The Pursuit of Transparency Does Not Trump the Work Product Privilege

By Michelle M. Henkel

In the past decade, the role of corporate tax executives has drastically changed, with executives operating in an environment with more burdensome requirements and with greater demands for transparency by the financial statement auditors and the Internal Revenue Service. Today’s environment is largely the result of (i) the tax shelter initiatives by the IRS and other tax authorities after the Enron collapse in 2001, (ii) the enactment of the Sarbanes-Oxley Act in 2002, and (iii) the issuance of FASB’s Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FIN 48) in 2006.

Corporations must grant their auditors complete transparency to avoid a qualified audit opinion. At the same time, this disclosure raises the issue whether the traditional privileges have been waived. For tax executives, the issue at the forefront is the protection of tax accrual and FIN 48 workpapers and other documents that can provide a roadmap to the tax authorities in auditing corporate tax returns. The IRS, for example, is more inclined to summon to taxpayers, and even third parties, to obtain the desired documents. In public forums, the IRS has touted its right to access these documents and has continuously relied on the Supreme Court decision in Arthur Young & Co. v. United States for the proposition that tax accrual workpapers are not privileged. In response, taxpayers have argued that Arthur Young is distinguishable and that the IRS has no bona fide need for these workpapers. There is now case law that should, at a minimum, give the IRS pause in its pursuit of complete transparency. The decisions in United States v. Rossum, United States v. Textron, Inc., and Regions Financial Corp. v. United States give tax executives real hope of preserving privilege. These cases represent an emerging line of authority holding that the work product privilege is alive and well in the tax world and that this privilege can protect critical documents from disclosure to the IRS and other tax authorities.

FIN 48: Mandatory Litigation Risk Assessment

For all business enterprises that are subject to generally accepted accounting principles (GAAP), FIN 48 provides rules for recognizing and measuring all tax positions that were previously taken in a filed tax return or that are expected to be taken in a future tax return. In summary, FIN 48 uses the following two-step analysis for evaluating a tax position:

Step 1 — Recognition. A tax position cannot be recognized in financial statements unless it is more likely than not that the tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In making this evaluation, the enterprise must assume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information.

Step 2 — Measurement. If the recognition threshold is met, the amount of the benefit that will be recognized in the financial statements is the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Of course, an assessment of litigation risk is not a new process for corporate taxpayers. They have always undertaken this type of analysis in establishing tax reserves. FIN 48 has simply mandated the methodology by which tax positions are recognized and measured, and this methodology necessarily encompasses the litigation risk assessment.

Although FIN 48 requires a litigation risk assessment, it does not require any specific documentation with respect to its two-step analysis of tax positions. Nevertheless, corporate taxpayers are routinely preparing FIN 48 workpapers to document their analysis. It is not uncommon for these workpapers to include (i) an inventory of uncertain tax positions, (ii) a litigation risk assessment for each tax position, and (iii) a matrix of the probabilities of succeeding on the merits for each tax position. These workpapers are reviewed by the outside auditor as part of the financial statement review and issuance of the related audit opinion.

IRS’s Policy of Restraint: Is It Reliable?

A. The Current Policy

In March 2007, the IRS’s Office of Chief Counsel announced its position that FIN 48 workpapers are tax accrual workpapers and are subject to the IRS’s current policy for requesting tax-related workpapers. This policy varies by the type of workpapers at issue, and to optimize any privilege against disclosure, it is prudent for taxpayers to segregate these workpapers. In this regard, the IRS has delineated three types of workpapers:

- Audit Workpapers: These workpapers are created by or for the independent auditor and are retained by the auditor. They include information about the procedures followed, the tests performed, the information obtained, and the conclusions regarding the auditor’s review of the financial statements. They may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor.
- Tax Accrual Workpapers: These workpapers are audit workpapers, whether prepared by the taxpayer or an independent accountant, relating to the tax reserve for current, deferred,
and potential or contingent tax liabilities and to the footnotes disclosing those tax liabilities. The total reserve amount is not part of the tax accrual workpapers and, therefore, can be requested as a routine part of the tax audit. On the other hand, the existence or amount of a tax reserve for a specific issue is part of the tax accrual workpapers.

