

Potential Consequences of Work-Product Privilege in Tax Disputes: When Is Litigation Anticipated?

By Thomas C. Borders and Brad McCormack

Taxpayers and practitioners have trumpeted recent taxpayer victories in a series of significant work-product cases as a powerful shield for taxpayers in disputes with the Internal Revenue Service.¹ Such victories, however, may ultimately be Pyrrhic for any taxpayer litigant that fails to consider the accompanying obligation to preserve documents that may be relevant to future litigation. The opinion in the much-heralded *Con Ed* case² — a taxpayer victory — underscores the perils facing a taxpayer. The IRS used the taxpayer's asserted work-product claim as a weapon to argue that the court should sanction *Con Ed* because it had destroyed relevant emails while it reasonably anticipated litigation. Although *Con Ed* emerged unscathed, overlooking both edges of the work-product sword could prove dangerous.

The law regarding the obligation to preserve documents that may be relevant to anticipated litigation is not well-developed in the tax controversy arena. Generally, the issue when a duty to preserve arises is a fact-intensive inquiry that defies general formulations, and it can be a particularly difficult determination in the federal tax controversy arena. An audit can at times be adversarial and quite contentious, especially given the IRS's recently vigorous enforcement actions against large corporate taxpayers and upper-income individuals, particularly with respect to transactions designated as Tier I or listed transactions.

In *Consolidated Edison Co. of New York v. United States*, the IRS challenged the taxpayer's lease-in, lease-out (LILLO) transaction effecting *Con Ed*'s 1997 return. In planning the transaction in 1997, the taxpayer sought advice from the law firm of Sherman & Sterling, which issued opinion letters on the tax risks and changes to the tax law affecting the transaction. The taxpayer's in-house counsel also prepared a memorandum discussing the possible application of section 467 of the Internal Revenue Code to the transaction. The government filed a motion to compel production of these documents, but the taxpayer invoked work-product protection. The court ruled that these documents were not protected work-product because they were not prepared in anticipation of litigation.

At trial, the government filed a "Spoliation of Evidence Claim" against *Con Ed*, alleging that *Con Ed* had destroyed potentially relevant emails in 2000 when the company migrated its email program to a new server and failed to backup the old emails. The government argued that *Con Ed* anticipated litigation by 2000 and thus had a duty to preserve the emails at the time of the migration. As a sanction, the government sought "an adverse inference that the destroyed information, if now available, would have been favorable to the United States and harmful to Consolidated Edison."

The court observed that the parties had flipped their positions from the court's earlier consideration of the government's motion to compel the 1997 tax advice memoranda. There the taxpayer

invoked work-product protection arguing that the memoranda at issue had been prepared in anticipation of litigation. The government countered that the memoranda were prepared for business purposes, not in anticipation of litigation, and therefore were not entitled to work-product protection. Later in regard to the separate issue whether there was spoliation, the government argued that one of the same memoranda was prepared in anticipation of litigation and the taxpayer argued the reverse.³

This anomalous situation illustrates the double-edged nature of a work-product claim. Nevertheless, as the court had held that there was no anticipation of litigation in 1997 for purposes of work-product protection, it consistently held that the taxpayer had not (nor should it have) reasonably anticipated litigation in 1997 for purposes of the government's spoliation claim either.⁴

The influential case of *Zubulake v. UBS Warburg, LLC*⁵ is a bellwether case on the duty of a potential litigant to preserve documents when that litigant reasonably anticipates litigation. The case involved an employment discrimination claim and the court found that a potential litigant's duty to preserve can begin well in advance of the actual filing of an administrative claim or lawsuit. The plaintiff, *Zubulake*, was an equities trader with UBS Warburg that sued her employer in federal court claiming gender discrimination, failure to promote, and retaliation. In routine discovery, plaintiff sought email records stored on UBS's computer systems that she maintained would prove her claims. It later became evident that certain of UBS's monthly backup tapes that plaintiff sought were missing. Plaintiff moved for sanctions against UBS for the defendant's failure to preserve the relevant tapes.

The court held that the defendants violated their duty to preserve the lost backup tapes. The court found that "the obligation to preserve evidence arises when the party has notice that the evidence is relevant to litigation or when a party should have known that the evidence may be relevant to future litigation."⁶ In that case, the court concluded that the obligation to preserve documents arose when relevant UBS employees began marking documents relating to the plaintiff's situation as "UBS Attorney Client Privilege" and the court found that "almost everyone associated with *Zubulake* recognized the possibility that she might sue."⁷

The lesson of *Zubulake* is clear: A potential litigant who "reasonably anticipates" litigation has a duty to preserve all documents relevant to the potential litigation, or that might lead to evidence that could be used in that litigation, or that another party to the litigation is likely to request. This includes both electronic and paper documents. Applied to tax audits, the preparation of documents thought to be protected by the work-product doctrine could impose a duty on a taxpayer to take affirmative steps to preserve documents related to the anticipated controversy.

