

Tax Litigation Issues

Expert Analysis

Protecting Privileged Documents From the IRS

Before executing complicated financial transactions, taxpayers frequently seek advice from lawyers and accountants regarding their likely tax consequences, and during the course of such transactions, the taxpayers may share analyses prepared by their tax professionals with third parties. In auditing tax returns reporting the transactions in question, the Internal Revenue Service may seek the analyses from those third parties. In order to resist production of the analyses in such circumstances, the taxpayers will need to establish both that the documents in question were privileged and that the applicable privileges were not waived.

In the past six months, the U.S. Court of Appeals for the Second Circuit has addressed assertions of privilege in two cases arising out of IRS audits, in both instances reversing district court decisions rejecting the taxpayers' assertion of privilege. These cases are instructive of the need to act vigilantly to protect the privileges at issue.

Background

Under section 6201 of the Internal Revenue Code, the IRS is "authorized and required to make the inquiries, determinations, and assessments of all taxes" imposed by the Code. To effectuate this role, Congress has given the IRS "expansive information-gathering authority."¹ Thus, in the course of auditing returns, the IRS regularly issues summonses to taxpayers and third parties "[f]or the purpose of ascertaining the correctness of [the return in question]...., determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability."²

Issues relating to the scope and validity of a summons are litigated in federal district court, either through a petition to quash brought by either the summoned party or the affected taxpayer³ or through a petition by the IRS seeking to enforce the summons.⁴ When litigating the validity of a summons, the IRS bears the initial burden of

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demonstrating the four factors identified in *United States v. Powell*:⁵ (1) "that the investigation will be conducted pursuant to a legitimate purpose," (2) "that the inquiry may be relevant to the purpose," (3) "that the information sought is not already within the [IRS's] possession," and (4) "that the administrative steps required by the [Internal Revenue] Code have been followed."⁶

The decisions in 'Highland Capital' and 'Schaeffler' are reminders of the need to rigorously analyze claims a taxpayer waived attorney-client privilege or work-product protection by sharing documents with third parties.

Once the IRS meets this minimal burden, the burden shifts to the party resisting the summons to disprove one of the Powell factors or to establish some other "appropriate ground" to quash the summons.⁷ One such appropriate ground is that the summons in question calls for materials that are either subject to the attorney-client privilege or immune from discovery pursuant to the attorney's work-product doctrine.

Highland Capital Case

In *Highland Capital Management v. United States*,⁸ a hedge fund had engaged in a series of transactions with Barclays Bank. Two of those transactions generated substantial losses, which Highland claimed on its 2008 income tax returns. The two transactions (and others) were the subject of litigation between Highland and Barclays, which was settled in 2012. In the course of auditing Highland's 2008 returns, the IRS repeatedly asked Highland for a copy of its settlement agreement with Barclays. Highland resisted the IRS's requests, asserting that the settlement agreement included

a confidentiality provision that would require it to give Barclays notice of the IRS's demand.

Apparently tired of Highland's delay, the IRS first obtained the settlement agreement from Barclays and then served a third-party summons on that bank seeking, among other things, "[a]ny documents, including but not limited to any tax opinions, tax analysis or similar information provided to you by an outside party/third party with respect to" various transactions.⁹

Highland moved to quash the third-party summons on a number of grounds including that it sought privileged information, and requested the opportunity to review any documents responsive to the requests seeking the potentially privileged information before they were produced to the IRS.¹⁰ In response, the IRS argued that Highland's claim lacked specificity, as it did not identify particular documents that may be privileged. It also contended that it was unlikely that Barclays held any privileged material given that its relationship with Highland had become contentious.¹¹ The district court rejected the motion to quash, albeit without expressly addressing Highland's claim of privilege.¹²

In an unpublished opinion, the Second Circuit affirmed the district court's rejection of many of Highland's arguments, but vacated and remanded for consideration of Highland's assertion of privilege. Despite the fact that Highland and Barclays had become adversaries in litigation, the Second Circuit noted that "[w]hen parties disagree whether a privilege applies, courts often review the contested materials in camera," and added that "requiring a litigant to turn over documents subject to a claim of attorney-client privilege...., without a judicial ruling on the merits of the claim, will undermine the attorney-client privilege and is therefore impermissible."¹³ Thus, the Second Circuit remanded the issue for reconsideration, "including whatever in camera review of the documents at issue may be appropriate in the circumstances presented."¹⁴

