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The Uncertain World of Uncertain Tax Position Disclosures and Privilege

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While death and taxes may be the only certainties in life, corporations have found that tax positions have become less certain as the complexity of business and tax rules increases.

Items such as the arm's-length pricing for international transfers of technology to affiliates and the creditability of research and development expenses are tax positions involving significant judgment calls that often result in disputes with the Internal Revenue Service and cause companies to record loss contingency reserves in their financial statements.

Beginning with their 2010 tax returns, generally filed in late 2011, corporations with more than $100 million in assets were required to file IRS's new schedule describing and ranking the corporation's uncertain tax positions (Schedule UTP).[1] Beginning with 2012 tax returns, that requirement will extend to corporations with more than $50 million in assets and, with 2014 tax returns, to those with more than $10 million in assets.

Schedule UTP disclosure brings into focus the challenges of preserving the confidentiality of documents, particularly tax accrual work papers, relating to uncertain tax positions disclosed on that schedule because of the potential for subject matter waiver of relevant privileges.

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This article discusses privileges potentially applicable to tax accrual work papers (including opinions obtained to support the tax treatment) and disclosures that could affect those privileges. It concludes with recommendations to best position a taxpayer to preserve privilege and prevent inadvertent disclosures.

Definition of Tax Accrual Work Papers

There is no universally accepted definition of tax accrual work papers. The Internal Revenue Manual defines the term to mean:

> [T]hose audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent audi-

[1] Announcement 2010-75, 2010-41 I.R.B. 428 (Sept. 24, 2010). For corporations whose tax reporting is done on a fiscal year, this obligation first applied for its fiscal year that began in calendar year 2010.

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tor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. These workpapers reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis.[2]

Based on the usage in the case law, the term also encompasses opinion letters prepared by outside counsel if those opinions are relied on in the analysis of whether a tax position is uncertain.

History of IRS's Policy on Requesting Tax Accrual Work Papers

Under a policy adopted in 1981, IRS will not request a taxpayer's tax accrual work papers except in ''unusual circumstances.'' An unusual circumstance exists where:

- a specific issue (or issues) has been identified for which the agent needs additional facts,
- the agent ''has sought from the taxpayer all facts known to the taxpayer relating to the identified issue(s),'' and
- the agent ''has sought from the taxpayer's accountant supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue(s).''[3]

In 2002, as part of its effort to combat tax shelters, IRS expanded the situations under which it would request work papers to include those where the taxpayer engaged in a transaction determined to be an abusive tax avoidance transaction.

In 2002, as part of its effort to combat tax shelters, IRS expanded the situations under which it would request those work papers to include those where the taxpayer engaged in a transaction determined by IRS to be an abusive tax avoidance transaction (a ''Listed Transaction'').[4]

If the taxpayer disclosed its participation in that transaction and claimed the benefits of only one such transaction, IRS would seek only the tax accrual work papers relating to that transaction. If the taxpayer did not disclose the transaction or claimed the benefits from more than one such transaction, IRS would request all of the taxpayer's tax accrual work papers.

Unrelated to IRS policy developments, the Financial Accounting Standards Board (FASB) recognized an issue in the varying interpretations being applied to contingent tax liabilities by different auditors. The FASB issue arose in part because those liabilities were covered under both under FAS 5 (regarding contingent liabilities in general) and FAS 109 (specific to income taxes).

To address this concern, FASB implemented FASB Interpretation No. 48 (FIN 48) effective for years beginning after Dec. 31, 2006, to clarify the treatment of contingent tax liabilities under FAS 109. Because FIN 48 specifically addresses uncertain tax positions, it eliminates the confusion that previously arose from those positions being subject to both FAS 5 and FAS 109.

Under FIN 48, companies must assume each tax position will be audited and create reserves for tax benefits stemming from ''uncertain tax'' positions. An uncertain tax position under FIN 48 is one where the company's position does not meet the ''more likely than not'' standard (MLTN).[5]

The sensitivity of a company's tax accrual work papers is heightened following the implementation of FIN 48 because the company must assume each transaction will be audited and must provide a more precise analysis of the likelihood that its treatment will be sustained on audit.

