ROBERTS & HOLLAND LLP

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Ruling Has Not Resolved Work-Product Privilege Issues

By: Elliot Pisem and David E. Kahen

One issue that arises with some frequency in the context of income tax audits by the Internal Revenue Service is the extent to which material in the files of the taxpayer is protected from disclosure to the Service under the work product privilege. *United States v. Roxworthy*, decided in August 2006 by the United States Court of Appeals for the Sixth Circuit (and discussed below), upheld the applicability of this privilege to protect from disclosure memoranda written by an outside accounting firm concerning the tax consequences of a transaction completed by the taxpayer in the preceding year. However, the recent issuance by the IRS of an Action on Decision setting forth the Service's non-acquiescence in this case indicates that this issue is far from resolved and is likely to continue to arise in controversies with the tax authorities.

United States v. Roxworthy

In *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006), the work product privilege issue addressed by the Court of Appeals arose from an audit of Yum! Brands, Inc. ("Yum") by the IRS for fiscal years 1997, 1998 and 1999.

In responding to a document request from the IRS, Yum produced a "privilege log" listing seven documents that it believed to be protected from disclosure under the work product doctrine. Five of the seven documents were ultimately produced after the parties entered into a limitation of waiver agreement.

The other two documents, consisting of what the decision characterized as memoranda prepared by KPMG that analyzed the tax consequences of a series of transactions relating to the creation of a captive insurance company, subsequent transfer of stock and recognition of a loss, were not produced. The IRS issued an administrative summons to Patrick Roxworthy, the Vice President of Tax at Yum, for those two documents. When those documents were not forthcoming, the IRS filed a petition in the United States District Court for the Western District of Kentucky to enforce its summons.

A magistrate judge concluded that the documents were not created "in anticipation of litigation" (which, as discussed below, is a prerequisite for application of the work product privilege), but rather to assist Yum in the preparation of its tax returns and annual audit, and therefore recommended that the summons be enforced. Notwithstanding affidavits and deposition testimony introduced by Yum to elaborate on the context in which the memoranda were prepared, the district court issued an order adopting the magistrate's report.

After a request for a stay of the order pending appeal was denied by the district court, Roxworthy filed an emergency motion for a stay with the Court of Appeals, which was granted.

Background

The work product doctrine provides, in substance, that material otherwise subject to discovery in litigation need not be disclosed (subject to limited exceptions) if it was prepared in anticipation of litigation by or for a party or that party's representative.

As discussed in the opinion of the Court of Appeals, the work product doctrine was first recognized by the Supreme Court in *Hickman v. Taylor* [1] as necessary to permit an attorney to assemble information and prepare legal theories and analysis for impending litigation without "undue and needless interference" through the discovery process.

The doctrine was later codified in the Federal Rules of Civil Procedure. Under Federal Rule of Civil Procedure 26(b)(3), a party may obtain discovery of documents "prepared in anticipation of litigation or for trial" by or for another party or its representative only upon a showing that the party seeking discovery has substantial need for the document and is unable without hardship to obtain the substantial equivalent of the document by other means.

Although the IRS summons referred to in the case was issued under Internal Revenue Code ("IRC") section 7602 and outside the scope of the Fed-

***Elliot Pisem** and **David E. Kahen** are partners in the law firm of Roberts & Holland LLP.*

eral Rules of Civil Procedure, IRS summons authority is subject to “the traditional privileges and limitations.”[2]

The decision discusses at some length the definition of the phrase “in anticipation of litigation” as used in the Rule. Consistent with other cases cited in the decision, the Court of Appeals commenced its analysis by noting that, to be protected under the work product privilege, the document must have been prepared or obtained *because of* the prospect of litigation. The decision further observes that this standard has two elements: The document must have been created because of a party’s subjective anticipation of litigation; and that anticipation must have been objectively reasonable.

By contrast, material prepared to assist in the preparation of tax returns is not, as a general matter, protected by privilege.[3]

Subjective Anticipation of Litigation

Turning to the facts of the case, the court notes that the two memoranda at issue, which were addressed from KPMG to the in-house corporate counsel of a predecessor of Yum, had a designation of attorney-client privilege but not any work-product designation.

The decision notes and appears to agree with the argument of Yum that the best evidence that the documents were created in anticipation of litigation was the content of the memoranda. Specifically, the decision notes that the memoranda, completed after the transactions addressed therein, included an eleven-page description of the background facts and “dense” legal analysis of current tax law, including arguments and counter-arguments as to areas of the law that the memoranda argued were unsettled.

The memoranda included statements regarding the calculation of bases of shares and the proper recognition of taxable income and capital loss resulting from the transactions. The memoranda further contained statements of legal conclusions such as the following: “[W]e believe that it is likely that a court would agree with,” and “[a]lthough not free from doubt, we believe that [the hypothetical argument] would be rejected by a court.”

The memoranda also included detailed analyses of the strengths and weaknesses of Yum’s positions. The court concluded that the IRS would appear to gain an unfair advantage by gaining access to this analysis, and found that this weighed in favor of characterizing the documents as privileged under the work product doctrine.

The decision then turned to a discussion of the circumstances in which the documents were prepared and the function intended to be served by the documents. The court found that there was ample evidence, in the form of affidavits and otherwise, to support the assertions of Yum that the documents were prepared in anticipation of litigation.

Specifically, it was noted that the treatment of captive insurance companies was unsettled, and the subject of considerable litigation between taxpayers and the Service; that Yum had claimed a loss of $112 million in connection with the transactions; and that the loss was expected to be recognized for tax but not book purposes.

The court found that the taxpayer met its burden of producing substantial evidence, largely in the form of affidavits, of a subjective belief that litigation was likely; and that the affidavits were not contraverted by other evidence in the record.