- **Tax Reconciliation Workpapers:** These workpapers are used in assembling and compiling financial data preparatory to placement on a tax return. They typically include final trial balances for each entity and a schedule of consolidating and adjusting entries and information used to trace financial information to the tax return. Any tax return preparation documents that reconcile net income per books or financial statements to taxable income also are tax reconciliation workpapers.

Under the IRS's current policy, tax reconciliation workpapers are the only workpapers that should be requested as a routine part of a tax audit. For both audit and tax accrual workpapers, the IRS has announced a policy of restraint even though the IRS takes the position that *Arthur Young* recognizes the IRS's right to obtain tax accrual workpapers. Under this policy, the IRS should seek audit or tax accrual workpapers only in "unusual circumstances" because the primary source of facts should be the corporation's records. The requisite unusual circumstances exist if (i) a specific factual issue has been identified by the IRS and additional factual information is needed; (ii) the IRS sought this factual data from the taxpayer and third parties; and (iii) the IRS sought a supplementary analysis of facts and performed a reconciliation of the Schedule M-1 or M-3 as it relates to that issue. Even where these circumstances exist, the IRS's request for audit or tax accrual workpapers should be limited to the portion of the workpapers that is "material and relevant" to the tax audit.

Despite the policy of restraint, the IRS has carved out an exception for corporations that have engaged in one or more "listed transactions." If the listed transaction was properly disclosed, the IRS can request the tax accrual workpapers relating only to that transaction for the year under audit, but can request the same workpapers for other years if relevant to the current year's audit. On the other hand, if the listed transaction was not properly disclosed, the IRS can request all tax accrual workpapers for the year under audit and also can request the workpapers for other years if relevant to the current year's audit. The IRS also can request all tax accrual workpapers for the year if either (i) the taxpayer claimed tax benefits from multiple listed transactions even if they were properly disclosed or (ii) the taxpayer had a single listed transaction that was properly disclosed and also had reported financial irregularities.

**B. Growing Concerns**

In the tax community, there is a growing concern about the need to provide the IRS and other tax authorities with tax accrual workpapers, which now include FIN 48 workpapers. These workpapers can highlight "soft spots" in the corporate tax returns and, therefore, can serve as a roadmap to these tax authorities. In addition, corporations are concerned that tax authorities will use the individual reserve amounts in the workpapers as a starting point in settlement negotiations for disputed tax positions. Some of the critical questions faced by today's tax executives are whether the tax accrual workpapers and other documents are protected under a claim of privilege, whether the privilege is waived by disclosure to the outside auditor, and whether the tax authorities have a bona fide need for the documents.

Many hear references to privilege and immediately think of the attorney-client privilege and the federal practitioner privilege under section 7525 and, as a result, dismiss privilege claims because these privileges are waived upon disclosure of the documents to the outside auditors. A separate privilege, however — the work product doctrine or privilege — may operate to provide complete transparency to the outside auditor, while protecting documents from being disclosed to tax authorities.

**C. Precautions for Taxpayers**

Even if a corporation did not engage in a listed transaction, it should consider the significance of the privilege issue because the IRS's policy of restraint may change. Indeed, the IRS has changed its policy before. For years, the IRS used only the "unusual circumstances" standard for requesting tax accrual workpapers, and such requests were rarely made. In 2002, the IRS changed this policy as part of its tax shelter initiative and, since then, there has been an exception for listed transactions.

Since FIN 48 was issued in June 2006, there has been considerable discussion by the IRS about FIN 48 and the resulting workpapers. The IRS has issued a field memorandum about FIN 48 implications, and it is clear that the IRS is reviewing FIN 48 disclosures in SEC filings. Since the documents prepared today will be the subject of the future policy (not the current policy), a "wait-and-see" approach to privilege protection is risky. Moreover, the state tax authorities do not necessarily share this policy of restraint, and states are increasingly sharing information with other states and with the IRS.