The potential litigant can satisfy this obligation by issuing a “litigation hold” memorandum. This document describes the nature of the potential litigation as well as what documents and information are potentially relevant in that litigation. A large corporate litigant often prepares this type of document through its internal (and often external) legal counsel who identify what types of information might be relevant and which individuals at the organization are likely to be in possession of such information. The entity then distributes this memorandum to the individuals identified as having potentially relevant information.

Larger corporate taxpayers often have information systems with automatic processes for determining which electronic information to store (and for what length of time) versus routine data deletion. Moreover, tax departments often have their own standing document holds relative to information and documents believed likely to be necessary during routine tax audits. As part of its duty to preserve, a potential litigant may have to consider overriding these automated systems to the extent necessary to preserve potentially relevant electronically stored information. The potential litigant may also have to identify relevant backup tapes for preservation. For example, in *Zubulake*, the court found that defendants violated their duty because they failed to preserve the backup tapes containing emails from the accounts of relevant individuals during the relevant time.⁸

A litigant who fails its duty to preserve faces a range of possible sanctions that vary in severity based on the litigant’s level of culpability for the missing documents. Most commonly, litigants may face monetary penalties from the court or the court will shift some of the costs of discovery to the violating party. For example, in *Zubulake* the court ordered defendant UBS to pay monetary damages to the plaintiff to cover plaintiff’s costs of redepositing certain key witnesses.⁹ More severe remedies can range up to an entry of judgment against a party that violates its duty to preserve.

Courts in the work-product context have found that anticipation of “dealing with the IRS” is akin to anticipating an “administrative dispute,” which can constitute “litigation” for the purposes of the work-product rules.¹⁰ Thus, anticipating an administrative dispute, be it at the IRS Examination or Appeals levels, may trigger a duty to preserve relevant documents. In *Deseret Management Corp. v. United States*, where the usual roles were reversed and the government was seeking work-product protection for its workpapers, the IRS argued (and the U.S. Court of Federal Claims agreed) that reasonable anticipation of litigation can begin at the start of an IRS audit because “once the audit has begun, the likelihood of litigation increases.”¹¹


In *Con Ed*, however, that same Court of Federal Claims observed that the taxpayer’s tax returns were routinely audited and that the taxpayer settled most of its audit issues through administrative channels. The court noted that the IRS has processes, including Appeals Office consideration, through which both parties hope and expect to obtain a settlement short of litigation. The court never decided when *Con Ed* should have reasonably anticipated litigation, finding only that it was sometime after *Con Ed* had migrated its email server in 2000. The audit did not end until the Notice of Proposed Adjustments was issued in December 2002. Consideration by the Appeals Office did not conclude until 2005.

Where a taxpayer engages in a transaction subject to the IRS Large & Midsize Business (LMSB) Division’s industry issue focus program, better known as “coordinated” or Tiered issues (e.g., Tier I issues, or those with high strategic importance affecting one or more industries), recent experience has shown that the IRS is less likely to resolve such issues on audit or at Appeals. The Examiner or Appeals Officer has far less discretion to resolve such issues without approval of the Issue Owner Executive in charge of the coordinated issue, and the field agent must apply any Tier I determinations to the case and implement all formal guidance (found in “coordinated issue papers”).

Moreover, the taxpayers often lack direct access to the issue management team — the ultimate decision-maker on whether the IRS will resolve the issue. Such coordinated issues also involve more input by industry and issue specialists. The IRS also increasingly collaborates with state and local tax authorities and its counterpart tax authorities in foreign jurisdictions, sharing information about certain cross-border transactions.

Whatever the purported merits of the ever-increasing issue coordination by LMSB (e.g., uniformity of the IRS’s approach to issues), experience suggests that coordination of issues results in protracted examinations and Appeals processes that delay or discourage the resolution of the issues by taxpayers and the IRS. For example, the Examination team must sometimes issue blanket information document requests (IDRs) (rather than individually tailored ones) that are difficult to comply with and lead to disputes on issues of privilege. In some cases, Examination or Appeals is constrained to propose accuracy-related penalties for certain issues no matter the facts and circumstances of the case; this development almost invariably poisons the water and greatly increases the likelihood of litigation. For all these reasons, for coordinated issues a taxpayer should consider issuing a document hold earlier than otherwise.

IRS audits can quickly become contentious and lead to impasses that could augur litigation, such as disputes over what the IRS deems an “abusive” transaction. Other relevant factors include the size of the proposed adjustment, large book-tax discrepancies, and the taxpayer’s experience with the IRS in earlier audits. It may also be necessary to look at the audit experience of other taxpayers in the same industry (to the extent known, such as through trade groups) to determine the propensity of the IRS to litigate an issue.

