayers by Wachovia. The Court found that Wachovia was a "broker" connecting the taxpayers with Jenkens & Gilchrist and KPMG. It also found that I.R.C. §7525 did not apply, in part because the United

States was not a party, and in part because Wachovia was a corporation indirectly participating in a tax shelter.

C. Privilege for Documents

1. United States v. KPMG LLP, 237 F. Supp. 2d 35 (D.D.C. 2002). The IRS served summonses in connection with its examination of KPMG's promotion of and participation in various tax shelter transactions. KPMG responded by producing 183 boxes of documents. KPMG did not object to identifying its clients by name. However, it did object to producing various documents on privilege grounds.

a. **FATP Privilege**: On behalf of its clients, KPMG claimed the FATP privilege for tax opinions written by KPMG to clients in connection with tax shelter investments. The Court held that the opinions were prepared in connection with the preparation of a tax return, and therefore the privilege did not apply. The court also held that confidential memoranda between KPMG employees discussing potential legislation affecting a shelter transaction were not privileged, again because they related to the preparation of a tax return. (Interestingly, the court reached this result without even stating whether KPMG in fact prepared the tax returns.)

b. The Court's holding is extremely broad, and arguably incorrect. While it is true that the attorney-client privilege has never extended to the act of preparing a tax return, it has extended to the analysis of how the tax laws will apply to a given set of facts in a tax opinion letter. Since the FATP privilege only extends to "tax advice," and tax advice ultimately relates to how a tax return is prepared, it is hard to understand what is left of the FATP privilege under the court's holding.

c. **Attorney-Client Privilege**: On behalf of its clients, KPMG claimed attorney-client privilege, work-product privilege and the FATP privilege for tax opinions from lawyers to their clients, which opinions were in KPMG's files. The court agreed that the attorney-client privilege applied. It did not discuss whether there was a waiver by reason of the fact that the opinion was in KPMG's files, or whether I.R.C. § 7525 prevented the waiver.

d. Interestingly, the court found that privilege existed for a **lawyer's** tax opinion (even though found in an accountant's file), but not for an **accountant's** tax opinion.

e. The court also addressed e-mails among various KPMG accountants and one lawyer that discussed draft agreements and business strategy decisions. Based on limited information, it did not think these were privileged because they did not concern legal advice.

V. Recent Tax Shelter Litigation – Taxpayer Cases

A. __In re: G-I Holdings, Inc., et al.__, 92 AFTR 2d 2003-6451 (D.N.J. 2003).

1. This case involves a 1990 transaction. The Government asserted deficiencies in excess of $900 million and also asserted penalties under I.R.C. § 6662.

2. **Attorney-Client Privilege**:

a. The Government served the following interrogatory:

> State whether you contend that you are not liable for the Accuracy-Related Penalties, or any portion thereof, because your treatment of the 1990 Transaction and Subsequent Events on your 1990 through 1999 federal income tax returns did not constitute "negligence or disregard of rules or regulations" within the meaning of 26 U.S.C. § 6662(b)(1) and (c). If so, state the basis for that contention… including communications with tax and/or legal advisors, to ensure that your treatment of the 1990 Transaction and Subsequent Events

b. The taxpayer answered:

> Debtors [i.e., taxpayers] nonetheless are not liable for Accuracy-Related Penalties because they had a reasonable basis for the tax treatment of the transaction at issue and also had reasonable cause for any underpayment of tax and acted in good faith with respect to any such underpayment in this case… The lack of negligence or disregard of the internal revenue laws is evident by the substantial authority supporting the Debtors' treatment of the transactions at issue... The Debtors also consulted with outside legal counsel and other advisers regarding the tax treatment of the 1990 Transaction and Subsequent Events**.**

c. The Court held that this response constituted a waiver of the attorney-client privilege for the three reasons:

> First, the party now asserting the privilege took an affirmative act by raising a "reliance on counsel" defense. Second, through the affirmative act, the part asserting the privilege put the protected information at issue by making it relevant to the penalty issue in this case. Third, the application of the privilege would deny the party seeking discovery, the Government, access to information vital to the prosecution of its claim.

d. The Court ordered the taxpayers to turn over all communications (including tax opinions) with outside tax counsel, including their tax opinions. It also allowed the Government to take depositions of outside tax counsel (William S. McKee and William F. Nelson).