'Schaeffler v. United States'

Approximately six weeks after deciding *Highland Capital*, the Second Circuit issued its opinion in *Schaeffler v. United States*,¹⁵ which addressed another claim of privilege with respect to tax analyses that had been provided to banks that

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had an interest in the outcome of a transaction. In *Schaeffler*, the taxpayer, Georg Schaeffler, was a U.S. businessman who owned 80 percent of a German automotive and industrial parts supplier through several entities known as the Schaeffler Group. In 2008, the Schaeffler Group made a tender offer for shares of a German company. While the offer, which was financed by a consortium of banks, was designed to acquire a minority interest in the company, as a result of the intervening global financial meltdown, its terms were far more attractive than had been intended and the offer was substantially oversubscribed.

The ballooning cost of the acquisition in conjunction with poor economic conditions led to concerns about the Schaeffler Group's solvency and its ability to service the debt. As a result of these concerns, Mr. Schaeffler, the Schaeffler Group and the consortium decided to refinance the debt and restructure the Schaeffler Group, which had significant tax consequences. Among other tax advisors, the Schaeffler Group retained Ernst & Young (E&Y) "to advise on the federal tax implications of the transactions and possible future litigation with the IRS."¹⁶

E&Y prepared a 58-page memorandum "that identified potential U.S. tax consequences of the refinancing and restructuring, identified and analyzed possible IRS challenges to the [proposed] tax treatment of the transactions, and discussed in detail the relevant statutory provisions, U.S. Treasury regulations, judicial decisions, and IRS rulings."¹⁷ The Schaeffler Group shared E&Y's memorandum and other privileged documents with the bank consortium, pursuant to an "Attorney Client Privilege Agreement" in which the consortium committed to maintain the confidentiality of the documents with respect to third parties.

As expected, the IRS audited Mr. Schaeffler's returns and, in connection with its audit, issued a summons to E&Y requesting, among other things, "legal opinions, analysis and appraisals" related to the restructuring and refinancing transactions.¹⁸ Mr. Schaeffler and the Schaeffler Group petitioned to quash the summons on the ground that it sought materials subject to both the attorney-client privilege and the attorney work-product doctrine. The district court denied the petition, finding that the Schaeffler Group had waived the attorney-client privilege by sharing the documents with the bank consortium.¹⁹

The district court further held that, although the E&Y memorandum was prepared at a time when the Schaeffler Group anticipated litigation and analyzed the strengths and weaknesses of its positions, given the size and complexity of the transaction, the Schaeffler Group would have sought and obtained advice in essentially similar form even if it had not anticipated litigation.²⁰

On appeal, the Second Circuit rejected both of these findings. First, the court addressed the Schaeffler Group's argument that sharing the documents in question with the bank consortium did not waive the attorney-client privilege given their "common legal interest." The court rejected the

district court's view that the "common interest" or "joint defense" exception to the waiver doctrine was inapplicable because the consortium "lack[ed]...any common legal stake in Schaeffler's putative litigation with the IRS, because it would not be named as a co-defendant in the anticipated litigation and 'only the [c]onsortium's economic interests,' as opposed to its legal interests, 'were in jeopardy.'"²¹ Given that the Schaeffler Group and the consortium "could avoid...mutual financial disaster by cooperating in securing a particular tax treatment of a refinancing and restructuring," which would "likely involve a legal encounter with the IRS," the Second Circuit concluded that they shared "a strong common interest in the outcome of that legal encounter."²²

The court noted that it had found "[n]o caselaw in this or another circuit [that] compels us to hold that the [c]onsortium's interest in appellants' obtaining favorable tax treatment for the

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refinancing and restructuring transaction is not a sufficient common legal interest."²³ The court reasoned that "[a] financial interest of a party, no matter how large, does not preclude a court from finding a legal interest shared with another party where the legal aspects materially affect the financial interests."²⁴ The court further noted that courts have held that insurers hold a common legal interest with the insured in the outcome of litigation and that the consortium "essentially insured" Schaeffler by "retain[ing] control over Mr. Schaeffler's legal decisions to settle, pay, or sue."²⁵