That a taxpayer’s “reasonable anticipation of litigation” may provide important safeguards to protect against disclosure of sensitive documents to the IRS has been widely praised by tax practitioners. What has gone largely overlooked are the potential burdens and duties that can accompany the invocation of such protections. Thus, taxpayers and their attorneys who are considering invoking the work-product doctrine to shield certain documents should consider the need for document-preservation measures and determine what measures meet the unique needs and obligations of the taxpayer. 

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1. See *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006) (overruling the lower court's order enforcing an IRS summons seeking two memoranda containing legal analysis of multimillion-dollar losses from captive insurance transactions and holding the work-product privilege protected these memoranda); *Regions Financial Corp. & Subsidiaries v. United States*, 101 AFTR 2d 2008-2179 (N.D. Ala. 2008) (granting a taxpayer corporation's motion to quash an IRS summons seeking portions of tax accrual workpapers from Regions' outside auditor, Ernst & Young, concerning Regions' participation in two unspecified "listed transactions" and finding these workpapers were protected work product); *United States v. Deloitte & Touche USA, LLP*, 2009 U.S. Dist. LEXIS 48080 (D.D.C. 2009), *aff'd*, 2010 U.S. App. LEXIS 13226 (D.C. Cir. Jun. 29, 2010) (granting third party taxpayer Dow Chemical's petition to quash a summons of documents that taxpayer gave to its outside audit firm Deloitte, finding that these documents constituted work product, the protection of which was not waived by disclosure to outside auditors). [Editor's Note: For an analysis of the court of appeals decision in *Deloitte*, see the article by Jean A. Pawlow and Kevin Spencer elsewhere in this issue.] For a similar decision in the state and local tax context, see *Commissioner of Revenue v. Comcast Corp.*, 901 N.E.2d 1185 (Mass. 2009). But see *United States v. Textron*, 2009 U.S. App. LEXIS 18103 (1st Cir. 2009) (*en banc*), *vacating and remanding*, 507 F.Supp.2d 138 (D.R.I. 2007), *cert denied*, 130 S. Ct. 3320 (2010). The First Circuit reversed the trial court's determination that work-product protection applied to Textron's internally prepared workpapers concerning certain "Sale-in, Lease-out" (SILO) transactions. An earlier three-judge panel of the First Circuit had affirmed the District Court's application

of work-product protection, although it had ordered a remand on the issue of waiver of that protection. 507 F. Supp. 2d 138 (1st Cir. 2007). The First Circuit granted a re-hearing en banc and vacated the earlier holding of the three-judge panel. The Supreme Court denied a petition for a writ of certiorari in May 2010.

2. *Consolidated Edison Co. of New York v. United States*, 90 Fed. Cl. 228 (Fed. Cl. 2009).
3. The court found it troubling that Con Ed's General Counsel offered an affidavit in support of the work-product claim that the memoranda were prepared in anticipation of litigation in 1997 but later testified at trial that he had "no reason to believe in 1997 that there would be litigation."
4. The IRS also argued unsuccessfully that the taxpayer should have reasonably anticipated litigation based on the issuance of Rev. Rul. 99-14, 1999-1 C.B. 835, which the government asserted proscribed transactions like the taxpayer's LILO. Moreover, the court found that even if Con Ed had violated its duty to preserve, it would have found the adverse inference sanction to be unwarranted because the government could not show that relevant emails were lost or that the government was prejudiced.
5. 220 F.R.D. 212 (S.D.N.Y. 2003).
6. 220 F.R.D. at 216, quoting *Fujitsu Ltd. v. Federal Express Corp.*, 247 F.3d 423 (2d Cir. 2001) (internal quotation marks omitted).
7. *Id.* at 217. See also *Anderson v. Sotheby's Inc. Severance Plan*, 2005 U.S. Dist. LEXIS 23517 (D.N.Y. 2005) (finding that a litigant's duty to preserve documents arose as of the date that litigant created a document over which it claimed work-product protection).
8. 220 F.R.D. at 219.
9. *Id.* at 222.
10. *Roxworthy*, 457 F.3d at 600, quoting *Hodges, Grant & Kaufmann v. Internal Revenue Service*, 768 F.2d 719, 719-22 (5th Cir. 1985).
11. 78 Fed. Cl. 88, 93 (2007). Where the shoe is on the other foot, and the government is arguing against work-product protection for a taxpayer's document, the government may argue that anticipation of an audit is not anticipation of litigation. For example, in the government's brief opposing the taxpayer's petition for certiorari in the *Textron* case, the government argued "the IRS audit itself is not litigation, and it is intended to be cooperative rather than adversarial." Brief for the United States in Opposition, *Textron Inc. v. United States*, No. 09-750, at 27 (April 2010).

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