3. **Bifurcation**

a. The taxpayers asked the court to bifurcate the proceedings under Rule 42(b) of the Federal Rules of Civil Procedure. Specifically, the taxpayers wanted the court to have separate trials with respect to liability and penalty, and to allow them to withhold the privileged materials until the penalty phase. The court denied the request, holding that the taxpayers had already waived the privilege when they answered their interrogatories.

4. **Kovel Privilege**

a. The taxpayer's in-house counsel retained an Arthur Andersen accountant to provide him with tax advice regarding the transaction. Because the transaction pre-dated the effective date of I.R.C. § 7525, the taxpayer asserted privilege under Kovel.

b. The court took a narrow view of Kovel, holding that it applies only where the accountant functions as a "translator" or "facilitator" who merely helps the attorney understand the client.

c. The court considered the accountant to be a "consultant" who provided independent tax advice and who thus went far beyond being a mere "translator." The Kovel case did employ the analogy of a translator who could help the lawyer understand the client, but the holding was not limited that situation. However, Kovel did state that if the advice were the accountant's, rather than the lawyer's, there would be no privilege. The accountant has to be assisting the lawyer to enable the lawyer to provide his own legal advice.

B. The Black & Decker Corp. v. United States, 92 AFTR 2d 2003-6426 (D. Md. 2003)

1. This case involves a 1998 "contingent liability" transaction. The Government asserted tax deficiencies. It had not yet asserted penalties under I.R.C. § 6662, but apparently it was considering doing so. The IRS, in discovery, sought documents that included communications between in-house tax counsel and Deloitte & Touche. The communications apparently pre-dated I.R.C. § 7525.

2. **Kovel Privilege**

a. The taxpayer asserted that the documents were subject to the attorney-client privilege and that Kovel was applicable because Deloitte & Touche had been retained by in-house counsel.

b. The Court rejected that position, in part because many of the communications were not with in-house counsel, but rather were with other corporate employees. However, the primary reason for rejecting Kovel was that the accountants were not providing "translation" services for an attorney. They were providing "hybrid advice" consisting of tax and business advice.

3. **Short vs. Long Opinion Letters**

a. Deloitte & Touche issued a "long" opinion as well as a "short" opinion. The former was intended to be confidential, but the short opinion was not. Apparently, the parties intended that the short opinion could be shown to the IRS.

b. The taxpayer apparently disclosed the short opinion, but argued that there was no waiver of the attorney-client privilege or the work-product doctrine because the short opinion was never privileged to begin with – it was always available for review by the IRS.

c. Although this was an ingenious argument, the Court rejected it.

d. Interestingly, the taxpayer actually agreed to produce the long opinion voluntarily, provided that it was not construed to be a subject matter waiver. The IRS agreed to accept the long opinion and not argue subject matter waiver. The Court appeared dubious, but agreed to accept the parties' agreement.

4. **Work-Product Doctrine**

a. The Government conceded that the documents had been prepared in anticipation of litigation, but it argued that the privilege was waived because the taxpayer intended to rely upon the advice of Deloitte & Touche in defending against penalties.

b. The Court held that, under the work-product doctrine, the disclosure of a single communication did not constitute a subject matter waiver for all documents.

c. The Court indicated that documents that were opinion work product were almost absolutely immune from disclosure. It held that fact work product had a lesser protection, but it nonetheless did not find a subject matter waiver as to any of the documents.

C. ***Long-Term Capital Holdings v. U.S.**, 91 AFTR 2d 2003-1139 (D. Conn. 2003)*

1. This case involves an investor's contribution of high-basis, low-value preferred stock that was received in a lease stripping transaction to a partnership in exchange for a partnership interest. Shearman and Sterling (S&S) gave a legal opinion to the taxpayer partnership regarding the basis of the preferred stock. The taxpayer partnership later sold the preferred stock at a loss. King & Spaulding (K&S) gave a legal opinion at that time regarding partnership tax issues.