The work papers should also indicate the positions for which no reserve is being made because the company expects to litigate and prevail. Furthermore, for those items that the company expects to settle with IRS, the tax accrual work papers typically reflect the amount for which the company believes it is MLTN it could settle the issue.[6]

Although auditors are supposed to conduct their own analyses of uncertain tax positions, they routinely ask the company for copies of its analysis and support of those positions, including memos or opinions that may have been intended to be privileged. As discussed in more detail below, these disclosures to auditors have significant implications for the privilege claims that can be asserted over these work papers.

Schedule UTP

A taxpayer must disclose two types of items on Schedule UTP, broadly speaking—items for which a re-

[2] I.R.M. 4.10.20.2(2).

[3] I.R.M. 4024.4, MT 4000-235 (May 14, 1981) (Guidelines for Requesting Audit of Tax Accrual Workpapers).

[4] Announcement 2002-63, 2002-2 C.B. 72. For a definition of Listed Transactions, see Treas. Reg. Section 1.6011-4(b)(2). For the current list of Listed Transactions, see http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html.

[5] The MLTN standard means there is a greater than 50 percent likelihood that the taxpayer's treatment of the item will be upheld.

[6] See FIN 48, ¶¶ A21-A24.

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serve was recorded and items for which no reserve was recorded because the taxpayer expects to litigate and it is MLTN that it will prevail.[7] Taxpayers need not disclose positions on Schedule UTP that are immaterial or ''highly certain'' under FIN 48 (i.e., based on ''clear and unambiguous tax law'').[8]

For each item disclosed on the schedule, the taxpayer must provide a ''concise description,'' rank the item in descending order based on the size of the reserve established for the item, identify the associated sections of the Internal Revenue Code (Code), and note any positions that constitute more than 10 percent of the total reserves for positions disclosed on the schedule.[9]

It is clear from IRS public statements that the decision to implement Schedule UTP is part of the agency's efforts to do ''more with less'' in enforcing the tax laws, given greater demands on stagnant IRS enforcement budgets and the increasing complexity of tax issues.

Equally clear is the use of Schedule UTP to help quell criticism of lax IRS enforcement results in light of the record profits being reported by large corporations that pay little corporate income tax. Of course, corporations are already subject to an overabundance of disclosure regimes, and the profit-versus-tax disparity is a function of longtime differences in financial accounting versus tax law. Nonetheless, Schedule UTP allows IRS to piggyback off of financial accounting analysis taxpayers were already performing after passage of the Sarbanes-Oxley Act (Pub. L. No. 107-204).

When IRS first released a draft of the proposed Schedule UTP, practitioners raised concerns about the potential impact on privilege claims of compliance with the form. One concern was that the proposed form's requirement of disclosing the nature of the uncertain issue might result in waiver of the attorney-client or attorney work product privilege.

Although IRS addressed some of the concerns regarding the impact of Schedule UTP on privileges, it did not eliminate them. First, in its policy IRS does not state that it will not argue that disclosures on Schedule UTP itself waive privilege.

In an effort to address this concern, IRS eliminated the requirement that taxpayers disclose the rationale and nature of the uncertainty.[10] It further clarified that taxpayers should not include information relating to the taxpayer's analysis of the litigation hazards or analysis supporting or contradicting its treatment.

IRS separately expanded its policy of restraint regarding tax accrual work papers. Under that revised policy of restraint, IRS will not argue that the disclosure of an otherwise privileged document to an independent auditor pursuant to an audit of its financial statements will constitute a waiver unless:

- the taxpayer has engaged in any other activity that would waive the privilege, or
- a request for tax accrual work papers is being made under its existing policies (i.e., under ''unusual circumstances'' or if the taxpayer claimed the benefits of a Listed Transaction).[11]

Although IRS addressed some of the concerns regarding the impact of Schedule UTP on privileges, it did not eliminate them. First, in its policy IRS does not state that it will not argue that disclosures on Schedule UTP itself waive privilege. Rather, IRS simply reduced the information taxpayers are required to disclose on Schedule UTP, making the waiver argument more difficult.

Second, the definition of ''unusual circumstances'' is exceedingly vague. Accordingly, even for taxpayers that do not claim the benefits of any Listed Transactions, there can be no certainty that IRS will not seek tax accrual work papers. Third, these policies are not legally binding on IRS and can be modified or withdrawn at any time.

