

In-House Perspectives on Considerations to Protect Privilege With Respect to Tax-Related Materials

By B. Benjamin Haas

Introduction

There has been quite a buzz surrounding the 3-2 decision of the United States Court of Appeals for the First Circuit in *United States v. Textron*.¹ The majority in *Textron* effectively created a new and troubling standard for protecting documents under the work-product doctrine. Specifically, the majority crafted a new standard of “prepared ‘for use’ in potential litigation” with respect to spreadsheets that detailed Textron’s tax accruals.² The majority determined that Textron’s workpapers were not produced “for use” in litigation because they were “independently required by statutory and audit requirements and that the work-product privilege does not apply.” The decision in *Textron* left many unanswered questions, including (i) whether backup memoranda can be considered work product even if the accompanying spreadsheets are not, and (ii) if the subject documents are shared with an outside auditor, whether work-product protection is waived under a theory that the auditor could be a conduit to a potential adversary (e.g., a taxing authority). *Textron*’s petition for a writ of certiorari was denied by the Supreme Court on May 24, 2010, making actions to protect privileged documents more important.³

As discussed in an article in the January-February 2010 issue of *The Tax Executive*, the *Textron* decision has broad implications in the state tax arena.⁴ For example, states generally request tax accrual workpapers in more circumstances than the Internal Revenue Service does and few state courts have defined “in anticipation of litigation” for state tax purposes; instead, most rely on the standards set by federal law.⁵ Many state departments of revenue (both within and outside the First Circuit) may begin using *Textron*’s “for use” standard. It also is possible that providing workpapers to one state department of revenue could result in the waiver of work product protection in other states, regardless of the other states’ standards for determining when work product protection applies.

Background

In addition to *Textron*-related issues, the Commissioner of Internal Revenue and IRS Chief Counsel have undertaken to modify the general relationship that the IRS has with large taxpayers by increasing the emphasis on tax risk management and transparency.⁶ Since the Supreme Court’s decision in *United States v. Arthur Young & Co.*,⁷ the IRS generally has adhered to a “policy of restraint” with respect to tax accrual workpapers.⁸ In 2002, the IRS revised its policy to permit the IRS to request tax accrual workpapers related to “listed transactions.”⁹ This self-imposed policy was not intended by the IRS as an acknowledgment that tax accrual workpapers are somehow protected under the attorney-client or statutory tax practitioner privilege. In fact, case law has fairly consistently held that tax accrual workpapers, once shared with an outside auditor, lose any potential for attorney-client or tax practitioner privilege.¹⁰

Most recently, the IRS issued Announcement 2010-9,¹¹ which effectively paves the way for the IRS to receive a road map that identifies uncertain tax positions of certain large corporate and partnership taxpayers. Announcement 2010-9 states that the IRS is developing a schedule that will require large business taxpayers to report uncertain tax positions on their tax returns. A draft of the schedule was released on April 19,¹² and while it may be revised, Schedule UTP currently requires (i) a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements and (ii) the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer’s risk analysis regarding its likelihood of prevailing on the merits). In addition to uncertain tax positions required to be reported under FIN 48, the IRS would also require the reporting of any position related to the determination of any federal income tax liability for which the taxpayer or related entity has not recorded a tax reserve because (i) the taxpayer expects to litigate the position or (ii) the taxpayer has determined that the IRS has a general administrative practice not to examine the position.¹³

Announcement 2010-9 does not purport to seek everything that typically is in a taxpayer’s workpapers, including, for example, the odds of success or allocated reserves, which is the information that is the subject of *Textron*. In addition, IRS Chief Counsel William Wilkins has stated that the new reporting obligation “does not directly change the IRS’s policy of restraint with respect to tax accrual workpapers or make an end run around summons enforcement.”¹⁴

Although the final contours of these developments are unclear, they collectively should cause in-house tax professionals to review their processes and procedures with respect to confidential documents. A key component from an in-house tax practitioner’s perspective will be defining the line between collaboration with the IRS and protecting privileged material, as well as ensuring that internal tax risk management policies are adhered to in a consistent and uniform manner.

The following discussion presents an in-house perspective on potential considerations to protect tax documents from discovery by taxing authorities. The issue of privilege protection is particularly relevant with respect to tax-related documents. For example, these documents could provide a roadmap of the technical issues and the taxpayer’s legal analysis of the strengths and weaknesses of such technical issues. In addition, such documents likely reveal the taxpayer’s reserve for each item, as well as facts that the taxing authority may not otherwise discover. Furthermore, these documents may present facts and issues in a less favorable light due to the nature of their preparation.