**Work Product Privilege**

The work product privilege was first recognized in *Hickman v. Taylor* where the Supreme Court established a zone of privacy for actions taken with an "eye toward litigation." Subsequently, the work product privilege was codified in Fed. R. Civ. Proc. 26(b)(3), which provides that a document is protected from discovery if it was "prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative." A document that meets this standard may still have to be produced if this privilege was waived by disclosure to an "adverse" party. In addition, even where no waiver has occurred, the privilege is not absolute and the document may have to be produced if the requesting party can prove that it has a substantial need for the information.

The Supreme Court has never provided a controlling standard on the meaning of "in anticipation of litigation." The circuit courts of appeals have applied two different standards in determining whether a document was prepared in anticipation of litigation.

Under the majority view, a document is protected work product if it was "prepared or obtained because of the prospect of litigation." This standard has been expressly adopted by all the
courts of appeal except the Fifth, Tenth, and Eleventh Circuits.\textsuperscript{31} This standard is the least restrictive standard because it recognizes that a document can be used for dual purposes without a loss of privilege. In United States\textit{ v. Adlman}, for example, the court held that an Arthur Andersen memorandum analyzing the potential IRS challenges and the related defenses regarding a proposed merger was protected by the work product privilege even though the memorandum assisted the taxpayer in making a business decision about proceeding with the merger.\textsuperscript{32} Thus, in considering the protection of tax accrual workpapers, the majority view recognizes that a document can have a dual purpose and still be protected by the work product privilege.

Under the minority view, a document is protected by the work product privilege only if the "primary motivating purpose" was to aid in possible future litigation.\textsuperscript{33} To date, this view has been adopted only by the Fifth Circuit.\textsuperscript{34} In United States\textit{ v. El Paso Co.}, the court addressed the applicability of privilege to the taxpayer's internal tax pool analysis, which consisted of several pages listing vulnerable tax positions, the dollar amount per item, and a memorandum addressing the assessment of litigation risk.\textsuperscript{35} The primary purpose of the tax pool analysis was financial reporting and not litigation, and therefore the court held that the analysis was not protected by the work product privilege.\textsuperscript{36} Under the primary purpose standard, therefore, work product claims may be more difficult to defend with respect to tax accrual workpapers, but even under this standard, taxpayers should not assume that privilege does not exist.

**Tax Documents: Does Work Product Privilege Apply?**

The work product doctrine applies to an IRS summons.\textsuperscript{37} Nevertheless, the IRS frequently defends its right to such workpapers by citing Arthur Young.\textsuperscript{38} In doing so, however, the IRS often ignores the actual facts and holding of Arthur Young. In this case, the Supreme Court held that there is no "accountant work product privilege" precluding the discovery of tax accrual workpapers.\textsuperscript{39} The workpapers at issue in Arthur Young were prepared by the outside auditor in the course of its own review of the corporation's contingent tax liabilities that were recorded in the financial statements under examination.\textsuperscript{40} In contrast, the workpapers that taxpayers currently seek to protect from disclosure are not the workpapers prepared by the outside auditor. In recent years, courts have addressed the application of the work product doctrine to tax documents. The facts and the courts' analyses provide insight on the steps that can be taken to maximize the protection of tax documents.

**A. United States v. Roxworthy**

In the post-Sarbanes-Oxley environment, Roxworthy was the first case in which a court addressed whether the work product doctrine applied to tax documents.\textsuperscript{41} In Roxworthy, the IRS issued a summons for two memoranda prepared by the taxpayer's tax advisers, KPMG, which analyzed the tax consequences of transactions involving the creation of a captive insurance company and subsequent stock transfers.\textsuperscript{42} The memoranda concluded that it was "more likely than not" that the tax treatment would apply and that this tax treatment was supported by substantial authority.\textsuperscript{43} The memoranda, which had a legend for attorney-client privilege but not work product privilege, were completed after the transactions were consummated and were provided to the taxpayer before the due date of the tax return.\textsuperscript{44} KPMG was not involved in the preparation of any of the taxpayer's returns.\textsuperscript{45} Roxworthy, the taxpayer's vice president of tax, submitted affidavits that the memoranda were created because litigation was anticipated.\textsuperscript{46} The specific reasons cited were the company's reporting a large loss for tax but not book purposes, the likelihood of an IRS audit because of the taxpayer's size, the law's being unsettled, and the IRS's inclination to litigate these types of issues.\textsuperscript{47} The taxpayer withheld the memoranda on a claim of work product privilege.