Finally, it should be noted that these policies of restraint are those of IRS alone. Therefore, if litigating a federal tax dispute outside of the Tax Court or against Justice Department attorneys (typical in the federal district courts and the Court of Federal Claims), there is no guarantee these policies will be followed.

Because of these and other concerns, taxpayers must carefully consider how to disclose uncertain tax positions for which a reserve is accrued (or where none is accrued because of the taxpayer's expectation to litigate and prevail).

Three Potential Privileges Covering Tax Accrual Work Papers

The three privileges potentially applicable to tax accrual work papers are:

- the attorney-client privilege,
- the Code Section 7525 federally authorized tax practitioner privilege (FATP), and
- the work product privilege.

Readers are likely familiar with the attorney-client privilege.[12] The FATP privilege is a provision in the Code created to give communications made to certain non-attorney tax practitioners protection similar to the attorney-client privilege.[13] Among the restrictions on the FATP privilege that limit its application vis-a-vis the attorney-client privilege are that it applies only applies to tax disputes, to civil matters, and it does not apply to the promotion of tax shelters.

[7] See Instructions for Schedule UTP.

[8] Announcement 2010-75, 2010-41 I.R.B. 428 (Sept. 24, 2010); FIN 48 ¶¶ A19-A20.

[9] See Instructions for Schedule UTP. To its credit, IRS requested and considered comments from taxpayers regarding the information to be reported on Schedule UTP. While not adopting many of these comments, IRS did in response withdraw its original proposed requirement that taxpayers disclose the amount reserved for positions listed on Schedule UTP.

[10] Announcement 2010-75, 2010-41 I.R.B. 428 (Sept. 24, 2010).

[11] Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010).

[12] The attorney-client privilege is a common law privilege applicable under Fed. R. Evid. 501.

[13] I.R.C. Section 7525.

A critical aspect of both the attorney-client privilege and the FATP privilege is the so-called ''subject matter waiver'' doctrine: A disclosure of privileged materials to a non-client waives the privilege not only to the disclosed communication, but also to any other privileged communications encompassing the same subject matter.

The work product privilege applies to materials prepared ''in anticipation of litigation.''[14] Unlike the attorney-client privilege, work product protection is not absolute but rather allows for a court to order disclosure of otherwise protected materials if the requesting party can show substantial need.

Although work product protection is not limited to materials created by attorneys, the involvement of an attorney increases the likelihood that a court will find that litigation was anticipated. Furthermore, work product created by attorneys is generally subject to enhanced protection (i.e., a greater showing of need must be demonstrated before disclosure will be required).

By contrast to the attorney-client and FATP privileges, there is not a broad subject matter waiver doctrine for work product. Thus, for example, it is possible to ''selectively disclose'' a document that is work product without being forced to disclose all other work product relating to the same subject matter. Finally, and especially relevant for tax accrual work papers, the work product privilege is not waived if materials are disclosed in a manner not likely to lead to discovery by the privilege holder's adversary.

Courts Apply Varying Standards To Privilege Analysis

An in-depth analysis of the case law applying these privileges to situations where IRS has sought to obtain copies of tax accrual work papers is beyond the scope of this article. That said, there has been considerable litigation over these issues recently, and important differences in legal standards have arisen in the courts of appeal.

Two points should be highlighted from this state of affairs: Courts have been inconsistent in their application of these privileges to tax accrual work papers and, given the practical pressures to disclose tax accrual work papers in many cases, a taxpayer may need to rely more often on the work product privilege.

The work product privilege may provide greater protection than the attorney-client or FATP privilege due to the greater potential of subject matter waiver of those latter privileges.

Until recently, most federal courts of appeal had adopted one of two tests for determining whether documents, including tax accrual work papers, were prepared in anticipation of litigation:

- the ''because of test,'' which asks whether the work papers were created ''because of'' litigation; or
- the ''primary purpose'' test, a more stringent standard that asks whether they were created primarily to assist in litigation.