Yum also established that its tax returns were prepared in-house, that KPMG had never played any role in the preparation of tax returns, and that the memoranda constituted the first time that anyone in the legal department of Yum had sought an opinion from KPMG on a U.S. Federal tax issue. These circumstances tended to support the assertions by Yum that the memoranda were not prepared to assist in the preparation of tax returns.

The timing of the preparation and delivery of the memoranda was also discussed. The magistrate judge had suggested that the fact that the memoranda were completed on the March 15 deadline for filing corporate tax returns indicated a closer connection to the preparation of tax returns than would be the case if the memoranda were prepared, for example, before the transactions were completed. The court declined, however, to view the preparation of the memoranda after the underlying transaction as indicative of preparation other than in anticipation of litigation.

The court also noted that the taxpayer filed for a six-month extension every year and filed its tax returns in September, such that the March 15 deadline was, per the affidavits filed by Yum, “of no significance to Yum.” The decision does not explore the possibility that, in view of the potentially significant impact of the transactions on the estimate of the tax due for the preceding year that would have to be included in the application for extension of time to file Yum’s Federal income tax return, counsel for Yum may have concluded that it was important to obtain the memoranda by March 15 so as to establish that the taxpayer reasonably relied on the advice of its tax advisors in preparing that estimate.

The magistrate judge and district court below apparently concluded that the memoranda were prepared in substantial part to show that there existed “substantial authority” in support of the chosen tax treatment. The existence of substantial authority could, under some circumstances, be a key element of avoiding the 20% penalty that may be imposed under IRC section 6662 with respect to substantial understatements of tax.

The Court of Appeals apparently concurred with the trial court that there was a likelihood that the memoranda were prepared in part to help Yum avoid certain penalties that might be asserted on audit. The Court of Appeals further concluded, however, that this circumstance would *not* cause the documents to lose their work product privilege, unless the documents would have been created in essentially the same form irrespective of the potential for litigation.

Because of Yum’s demonstration of a subjective belief in the likelihood of litigation, the Court of Appeals found it unnecessary to address the question of

when, if ever, the subjective anticipation of a (tax) audit may itself suffice to constitute subjective anticipation of litigation.

Objectively Reasonable Anticipation of Litigation

The court further concluded that the anticipation of litigation by Yum was objectively reasonable. Yum noted, in particular, that: in light of the company's size, an IRS audit for the year was certain to occur; that a transaction giving rise to a book-tax difference of $112 million would clearly be scrutinized in that audit; and that KPMG had advised that the law in this area was unsettled and that the IRS had recently targeted this type of transaction Thus, Yum had, according to the court, identified a specific set of facts likely to lead to litigation, as well as the person likely to assert the claim and the likely nature of the claim; and therefore established an objectively reasonable anticipation of litigation as to the transactions addressed in the memoranda.

The objectively reasonable anticipation of litigation standard seems to have an interesting twist. The more likely the IRS is to object to the position taken by the taxpayer, the clearer it will be that there was an objectively reasonable anticipation of litigation, a key element of the work product privilege as explored in this case. Conversely, where a taxpayer taking a relatively conservative position with respect to the tax consequences of a transaction obtains a memorandum from its tax advisor to address the (perhaps remote) possibility that a worse result may apply, the taxpayer may find it more difficult to persuade a court that it had an objectively reasonable anticipation of litigation and that the memorandum is protected by the work product privilege.

In sum, the Court of Appeals concluded that the district court erred in adopting the magistrate judge's conclusions that Yum had not demonstrated that there was a subjective anticipation of litigation, and that such anticipation was reasonable; reversed the district court's order to compel production; and remanded the case to the district court for entry of an order to grant the motion to quash the summons.

Action on Decision

On October 1, 2007, the IRS issued an Action on Decision (No. 2007-004, IRB No. 2007-40) (the "AOD") stating that, in its view, the Court of Appeals decision in *Roxworthy* was incorrect. In the view of the IRS, there was sufficient evidence in the record to support the government position that the KPMG documents, referred to in the AOD as opinion letters, were obtained in anticipation of an audit. The AOD states that, "[i]f a document is prepared before even an audit [sic] has been initiated, the specter of litigation is, absent objective facts not present in this case, too insubstantial and attenuated to support a conclusion that the possibility of litigation is 'concrete or significant.'"

The AOD does not discuss the nature of the further "objective facts" that might establish the basis, in the view of the IRS, that the possibility of litigation was sufficiently concrete to support the application of the work product privilege.

The AOD concludes with the following statement: "The Service will continue to aggressively seek the enforcement of summonses, challenging unjustified assertions of the work product doctrine (and other privileges) in all appropriate cases, including those that would be appealable to the Sixth Circuit."

Regardless of the merits of the IRS nonacquiescence as set forth in the AOD, it seems virtually certain that there will be further litigation between taxpayers and the government in this area. Indeed, *Roxworthy* itself has since cited by the Government, and discussed with approval by the Court of Federal Claims, in a recent decision largely turning back an attempt by a taxpayer to obtain disclosure of government records in support of the taxpayer's claim for a refund.[4]

It is clear, however, that taxpayers and their advisors must be mindful of the need to act in a manner that preserves the work product privilege to the greatest extent possible in appropriate situations.

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[1] 329 U.S. 495, at 511 (1947).

[2] *United States v. Euge*, 444 U.S. 707, 714 (1980).

[3] *See United States v. Frederick*, 83 AFTR 2d 99-1870 (7th Cir. 1999).

[4] *Deseret Management Corp. v. United States*, 99 AFTR 2d 2007-1891 (Ct. Fed. Cl. 2007).

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