2. When the tax returns were being prepared, the taxpayer provided the S&S opinion to its accountants. It also told the accountants that K&S had opined that it was more likely than not that a loss could be taken.

3. The taxpayer provided the IRS with the S&S opinion during an audit, but it did not provide the K&S opinion.

4. **Attorney-Client Privilege**.

a. The IRS argued that the disclosure of the S&S opinion was a subject matter waiver, and that therefore the K&S opinion had to be disclosed.

b. The Court ruled that the S&S opinion was separate from the K&S opinion. The former had to do with basis of an acquired asset. The latter had to do with selling that asset in a subsequent transaction.

c. The Court also ruled that the S&S opinion was never intended to be kept confidential because it was always intended to be used as a source for the accountants in preparing the tax return and as a record required to be kept under Treasury Regulations of tax basis. Consequently, the disclosure on the non-privileged S&S opinion was not a waiver as to anything else.

d. The IRS argued that the K&S opinion had to be turned over because the taxpayer was relying upon it to defend against penalties. The taxpayer argued that it had not yet indicated that it would be relying on the opinion. The Court ordered the taxpayer to tell the IRS whether it would be relying on the opinion.

e. The IRS argued that there was a waiver when the taxpayer orally advised the accountants preparing the tax returns that K&S had issued a more likely than not opinion. The Court agreed that this was a waiver, but it held that because the disclosure was extra-judicial, and because the taxpayer was not relying upon the disclosure in litigation, the waiver would be limited to just that part of the opinion that was disclosed. Presumably, this was the K&S conclusion only, not the analysis underlying that conclusion. (However, even this portion of the opinion was protected by the work-product doctrine, as discussed below.)

5. **Work-Product Privilege**.

a. The Court held in an earlier opinion that the K&S opinion was protected by the work-product doctrine because it had been prepared in anticipation of litigation. Long-Term Capital Holdings v. U.S., 90 AFTR 2d 2002-7446 (D. Conn. 2002).

b. In reaching the conclusion that an opinion prepared at the time of a transaction may nonetheless be prepared in anticipation of litigation, the Court relied upon Adlman II. It did not cite Ackert II, even though the latter was decided by the same district court.

c. The Court held that opinion work product was protected from disclosure, including that portion of the opinion that had been held unprotected under the attorney-client privilege.

d. The Court held that the IRS could obtain factual work product only upon a showing of substantial need and the inability otherwise to obtain the factual materials without undue hardship.

VI. FIN 48 and Tax Accrual Workpapers

A. FIN 48 Disclosures

1. On July 13, 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Tax—an Interpretation of FASB Statement No. 109. FIN 48, which is effective for fiscal years beginning after December 15, 2006, makes significant changes in the way a company should recognize, measure, and disclose uncertain income tax positions in its financial statements.

2. FIN 48 mandates that companies evaluate all material income tax positions for periods that remain open under applicable statutes of limitation, as well as positions expected to be taken in future returns.

3. Under FIN 48, a company can recognize an income tax benefit only if the position has a “more likely than not” (i.e., more than 50 percent) chance of being sustained on the technical merits. In making this determination, the possibility that the company will not be audited, or the position will escape an auditor’s notice, cannot be taken into account.

4. If a position has a “more likely than not” chance of being sustained on the technical merits, then as a second step, FIN 48 requires that the company measure the benefit using a “cumulative probability” analysis. A company should recognize the largest amount of benefit that has a greater than 50% likelihood of being realized in settlement.

5. FIN 48 requires a tabular presentation of “unrecognized tax benefits,” meaning positions for which a benefit has been or is expected to be taken on a tax return but that cannot be taken for financial statement purposes (because the position does not meet the “more likely than not” recognition threshold) or that is measured at an amount less than the benefit claimed or expected to be claimed on a tax return. The following must be shown:

> 1) The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.
>
> 2) The gross amounts of the increases in unrecognized tax benefits as a result of tax positions taken during the current period.
>
> 3) The amount of decreases in unrecognized tax benefits relating to settlements with taxing authorities.
>
> 4) Reductions to unrecognized tax benefits resulting from the lapse of the applicable statute of limitations.