In Roxworthy, the Sixth Circuit expressly adopted the "because of" standard in applying the work product privilege.\textsuperscript{48} Recognizing that documents prepared in the ordinary course of business are not protected work product, the court stated that "a document will not be protected if it would have been prepared in substantially the same manner irrespective of the anticipated litigation."\textsuperscript{49} Using the "because of" standard, the court then analyzed (i) whether the taxpayer had a subjective belief that litigation was a real possibility, and (ii) whether this belief was objectively reasonable.\textsuperscript{50}

For the first prong of this analysis, the key issue is the "function that the document serves."\textsuperscript{51} The absence of a work product designation did not resolve the issue whether the documents were created in anticipation of litigation.\textsuperscript{52} The court relied on the affidavits, finding that they were not merely conclusory statements but rather clarified the record, which was devoid of any conflicting evidence.\textsuperscript{53} The court also noted that the completion of the memorandum after the transactions "could easily lead to the conclusion that the opinion was more likely to be in anticipation of litigation as opposed to being used for ordinary business purposes."\textsuperscript{54} Even if the documents were prepared in part to assist the taxpayer in avoiding penalties during the audit, the court found that the documents did not lose their privilege unless they would have been created in essentially similar form regardless of any litigation.\textsuperscript{55} A document can be "created for both use in the ordinary course of business and in anticipation of litigation without losing its work product privilege."\textsuperscript{56} Therefore, there was a subjective belief that litigation was a real possibility.

Next, the court analyzed the reasonableness of the taxpayer's belief, more specifically, whether this risk was too speculative to be objectively reasonable.\textsuperscript{57} Based on the facts in the affidavits, the court found there was a reasonable expectation of litigation even though there had been no overt indication from the IRS that it intended to pursue litigation.\textsuperscript{58} Accordingly, the court held that the two KPMG memoranda were protected work product.\textsuperscript{59}

**B. United States v. Textron, Inc.**

Textron\textsuperscript{60} is the first case to address the privileged nature of tax accrual workpapers since the Fifth Circuit's decision in El Paso\textsuperscript{61} in 1982. Textron, like other large corporations, was audited on a routine basis and, in prior eight audit cycles, had been to IRS Appeals seven times with three of the disputes resulting in litigation.\textsuperscript{62} Textron had invested in multiple listed transactions and the IRS requested all of the tax accrual workpapers for 2001.\textsuperscript{63} These work-
papers were all prepared by counsel and included (i) a spreadsheet of issues where the tax laws were unclear and were subject to IRS challenge, (ii) percentage estimates of the chances of prevailing in litigation, (iii) dollar amount of tax reserves, and (iv) backup workpapers with the prior year’s spreadsheet, draft spreadsheets, notes, and a memorandum from in-house tax attorneys with opinions on uncertain items and percentage estimates. These workpapers did not include any facts about the transactions. In addition, they were prepared after the filing of the tax return. The taxpayer shared the workpapers with the outside auditor with the understanding that all information will be confidential.

The issue before the court was whether the workpapers were prepared in the ordinary course of business to satisfy the GAAP requirements or whether they were prepared in anticipation of litigation. In analyzing this issue, the court emphasized that the workpapers:

...would not have been prepared at all “but for” the fact that Textron anticipated the possibility of litigation with the IRS. If Textron had not anticipated a dispute with the IRS, there would have been no reason for it to establish any reserve or to prepare the workpapers used to calculate the reserve. Thus, while it may be accurate to say that... the workpapers were useful in obtaining a “clean” opinion from [Ernst & Young] regarding the adequacy of the reserve amount, there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding.

Based on Textron’s history with IRS audits, the appeals process, and litigated cases, the court found the taxpayer’s belief that litigation was anticipated was well founded, and the tax accrual workpapers were protected work product. Textron is currently on appeal to the First Circuit.