A well-defined policy that takes into account as many of the following considerations as practicable under the circumstances should place a taxpayer in the best possible position to defend against privilege challenges with respect to its tax accrual workpapers.¹⁷

Practical Measures

A. Determine the Scope of Outside Independent Auditor's Review of Potentially Privileged Documents

1. Generally

It is likely inevitable that a company will share some potentially privileged tax materials with its independent auditor in order for the auditor to attest to its tax reserves. Limiting the scope of the auditor's review, however, could prove invaluable to protecting applicable privileges. Once a document has been shared with the auditor, the attorney-client privilege (as well as the tax practitioner privilege) generally is waived, though the document may continue to qualify for work product protection.¹⁸ After the scope of the outside auditor's review has been defined, the taxpayer should maintain meticulous records of what is shown to the auditor in order to preserve privilege protection for items that were not shared.

From the onset, a non-disclosure letter should be executed as part of the engagement with the auditor. The letter should contain statements similar to the following: (a) the disclosed information is protected by one or more evidentiary privileges, including the work-product doctrine and the attorney-client privilege; (b) the auditor acknowledges the evidentiary privileges and agrees that the disclosure of such information by the company to the auditor does not alter or diminish such privileges; (c) the auditor has statutory and professional confidentiality obligations with respect to the disclosed information and, further, will not disclose or produce such information without the express written consent of the company; and (d) the auditor will immediately notify the company upon receiving a request for disclosure of the information.¹⁹

2. Technical Tax Advice, Other than Tax Opinions

Before giving the auditors the full technical tax analysis for their review, the taxpayer should discuss with them the potential to limit their review to the percentages and reserve amounts with respect to the issue. Given the auditor's responsibility in certifying the financial statements, the auditor likely will consider this insufficient. In such case, the taxpayer should explore with the auditor whether providing an internally prepared summary with the factual background and conclusion with respect to the issue could be acceptable. Any such summary could be combined with a discussion with company personnel knowledgeable about the relevant facts and analysis.²⁰ There is a strong likelihood, however, that such a summary and discussion may be seen as insufficient by the auditor. Considering the likelihood that the auditors will want to review each issue's full technical tax analysis, the taxpayer should be selective in creating technical analyses and seeking written advice from counsel.

The taxpayer should refrain from routinely giving its auditor copies of its own technical tax accrual workpaper materials. Public Company Accounting Oversight Board, Audit Standard No.3, which specifies that auditors should obtain abstracts or copies of inspected significant "contracts or agreements," makes no similar prescription with respect to technical tax analyses or tax accrual

workpapers. In addition, the American Institute of Certified Public Accountants' Auditing Standards Board Interpretive Guidance Section 9326 requires that the audit documentation (a) include sufficient evidential matter about the significant elements of a client's tax exposure analysis that support the client's tax accrual and related disclosures and (b) reflect the procedures the auditor performed and the conclusions reached. AU 9326.13 further provides that the audit documentation can take the form of auditor-prepared summaries. Thus, in general, auditor-prepared memoranda of the inspected documents should be sufficient to support the auditor's opinion, rendering it unnecessary for the auditors to retain copies of client-prepared or client-obtained documents.

3. Tax Opinions

With respect to tax opinions that support the tax accrual of an item, auditors generally adhere to a more stringent policy and request to review all such opinions. AU 9326.22 generally provides that an auditor "should" obtain access to opinions that support the client's tax accruals or matters affecting it, regardless of potential concerns with respect to the attorney-client privilege. AU 9326.22 also provides that the audit documentation "should" include either the actual opinion, or other sufficient documentation supporting the facts and analysis reached in the opinion.²¹

The word "should" is interpreted as "shall" by large outside auditors, and they are reluctant to accept "other sufficient documentation" as an alternative to the actual opinion. Thus, disclosure of what could otherwise be attorney-client privileged information is often necessary. The American Bar Association has requested that federal regulators, along with the accounting and legal professions, make clear "what information auditors need, and more importantly do not need, for the proper conduct of an audit."²² No guidance has been issued yet, effectively yielding an environment where sharing tax opinions is mandated in order for an outside auditor to sign-off on a company's financial statements.