The U.S. Court of Appeals for the D.C. Circuit's opinion in *United States v. Deloitte LLP*[15] illustrates application of the ''because of'' test. The work papers at issue in that case consisted of documents prepared by Dow Chemical Co.'s auditors based on conversations they had with Dow's attorneys. In holding that these documents were covered by the work product privilege, the D.C. Circuit focused on the content of the documents. In doing so, it rejected the government's argument that the fact that the documents were prepared by auditors precluded them from being work product.

In a recent case, however, the First Circuit Court of Appeals (which covers taxpayers resident in several Northeastern states, including Massachusetts) adopted yet a third—and troublesome—test. In *United States v. Textron Inc.*,[16] the taxpayer had entered into multiple Listed Transactions. Consistent with its policy, IRS issued a summons requesting copies of all of the taxpayer's tax accrual work papers.

The trial court in that case found that the attorney-client privilege and FATP privilege had been waived based on disclosures to the auditors. *United States v. Textron Inc.*[17] Nonetheless, the trial judge held the tax accrual work papers were protected work product because the disclosure to the auditors did not waive that protection.

On appeal, the First Circuit addressed only the work product privilege. In applying that privilege, the First Circuit described the documents' purpose as ''to make book entries, prepare financial statements and obtain a clean audit.'' It added that ''[a]ny experienced litigator would describe the tax accrual work papers as tax documents and not as case preparation materials.'' Applying a test that focused on whether the documents were created for ''use'' in litigation (rather than merely in anticipation of that litigation), the First Circuit found they were not protectable work product.

Several other cases highlight the risks of disclosure. For example, in *Long-Term Capital Holdings v. United States*,[18] the court held that the company's disclosure to its auditors that it received a ''more likely than not'' opinion regarding a transaction constituted a waiver of that opinion and its subject matter because it disclosed the ''gist'' of the opinion. To clarify, the taxpayer did not disclose the opinion to its auditors; it disclosed only that it had received an opinion from counsel that reached a MLTN conclusion.

Furthermore, in *Salem Financial Inc. v. United States*,[19] the taxpayer was found to have waived work product protection on its tax accrual work papers because it used its auditor's analysis as a basis for penalty defense and allowed the auditor's employees to testify as to the reasonableness of its reserves. Unsurprisingly, the court found this affirmative use of the auditor's

[14] See Fed. R. Civ. P. Rule 26(b)(3).

[15] 610 F.3d 129 (D.C. Cir. 2010).

[16] 577 F.3d 21 (1st Cir. 2009).

[17] 507 F. Supp. 2d 138 (D. R.I. 2007), *rev'd on other grounds*, 577 F.3d 21 (1st Cir. 2009).

[18] 90 AFTR 2d 2002-7446 (D. Conn. 2002), *rev'd on other grounds*, 2003-1 USTC ¶ 50105 (D. Conn. 2003)).

[19] 109 AFTR 2d 2012-604 (Ct. Fed. Cl. 2012).

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work was inconsistent with keeping it from its adversary. Notably, however, because the taxpayer never disclosed the actual work papers, the court appears to have applied a form of subject matter waiver to materials protected as work product.

Maximizing Chances of Protecting Privilege In Light of Schedule UTP

As highlighted by just the few cases discussed above, the government's desire to identify and understand corporations' uncertain tax positions raises privilege concerns because of the potential disclosure of supporting and related materials. Although a primary disclosure concern before the advent of Schedule UTP was to a company's auditors, the requirement to file Schedule UTP introduces a new element into the mix.

Given these disclosure concerns, the work product privilege may provide greater protection than the attorney-client or FATP privilege due to the greater potential of subject matter waiver of those latter privileges. Because broad subject matter waiver rarely applies to work product, the filing of a carefully prepared Schedule UTP should not constitute waiver of that privilege (even though the disclosure is to the company's potential adversary in a tax dispute) because it is not the work product itself being disclosed but rather the limited information required to be included on Schedule UTP.

But there is no certainty as to how courts will apply the law in this context. While not clear, as noted above, the Court of Federal Claims may have applied subject matter waiver to work product in *Salem Financial Inc. v. United States*.[20] And in some cases, a taxpayer may want to take the position that certain portions of its tax accrual work papers are protected by the attorney-client and/or FATP privilege, particularly where establishing ''anticipation of litigation'' is difficult.