C. Regions Financial Corp. v. United States

Most recently, the Northern District of Alabama issued an opinion in Regions that tax-sensitive documents were protected by the work product privilege regardless of whether the “because of” or “primary motivation” standard was applied. Regions had engaged in listed transactions and, therefore, the IRS requested the tax accrual workpapers and served a summons on Ernst & Young (E&Y), the firm’s outside auditor. On a claim of work product privilege, 20 documents were withheld or redacted. These documents included three prepared by Alston & Bird, the firm’s outside tax counsel, and one prepared by non-audit partners of E&Y. These core documents were all requested because the taxpayer’s general counsel expected an IRS review of a transaction and all of them expressed opinions, evaluated legal theories, and analyzed possible IRS challenges. The other documents discussed these core documents. The documents at issue were disclosed to E&Y, which agreed to keep, and had a duty to keep, the information confidential.

As in Textron, the heart of the dispute was whether the work product privilege applies to tax accrual workpapers. In analyzing this issue, the court noted that the Eleventh Circuit had not yet adopted either the “because of” or “primary motivation” standard and, if forced to decide, it would follow the more protective “because of” standard. Importantly, however, the court found it unnecessary to make this decision because both standards were met in Regions.

Under either test, the critical inquiry is the purpose for creating the documents. As in Textron, the government argued that the documents were created to establish the corporation’s tax reserves and to satisfy its auditor. Regions argued that it would not have needed to establish reserves for contingent liabilities at all unless it thought the IRS would contest the transaction’s tax treatment. The court agreed with Regions. The court noted that, even under the Fifth Circuit’s primary motivation standard, the “litigation need not necessarily be imminent”; rather, the privilege can apply if the document was created “to aid in possible litigation.” Thus, the court rejected the IRS’s view that the taxpayer could not claim privilege if the contested documents had any use other than litigation. Indeed, “[e]ven the strictest application of the ‘primary motivating purpose’ test would still allow a document whose creation was primarily motivated by litigation to be used in some other fashion.”

Because the portions of the documents at issue contained mental impressions and legal theories of its counsel, they were the type of documents that the work product privilege was designed to protect. Ultimately, the court found the documents would not have been created if Regions was not “primarily concerned” with litigation. The documents were protected by the work product privilege.

Waiver: Disclosure to Adversaries

If a document is prepared in anticipation of litigation and qualifies as protected work product, the next inquiry is whether this privilege has been waived. Unlike the attorney-client and the federal tax practitioner privileges, the work product privilege is not automatically waived when the document is shared with a third party. Instead, this privilege is waived “only if the disclosure substantially increases the opportunity for potential adversaries to obtain the information.” The relevant test, therefore, is whether the third party is or should be considered an adversary or, expressed another way, whether the third party shares a common interest with the company.

Outside auditors require complete access to corporate documents for purposes of issuing an unqualified opinion on the financial statements. A critical issue for today’s tax executives is whether the disclosure of the tax accrual workpapers and other documents to the auditors waives any work product privilege. The answer depends on whether the auditing firm shares a common interest with the corporation or should instead be viewed as an adversary. This determination is based on the specific facts of the case.

In non-tax cases, several courts have addressed the precise issue whether disclosure of documents to the outside auditing firm constitutes a waiver of the work product privilege. In Medinol Ltd. v. Boston Scientific Corp., a federal district court in New York held that disclosure of special litigation committee minutes to the outside auditor constituted waiver. In reaching this conclusion, the court relied on the auditing firm’s obligation under the securities laws to express an independent opinion on the accuracy of the financial
statements. Because of this "public watchdog" function, the court found that the auditor did not share a common interest with the company and, therefore, the disclosure resulted in a waiver.

On three other occasions, however, the same District Court has reached a different conclusion. In Merrill Lynch & Co. v. Allegheny Energy, Inc., the court recognized the public watchdog function to ensure accuracy of the financial statements, which is a critical part of the Sarbanes-Oxley Act. The court, however, found that the work product case law requires a "tangible adversarial relationship." The example cited by the court was United States v. Massachusetts Institute of Technology, in which the First Circuit found that the disclosure of documents to the audit agency of the Department of Defense to ensure accuracy of billing statements was a waiver of the work product privilege because that same agency also was charged with litigating disputes over billing. Unlike the audit agency in MIT, the financial statement auditor in Merrill Lynch had no such responsibility for litigating disputes and, therefore, any tension caused by the public watchdog function was not of adversarial relationship contemplated by the work product privilege.