After holding that the attorney-client privilege had not been waived, the Second Circuit turned to the district court's finding that E&Y's memorandum was not entitled to work product protection. The court noted that, under *United States v. Adlman*,²⁶ a document is protected if it "can fairly be said to have been prepared or obtained because of the prospect of litigation." Conversely, a document "prepared in the ordinary course of business in a form that would not vary regardless of whether litigation was expected" is not afforded protection.²⁷ The court found that the E&Y documents fell into the former category, as they were "specifically aimed at addressing the urgent circumstances arising from the need for refinancing and restructuring and [were] necessarily geared to an anticipated audit and subsequent litigation, which was on this record highly likely."²⁸

The appellate court rejected the district court's view that E&Y provided advice that they were "ethically and legally required to give...even in the absence of anticipated litigation," finding that

no law or regulation required the "highly detailed, litigation-focused analysis and advice" contained in E&Y's memorandum.²⁹ The court also found that "[t]he size of a transaction and the complexity and ambiguity of the appropriate tax treatment are important variables that govern the probability of the IRS's heightened scrutiny and, therefore, the likelihood of litigation," and concluded that the district court's implication that "tax analyses and opinions created to assist in complex transactions with uncertain tax consequences can never have work-product protection" was inconsistent with *Adlman*.³⁰

Conclusion

The Second Circuit's recent decisions in *Highland Capital* and *Schaeffler* are important reminders of the need to rigorously analyze claims that a taxpayer waived the attorney-client privilege or work-product protection by sharing documents with third parties. In light of these decisions, practitioners representing taxpayers in audits need to carefully consider whether they can assert a privilege notwithstanding the fact that a document may be found in a third party's files.

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1. *United States v. Arthur Young & Co.*, 465 U.S. 805, 816 (1984).

2. 26 U.S.C. §7602(a).

3. 26 U.S.C. §7609(b).

4. 26 U.S.C. §7604(b).

5. 379 U.S. 48 (1964).

6. *Id.* at 57-58.

7. *Reisman v. Caplin*, 375 U.S. 440, 449 (1964).

8. 2015 WL 5692377 (2d Cir. Sept. 29, 2015).

9. *Highland Capital Management v. United States*, No. 14-mc-0174, Dkt. No. 2, at Ex. A-6 (S.D.N.Y. filed June 10, 2014).

10. *Id.* at 11.

11. *Highland Capital Management v. United States*, No. 14-mc-0174, Dkt. No. 14, at 20-21 (S.D.N.Y. filed July 30, 2014).

12. *Highland Capital Management v. United States*, 51 F.Supp.3d 544, 553 (S.D.N.Y. 2014).

13. *Highland Capital*, 2015 WL 5692377, at *3 (citation and emphasis omitted).

14. *Id.*

15. 806 F.3d 34 (2d Cir. 2015).

16. *Id.* at 37. Pursuant to 26 U.S.C. §7525, communications between a taxpayer and an accountant may be deemed privileged. The scope and waiver of the tax practitioner privilege is "essentially coterminous with the attorney-client privilege" and can also serve as grounds to quash summons requests. See *Schaeffler*, 806 F.3d at 38 n.3.

17. *Id.* at 38.

18. *Id.*

19. *Schaeffler v. United States*, 22 F.Supp.3d 319, 331-34 (S.D.N.Y. 2014).

20. *Id.* at 337-40. In reaching this conclusion, the district court noted that tax practitioners are precluded from considering the possibility that a return will go unaudited in advising clients regarding the tax consequences of transactions. *Id.* at 339-40 (citing Treasury Department Circular 230 §10.35(c)(3)(iii) and 26 C.F.R. §1.6694-2(b)).

21. *Schaeffler*, 806 F.3d at 38 (quoting *Schaeffler*, 22 F.Supp.3d at 333).

22. *Id.* at 41.

23. *Id.* at 42.

24. *Id.*

25. *Id.*

26. 134 F.3d 1194 (2d Cir. 1998).

27. *Schaeffler*, 806 F.3d at 43-44.

28. *Id.* at 44.

29. *Id.*

30. *Id.* at 44-45.