4. Outside Auditor Workpapers

The taxpayer should request that its outside auditor make minimal references to the content of privileged materials in preparing their own audit workpapers and summaries. In addition, the taxpayer should request the opportunity to review the auditors' audit workpapers and summaries to confirm their content.²³ An independent auditor's workpapers generally could be subject of a taxing authority's summons.²⁴

B. Implement Structured Criteria for Documenting Technical Conclusions and Maintaining and Sharing Technical Materials

1. Documentation

In technical memoranda, opinions, and other communications, the taxpayer should make appropriate references to the potential for litigation and the likelihood of success if challenged in court by the IRS or other taxing authority as relevant. For example, the taxpayer should specifically discuss the potential litigation aspects of the issues, as well as the likelihood of success on the merits. As appropriate, clear legends should be included on the face of documents (*e.g.*, "Work-product Privileged and Confidential"; "Attorney-Client Privileged and Confidential"; if prepared by a non-attorney at the request of an attorney, "Prepared at the Request of Counsel"), while being mindful of

the risks of overusing legends; they should be used only when appropriate given the nature and content of the communication.

In addition, the relevance of the drafter, as well as internal and external reviewers, should be considered. For example, the taxpayer should have its inside or outside tax counsel assist in preparing supporting technical narratives about specific issues identified in tax accrual workpapers, if any. The involvement of inside or outside counsel bolsters the position that there is a genuine concern that litigation may ensue, which will support the claim of work-product privilege protection.²⁵

2. Maintaining Documentation

Technical memoranda, opinions, and other communications should be maintained separately from corresponding non-technical documents. This is particularly relevant with respect to non-technical financial reporting documents, including FIN 48 materials. For example, the taxpayer should endeavor to limit its tax accrual workpapers to numerical analyses with minimal supporting narratives. To the extent practicable, the taxpayer should create non-technical summaries of tax accrual related issues to be shared with your external auditors.

In addition, the taxpayer should strictly limit access (both paper and electronic) to intended privileged materials and include only members of the privilege group (*i.e.*, those who “need to know”) in distribution lists or access approvals. In addition, the taxpayer should specifically instruct the knowledge group not to forward relevant documents, and be discriminate in using the “reply to all” function in email correspondence. The privilege group members should be easily identifiable and known. For example, the taxpayer should identify who the privilege group members are directly on paper and electronic file labels and working group lists. Ideally, the taxpayer should maintain separate file systems for technical memoranda and communications and the privileged files should be kept under the dominion and control of the privilege group.

3. Internal Auditor Workpapers

Similar to the recommendation with respect to outside auditors, the taxpayer should request that its internal controller group make minimal references to the content of privileged materials in preparation of its audit workpapers. In addition, the taxpayer should request to review the controller’s audit workpapers to confirm their content.

C. Clearly define the role of your attorneys.

1. Generally

To the extent practicable, the taxpayer should use lawyers to create work-product related materials. Although it is well established that “work product” need not be attorney work product, as long as that it is prepared in anticipation of litigation, it generally is easier to illustrate that a document is protected work product when an attorney, or a person working for the attorney, prepares it.²⁶

The taxpayer should consider giving legal titles to those in the tax organization whose primary role and function is to provide legal advice, as opposed to business, tax return, or financial accounting advice. Providing such titles will bolster the ability to more clearly distinguish a lawyer’s work from tax return preparation or tax audit work, which generally is not considered rendering legal advice.²⁷

2. Requesting Advice and Engaging Counsel

The taxpayer should separate legal advice from non-legal advice (*e.g.*, tax return preparation, financial accounting) by using appropriate terminology in requesting and rendering legal advice (*e.g.*, “I request the opinion of counsel regarding . . .”; or “at the request of counsel”). When rendering or requesting legal advice, the taxpayer should omit people who do not need to see the legal advice. The foregoing points are particularly important because a non-privileged use of a document generally will waive protection for a potential privileged use of the same document.²⁸

Similarly, from an external engagement perspective and internal practice perspective, the taxpayer should separate transactional legal advice from potential controversy legal advice. For example, to the extent practical, the taxpayer should separately engage transactional counsel for transactional matters and litigation counsel with respect to potential controversy matters. This should assist in appropriately defining the issues that may be subject to work-product privilege protection. If engaging separate counsel is not practical, protection may still be available if the document was in fact prepared in anticipation of litigation, as well as for the transactional or business purposes for creating it.²⁹

Litigation counsel should be consulted with respect to the determination whether litigation may be anticipated for a given issue. The taxpayer should place “litigation holds” on all documents (paper and electronic) related to an issue for which work-product privilege protection may be claimed. In order to avoid spoliation issues, the taxpayer should adhere to its internal document retention and destruction policy, if applicable. Generally, such policy should explain the purposes underlying it (*e.g.*, the justification for such destruction) and be followed consistently (*i.e.*, selective application may raise suspicions).