Therefore, it is important to draft the descriptions of issues provided on Schedule UTP with great care. Accordingly, the process of completing Schedule UTP should include the input of someone well versed in privilege issues.

The key challenge in relying on work product protection is an evidentiary one—establishing that the materials relating to uncertain tax positions were prepared in anticipation of litigation. This requires differentiating sensitive uncertain tax positions where there is an actual prospect of litigation from other tax positions. The task is complicated by the fact that typically much of the analysis is prepared by accountants, and some courts may view such analysis as inherently created for tax preparation purposes, rather than for litigation purposes.

This distinction can be strengthened by using different processes for handling documentation of uncertain tax positions versus that of more routine tax positions. Uncertain tax positions should be treated like other potential litigation matters. Depending on how the company's tax department is organized and staffed, a company may want to involve its legal department in the review and analysis of uncertain tax positions.

There may also be a benefit to engaging outside counsel to advise on high exposure tax issues and for that outside counsel to engage any economists, accountants, or other experts as are necessary to assist in providing the legal advice.[21]

The internal dissemination of information relating to these uncertain tax positions should be more restricted than it is for other tax matters and should follow the company's policy for other potential litigation matters. This may include segregating electronic files into secured databases and work spaces and keeping hard copies in separate files or even in physically secured locations (e.g., locked offices, desks, or filing cabinets).

The requirement to disclose uncertain tax positions on Schedule UTP if no reserve is created because a taxpayer expects to litigate and prevail creates another potential trap for the unwary. Because of this requirement, it may be difficult to establish that anticipation was expected for positions not disclosed on Schedule UTP. If the taxpayer expected to litigate and prevail at the time it filed the Schedule UTP, it should have disclosed the position.[22]If the taxpayer expected to litigate but had a less than MLTN expectation of prevailing, it should have disclosed the position because a reserve should have been created.

Given this concern, a company's lawyers and tax executives should coordinate their handling of uncertain tax positions to ensure that any such positions for which work product protection may be relied upon are disclosed on Schedule UTP.

In an unpublished district court opinion, *Regions Financial Corp. v. United States*,[23] the court's holding that the tax accrual work papers at issue were subject to work product protection considered the fact that the disclosure of those materials to the taxpayer's auditor was made under a nondisclosure agreement (NDA). This supported the court's conclusion that the disclosure to the auditors was not made in a way likely to lead to discovery of the information by IRS.

Although auditors are unlikely to agree to a broad NDA post-Sarbanes Oxley, it is worth exploring whether a limited NDA could be made to protect a limited set of materials (i.e., those marked as work product) from being disclosed in a manner that could lead to their discovery by the company's potential adversaries. This NDA need not and should not be limited to uncertain tax positions but should cover any materials relating to contingent liabilities arising from any potential litigation.

Finally, companies should not rely on sensitive materials as a basis for any penalty defense in a tax dispute. As the taxpayer in *Salem Financial* discovered, courts are loath to extend any protection to materials asserted as a basis for penalty defense on the principle that privilege should not function as both a ''sword and a shield.''

While it may be tempting to rely on the same opinion for both FIN 48 and penalty defense purposes, doing so

[20] Id.

[21] The importance of these procedures varies depending on the size and composition of the tax department. For example, if it is a large tax department that has attorneys acting in legal capacities, the involvement of the legal department is less important. If the tax department lacks such personnel, the use of the company's legal department and/or outside counsel becomes more critical.

[22] It would difficult to defend a position that no disclosure was made on Schedule UTP because the position was ''highly certain'' under FIN 48 (i.e., based on ''clear and unambiguous tax law'') and that litigation was anticipated.

[23] Case No. 2:06-CV-00895-RDP (N.D. Ala. 2008).

will almost certainly result in the waiver of any privilege intended to protect the confidentiality of that opinion. In addition, an auditor's conclusions regarding the proper FIN 48 reporting of a position should not be used as a penalty defense under any circumstances, as doing so may cause waiver of any privilege covering all tax accrual work papers regarding that position. Financial statement accounting and penalty defense are two distinct concerns—use of the same analysis for both purposes should generally be expected to result in full disclosure of that analysis.