This disclosure is on a gross basis. Disclosure by tax year or jurisdiction is not required.

6. Disclosure is required of the total amount of unrecognized tax benefits that would affect the effective tax rate if they were recognized.

7. Disclosure is required of the total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position.

8. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, disclosure is required of:

1) The nature of the uncertainty.

2) The nature of the event that could occur in the next 12 months that would cause the change.

3) An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

9. There must be a description of tax years that remain subject to examination by major tax jurisdictions.

10. Some of these disclosures will be useful to taxing authorities (including the IRS) in the course of auditing a company's tax returns. The workpapers used to prepare these disclosures, and any opinions obtained by the company, may also be of interest to the taxing authorities.

11. Post-audit disclosures may also be of interest to taxing authorities. A taxpayer who has not booked the benefits of an uncertain tax position may do so after the issue is "effectively settled." This may occur after an audit even if the uncertain position has not specifically been examined if it is remote that the taxing authority would reopen the audit. Taxpayers may be concerned that taxing authorities will review post-audit disclosures and possibly re-open audits, and they may wait until the statute of limitations expires to book the tax benefits.

B. IRS Policy On Workpapers and FIN 48

1. Prior to 2002, the IRS exercised a "policy of restraint" in requesting tax accrual workpapers.

2. In Announcement 2002-63 (incorporated into Sect. 4.10.20 of the Internal Revenue Manual), the IRS said it would:

1) Request tax accrual workpapers related to a taxpayer's participation in a listed transaction, if the taxpayer engaged in a single listed transaction and properly disclosed its participation.

2) Request all tax accrual workpapers, if the taxpayer has engaged in multiple listed transactions or in a single listed transaction that was not properly disclosed.

3. On May 10, 2007, the IRS LMSB Division issued a memorandum stating that FIN 48 workpapers will be considered to be tax accrual workpapers subject to the IRS policy of restraint.

4. On the other hand, the IRS has directed its examiners to consider the FIN 48 disclosures in quarterly and annual financial statements, and it is conducting training of its examiners to enable them to probe behind the public disclosures.

5. I.R.C. § 7605(b) limits, but does not prohibit, the IRS from reopening an audit.
IRS policy is, in general, not to reopen tax years that have been examined and closed. IRM 1.2.1.4.1, P-4-3 (12/21/1984). However, there are exceptional circumstances in which an audit can be reopened, and the IRS has stated that such circumstances may arise more frequently as a result of FIN 48. LMSB-04-0507-045 (May 1, 2007).

C. The Textron Case

1. Textron participated in nine SILO transactions (i.e., listed transactions) in 2001. The IRS issued summonses for all tax accrual workpapers for 2001 for that year; Textron declined to produce them, and the IRS has moved to enforce the summons. The case is pending.

2. Textron had in-house tax attorneys who analyzed the company's tax positions and who, along with in-house CPAs, used these analyses to prepare tax accrual workpapers. The workpapers included a spreadsheet listing the issues, hazards of litigation percentages, and a tax reserve amount.

3. Textron kept these records, except that it showed them to its auditor, Ernst & Young, even though it required the auditor to keep the records confidential.

4. In its defense, Textron asserts the following privileges: work product; attorney-client and IRC Sect. 7525.

5. Work product privilege: This is probably Textron's best argument. The Adlman and Roxworthy cases establish that the anticipation of litigation requirement can be met even as to analyses done before a tax return is filed.

6. Attorney-client privilege: Textron has a problem asserting this privilege because it showed the analyses to its auditors. That is likely to be considered a waiver. (Note that disclosure to accountants is not necessarily a waiver of the work product privilege because the accountants are not adversaries of the client.)

7. IRC Sect. 7525 privilege: Textron also has a waiver problem in asserting this privilege, which is analogous to the attorney-client privilege. Even though the auditors may be FATPs, their role was to audit the books and not to provide tax advice.

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