The court found it important that no further disclosure could occur because the auditing firm was under ethical and professional obligations to keep the documents confidential. The defendant was not entitled to a "roadmap" to Merrill Lynch's internal investigations and to counsel's mental impressions and opinions, and there was no waiver by disclosing any of this information to the auditor. At least four other courts have followed this rationale and held that no waiver occurred.

In both the Textron and Regions cases, the court addressed this same issue with respect to tax accrual workpapers. In both cases, the IRS cited the MIT case. In both cases, the court found the case unpersuasive for the same reasons as the court did in Merrill Lynch. Thus, in Textron, E&Y had no obligation to determine the accuracy of Textron's tax liability and it was not a potential adversary or acting on behalf of a potential adversary. Similarly, in Regions, the court found "no conceivable scenario" in which E&Y would file a lawsuit against Regions because of something that it learned from the contested documents. Both courts emphasized E&Y's obligation, by agreement or under the AICPA rules, not to disclose the confidential client information. Both courts held that the disclosure to E&Y did not waive the work product privilege.

Qualified Immunity: Substantial Need

The work product privilege provides a qualified immunity. Thus, even if the work product privilege applies, the IRS cannot obtain the information if the IRS proves (i) it has a "substantial need" for the privileged information in the preparation of the IRS's case and (ii) it is "unable without undue hardship to obtain the substantial equivalent of the materials by other means." Even where this showing has been made, "the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative of a party concerning the litigation."

The court in Textron addressed the question of the IRS's need for the tax accrual workpapers prepared by counsel. The court found that, even though the workpapers would provide insight on the tax liability, (i) such determination must be based on factual information, (ii) none of that information was available in the workpapers, and (iii) all that information was readily available from other documents. Disclosure of counsel's workpapers would have created an unfair advantage for the IRS, and the court found that the IRS did not have a substantial need for the workpapers.

In Regions, the court did not rule on this issue but did point out that the IRS never enunciated why it "needed" the contested documents to determine the tax liability of Regions when it already had possession of the original factual documents regarding the transaction. The holding in Textron and the comments by the court in Regions are consistent with the IRS's own policy that tax accrual workpapers should be sought only in "unusual circumstances" because the primary source of facts should be the corporation's records.

Best Practices & Procedures

Recent case law indicates that the work product privilege can protect documents from disclosure to the tax authorities. Because a corporate tax return may not be audited until several years after it was filed, it may be years before a taxpayer knows whether there is even a need to claim work product privilege. Any such claim will be based on all the facts and circumstances at the time of the request for transparency is made. Taxpayers cannot wait, however, until the need arises before it preserves its right to claim work product privilege. As a result, there is an increasing need for documentation guidelines to maximize a corporation's ability to claim privilege if the need ever arises.

The difficulty for taxpayers is weighing the likelihood of claiming work product privilege versus the burden of implementing guidelines to maximize the chances of succeeding on this claim. With the myriad requirements imposed on today's tax executives, it is impracticable from an internal resource perspective to apply these guidelines to every tax position. An alternative course of action is to identify the uncertain tax positions where the consequences of disclosure may be most sensitive and the likelihood of litigation is greatest. For example, this could include listed transactions, high dollar issues, recurring issues, or industry issues. For these issues, best practices and procedures can be implemented to focus on the preparation, control, and disclosure of tax accrual workpapers and other tax-sensitive documents.

A. Preparation of Documents

It is a matter of business judgment about what documents need to be prepared and, even more importantly, when they should be prepared. For example, a tax opinion may be prepared after the transaction closes or the return is filed. In addition, the litigation risk assessment for uncertain tax positions should be prepared on a recurring basis, as is usually done for general litigation reserves. Management should always be apprised of litigation risks and, therefore, the recurring review of uncertain tax positions "de-links" the timing of preparing the litigation risk assessment workpapers from the annual financial statement review by the outside auditor.