D. Cooperate with the IRS and Other Taxing Authorities by Furnishing All Non-Privileged Information and Documentation in a Timely Manner

Requests for documents generally could come through a routine audit or upon receiving a summons. Regardless of the genesis of the request, all non-privileged materials should be provided in a timely manner. In addition to fostering good will, this tactic could discourage additional requests for potentially privileged documents. Significantly, submitting documents to taxing authorities pursuant to a request should not constitute subject matter waiver. Pursuant to recently revised Federal Rule of Evidence 502, for example, waiver of the attorney-client privilege or work-product privilege with respect to undisclosed information concerning the same subject matter could occur if a party intentionally discloses protected information in a selective, misleading, and unfair manner. This represents a narrowing of the scope of potential subject matter waivers and, as acknowledged by the IRS, should protect undisclosed documents as a result of disclosing requested documents in the context of a tax audit or summons.³⁰

E. Establish Well-Documented Processes and Procedures with Respect to Tax-Related Materials

In addition to working with outside independent auditors to

define the scope of their review of potentially privileged materials, the taxpayer should work with its internal and external tax and litigation counsel to develop documented policies and procedures with respect to tax-related materials. In the event of litigation with respect to privilege, having a formal policy should significantly enhance the chances of being successful because clear distinctions between protected and unprotected documents and consistent practices are vital. ¹³