It is also important to consider how a document should be prepared. As stated by the Sixth Circuit in Rozwodzki, "a document will not be protected if it would have been prepared in substan-
tially the same manner irrespective of the anticipated litigation.18 The courts in Textron and Regions effectively agreed when they emphasized that the tax accrual workpapers would not have been prepared "but for" the prospect of litigation.19 As a result, standard forms should not be used to document every tax position. Only documents that are prepared because of a litigation risk, including the litigation risk assessment under FIN 48, should be marked with a legend that they are "subject to the work product privilege."

In addition, although work product privilege can apply to documents prepared by someone other than counsel, Textron and Regions suggest that the chances of succeeding on a work privilege claim will be increased with outside counsel involved. In fact, the use of outside "litigation" counsel provides the greatest protection especially when evaluating the chances of succeeding on the merits in a dispute with the IRS. Other possibilities can include the use of in-house counsel, including someone in the corporation’s legal department who is routinely involved in general litigation reserves, or the use of Kovel arrangements where the individual preparing the document is working under the supervision of counsel.

B. Control of Documents
To the extent possible, privileged and non-privileged documents should be segregated. For example, tax opinions should be segregated and, if possible, maintained by in-house tax counsel. Similarly, FIN 48 litigation risk assessments should be maintained in a separate file labeled “tax litigation workpapers,” and these workpapers should include all potentially privileged information regarding the tax reserves on an individual issue basis. Tax reconciliation, tax provision, or other compliance type workpapers should be separately maintained so that, if requested by a tax authority, they can be produced without the risk of waiver.

If a taxpayer has tax accrual workpapers, litigation risk assessments, or other documents that it may want to protect from discovery under a claim of work product privilege, the taxpayer may have a duty to preserve all related evidence to avoid any potential claims of spoliation by the tax authorities. The law varies from circuit to circuit but a claim of spoliation may require some showing that the evidence was lost owing to a culpable breach of the duty to preserve the evidence.20 As a precaution, taxpayers should make efforts to maintain the tax-sensitive documents and related evidence.

C. Disclosure of Documents
Importantly, taxpayers should avoid widespread distribution of privileged work product. Waiver of the work product privilege will occur if the documents are disclosed to an adverse party. There is an emerging line of authority, however, that disclosure to outside auditors is not a waiver. That said, a list of disclosed documents should be maintained so that there is detailed record of what is discussed, shown, or provided to the auditor without tainting or otherwise altering the substance of the protected workpapers.

Conclusion
Although the question is far from certain, there is an emerging line of authority that supports the proposition that tax accrual workpapers and other tax-sensitive documents can be subject to a bona claim of work product privilege. Taxpayers have been assessing the hazards of litigation for years and these assessments would not be done “but for” the risk of litigation. FIN 48 does not change the nature of these analyses. Under the majority view, a document can have a dual purpose of facilitating the issuance of accurate financial statements and still be protected work product. The work product privilege is alive and well in the tax world, and precautions should be taken to protect tax-sensitive documents.6

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2. United States v. Rexworthy, 457 F.3d 590 (6th Cir. 2006).
5. FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, at ¶¶ 3-4 (Financial Accounting Standards Board 2006). FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure. Id. at ¶¶ 10-21.
6. Id. at ¶¶ 5-7.
7. Id.
8. Id. at ¶ 8.
11. Id.
12. Id.
17. Id.
18. Id.
20. I.R.M. 4.10.20.3.1(1) (Jul. 12, 2004); I.R.M. 4.10.20.3.2 (Jul. 12, 2004).
22. I.R.M. 4.10.20.3.1(2) (Jul. 12, 2004).
25. I.R.M. 4.10.20.3.2.3(1) (Jan. 15, 2005) (effective for returns filed on or after July 1, 2002).
26. I.R.M. 4.10.20.3.2.3(2) (Jan. 15, 2005) (effective for returns filed on or after July 1, 2002).
27. I.R.M. 4.10.20.3.2.3(3) (Jan. 15, 2005) (effective for returns filed on or after July 1, 2002).
31. See, e.g., Adlman, 134 F.3d at 1202; Roxworthy, 457 F.3d at 593; In re Grand Jury Subpoena, 357 F.3d 900, 907 (9th Cir. 2003), Maine v. Department of the Interior, 299 F.3d 60, 68 (1st Cir. 2002); National Union Fire Insurance Co. of Pittsburgh v. Murray Sheet Metal Co., 967 F.2d 980, 984 (4th Cir. 1992); Simon v. G.D. Searle & Co., 816 F.2d 397, 401 (8th Cir. 1987); Senate of Puerto Rico v. United States, 823 F.2d 574, 587 (D.C. Cir. 1987); Binks Manufacturing Co. v. National Presto Industries, 709 F.2d 1109, 1119 (7th Cir. 1983); In re Grand Jury Proceedings, 604 F.2d 798, 803 (3d Cir. 1979).
32. Adlman, 134 F.3d at 1195.
33. See United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982) (quoting United States v. Davis, 636 F.2d 1028, 1040 (5th Cir. 1981)).
34. El Paso, 682 F.2d 530.
35. Id. at 535-36, 543.
36. Id. at 543-44.
39. Id. at 815-19.
40. Id. at 812-13.
41. Roxworthy, 457 F.3d 590 (6th Cir. 2006).
42. Id. at 592, 594-95.
43. Id. at 594-95.
44. Id. at 594, 596.
45. Id. at 596.
46. Id. at 592.
47. Id. In reversing a trial court decision in the government’s favor, the Sixth Circuit relied on the affidavits that were submitted to expand the record after the judge’s findings. Id. at 592, 596-97. The Sixth Circuit noted that an affidavit could be used to offer proof but that the application of the privilege would be rejected “where the ‘only basis’ for the claim is an affidavit containing ‘conclusory statement[s].’” Id. at 597 (citations omitted).
48. Id. at 593.
49. Id. at 593-94.
50. Id. at 594.
51. Id. at 595.
52. Id. at 597.
53. Id.
54. Id.
55. Id. at 598-99.
56. Id. at 599.
57. Id. at 600.
58. Id.
59. Id. at 591, 600-01.
61. El Paso, 682 F.2d 530.
63. Id. at 142.
64. Id. at 142-43.
65. Id. at 143.
66. Id.
67. Id.
68. Id. at 150.
69. Id.
70. Id. In addition, the court found the workpapers to be protected by the attorney-client privilege and the section 7525 federal practitioner privilege. Id. at 146-48.
72. Id. at ¶ 1.
73. Id. at ¶ 1.
74. Id. at ¶ 1.
75. Id. at ¶ 1.
76. Id. at ¶ 1.
77. Id. at ¶ 1.
78. Id. at ¶ 2.
79. Id. at ¶ 3, 5.
80. Id. at ¶ 5.
81. Id.
82. Id.
83. Id.
84. Id. at ¶ 6.
85. Id.
86. Id. at ¶ 6-7.
87. Id. at ¶ 6 n.11.
88. Id. at 7.
89. Id. at ¶ 6-7.
90. Id.
92. Id. at 446.
93. Id.
95. Id. at 115-16.
96. Id. at 116-17.
99. Id.
100. United States v. Massachusetts Institute of Technology, 129 F.3d 681, 687 (1st Cir. 1997).
101. Merrill Lynch (citing MIT, 129 F.3d at 687).
103. Id.
104. Id. at 449.
111. Textron, 507 F. Supp. 2d at 152-54; Regions, 2008 WL 2139008, at *8.
113. Id.
114. Textron, 507 F. Supp. 2d at 155. Satisfaction of the relevance standard for purposes of issuing a summons under I.R.C. § 7602 does not mean that the substantial need standard under Fed. R. Civ. Proc. 26(b)(3) also has been met, especially where the mental impressions, conclusions, opinions, or legal theories of counsel are at issue. Id. at 154.
118. Roxworthy, 457 F.3d at 593-94.
120. See, e.g., Columbia First Bank, FSB v. United States, 54 Fed. Cl. 693, 702 (2002); Residential Funding Corp. v. Degorce Financial Corp., 306 F.3d 99, 107 (2d Cir. 2002).