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1. 577 F.3d 21 (1st Cir. 2009) (*en banc*), cert. denied, 560 U.S. 09-750 (U.S. May 24, 2010).
2. See, generally Jean A. Parlow and Kevin Spencer, "Third Time's Not a Charm: *En Banc* First Circuit Permits IRS to Obtain Roadmap to 'Soft Spots' on Textron's Return," 61 TAX EXECUTIVE 333 (Fall 2009).
3. Technically, the denial of certiorari has no precedential effect, but the Supreme Court's refusal to review the case may embolden the IRS to seek access to workpapers more frequently.
4. See Pilar Mata and Richard C. Call, "Best Practices for Creating, Maintaining, and Protecting State Income Tax Audit Files," 62 TAX EXECUTIVE 25 (January-February 2010).
5. See, e.g., *Commissioner of Revenue v. Comcast Corp.*, 901 N.E.2d 1185 (2009).
6. See, e.g., John Klotsche, Neil Traubenberg, and Tracy Hollingsworth, "Tax Risk Management: Shulman's Conversation with the Board," TAX NOTES TODAY, January 11, 2010. Transparency also has been emphasized by other governmental bodies. For example, in August 2007, the Senate Permanent Subcommittee on Investigations issued questionnaires to several large international corporations seeking background information with respect to their Financial Accounting Standards Board Interpretation No. 48 (FIN 48) reserves.
7. 465 U.S. 805 (1984).
8. IRS Announcement 84-46, 1984-18 I.R.B. 18. Historically, the self-imposed policy of restraint provided that an examiner would only request tax accrual workpapers in "unusual circumstances." IRM 4.10.20.3.1.
9. IRS Announcement 2002-63, 2002-2 C.B. 72. See also IRM 4.10.20.2; IRS A.M. 2007-12; LMSB-04-0507-044.
10. See, e.g., *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982). See also Claudine V. Pease-Wigenter, "The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of *U.S. v. Textron*," 8 Houston Business & Tax Law Journal 388 (2008).
11. 2010-7 I.R.B. 408.
12. Announcement 2010-30, 2010-19 I.R.B. 668.
13. Announcement 2010-9 states that the IRS intends to retain its existing policy of restraint for requesting tax accrual workpapers, but the announcement cautions that the IRS will continue to review the policy and consider additional modifications, as appropriate or necessary, to ensure it obtains on a timely basis complete and accurate information regarding a taxpayer's uncertain tax positions.
14. See Jeremiah Coder, "Wilkins Discusses Need for Uncertain Tax Position Reporting," TAX NOTES TODAY, March 3, 2010.
15. For these purposes, tax documents include tax-related memoranda, opinions, and emails, as well as various tax reporting financial data, which generally are referred to as tax accrual workpapers. The IRS has said that tax accrual workpapers include FIN 48 related materials that are prepared to comply with standards regarding accounting for uncertain tax positions. See A.M. 2007-0012 (March 22, 2007). The IRS also has stated that FIN 48 disclosures "should be considered by examiners and others when conducting risk assessments." See LMSB-04-0507-044 (May 10, 2007) (emphasis added).
16. The examining agent in *Textron* effectively acknowledged the "roadmap" notion in his testimony at the *Textron* evidentiary hearing. See transcript of *Textron* evidentiary hearing, beginning at page 90, C.A. No. 06-198T (June 26, 2007). See also Lee A. Sheppard, "News Analysis: *Textron* Case Expands Work Product Privilege," TAX NOTES TODAY, September 11, 2007.
17. No inference should be drawn that all the recommendations discussed in this article must be implemented in order to successfully defend against privilege challenges.
18. See *United States v. Deloitte & Touche USA, LLP*, 623 F. Supp.2d 39 (D.D.C. 2009); *Regions Financial Corp. v. United States*, 101 AFTR 2d 2008-2179 (N.D. Ala. 2008), appeal dismissed, No. 08-13866 (11th Cir. 2008). See also *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th Cir. 1987), cert. denied, 484 U.S. 917 (1987).
19. These contractual standards are in addition to the confidentiality standards imposed on auditors by professional ethical standards. See, e.g., AICPA Professional Standards, Code of Professional Conduct and By-laws, Section ET 301 (June 1, 2008).
20. A general discussion of the legal authorities and theories on which a client's tax position rests would not necessarily waive the attorney-client privilege. See, e.g., *Brown v. City of Detroit*, 259 F. Supp.2d 611 (E.D. Mich. 2003); *Krenning v. Hunter Health Clinic*, 166 F.R.D. 33 (D. Kan. 1996).
21. AU 9326.22 further provides that the auditor may accept a redacted or modified opinion, as long as that it contains sufficient content to articulate and document the client's position. The auditor also may accept a client's analysis summarizing the outside counsel's opinion, although such analysis must provide enough information for the auditor to formulate its own conclusion. There is a risk that the attorney-client privilege could be waived in any event by providing either a redacted opinion or a summary of the opinion.
22. See *ABA Task Force Report and Recommendation to the ABA House of Delegates on Audit Issues*, Aug. 8, 2006 (the ABA Report). The ABA Report states that, in its view, under most circumstances, it will be possible to produce materials satisfying audit requirements by disclosing the factual and legal bases for the tax position without the need to disclose the opinion of counsel.
23. An auditor may be reluctant to modify its workpapers at a client's request; nevertheless, there is utility in understanding (on a contemporaneous basis) what is contained in such workpapers.

24. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).
25. See, e.g., *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981), *cert. denied*, 454 U.S. 862 (1981); *United States v. Gunter*, 474 F.2d 297 (9th Cir. 1973); *Canaday v. United States*, 354 F.2d 849 (8th Cir. 1954); *In re Grand Jury Investigation (Shroeder)*, 842 F.2d 1223 (11th Cir. 1987).
26. See, e.g., *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981), *cert. denied*, 454 U.S. 862 (1981); *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982).
27. See *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981), *cert. denied*, 454 U.S. 862 (1981); *United States v. Gunter*, 474 F.2d 297 (9th Cir. 1973); *Canaday v. United States*, 354 F.2d 849 (8th Cir. 1954); *In re Grand Jury Investigation (Shroeder)*, 842 F.2d 1223 (11th Cir. 1987). Even if tax return or tax audit work were considered legal advice, it likely would not be deemed to be “confidential.” See, e.g., *Colton v. United States*, 306 F.2d 633 (2d Cir. 1962). Under the statutory tax practitioner privilege, non-lawyer practitioners are not entitled to privilege protection when they are doing other than lawyer’s work. *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).
28. See, e.g., *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).
29. See, e.g., *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006).
30. See, e.g., Office of Chief Counsel Notice 2009-023, CC-2009-023 (August 3, 2009). Some courts have held that subject matter waiver can only occur with respect to the attorney-client privilege and not to work-product protection. See, e.g., *Periman v. United States*, 665 F.2d 1214 (D.C. Cir. 1981); *In re Sealed Case*, 676 F.2d 793 (D.C. Cir. 1982).