

To Preserve, Protect, and Defend:

Privilege, Confidentiality, Kovel and Other Ethical Considerations When Communicating Tax Advice

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Why Privilege Matters

Maintaining Privilege Raises Important Issues

- Continually increasing pressure to produce privileged material:
 - IRS now routinely asks for opinions
 - SEC and other regulators also seek privileged material during investigations

Potential Benefits of Maintaining Privilege

- Limits discovery of in-house counsel files, advisors' files, and communications between the taxpayer and advisor
- May prevent misimpression of the role of tax considerations
- May avoid waiver arguments in other disputes

Potential Costs of Maintaining Privilege

- Potential negative reaction by IRS
- Potential loss of penalty protection
- Potential inability to document certain elements of an issue

Privilege decisions are made in context and require continual reevaluation

Audit → Summons → Appeals → Litigation

Types of Privilege

- Attorney-Client Privilege
 - Strong protection but easy to waive
- Section 7525 Tax Practitioner Privilege
 - Exceptions to this privilege are broad
 - Easy to waive
- Work-Product Protection
 - Opinion and fact work product
 - Harder to establish, but also harder to waive

Multiple Advisors / Multiple Jurisdictions

From: Tax Director
To: Accounting Firm Advisor 1, Accounting Firm Advisor 2, Valuation Consultant, Law Firm Advisor 1, Law Firm Advisor 2, Foreign Advisor (Accounting Firm)
Subject: New Restructuring

To the Team:

We have a big group to help us with this restructuring because we want no stone left unturned. We believe the IRS is likely to challenge this one.

Why is a Tax Opinion Obtained?

From: Tax Department Attorney
To: Outside Counsel
Subject: RE:RE: Opinion Requested for Transaction A

As you know, IRS is aggressively pursuing penalties across the board, and we need to get this to have in the file for penalty protection.

-----Original Message-----

From: Outside Counsel
To: Tax Department Attorney
Subject: RE: Opinion Requested for Transaction A

Sure thing. Why do you think you need an opinion?

Thanks,
Attorney

-----Original Message-----

From: Tax Department Attorney
To: Outside Counsel
Subject: Opinion Requested for Transaction A

Joe – Need an opinion on that transaction we were discussing

Reporting Financial Data

From: Finance

To: Tax

Earnings are coming up next week and we have this big restructuring that likely requires a big reserve, but I don't want to be the one reporting entity that drags down earnings for the whole company. How can we push the reserve into next quarter where the hit won't have such an impact?

Disavowing Form

From: Tax
To: Treasurer, Accounting Department Employee, Tax Department Employee
Subject: Deal Terms

While the terms of the deal in the transaction documents allow us to account for the interest as equity not debt, **we believe the *spirit* of the deal with Counterparty is as follows...**



From: Tax Counsel
To: In House Compliance / Return Preparer
Subject: Schedule UTP Concise Description for Transaction Y

We are going to post a reserve for Transaction Y due to uncertainty over whether the IRS could prevail on an argument recharacterizing it as a disguised sale. We need to be very careful about how this is described on the 2010 Schedule UTP. The instructions require disclosure of “relevant facts affecting the tax treatment,” but our facts aren’t so hot and I would prefer not to disclose them if we don’t have to.

Attorney-Client Privilege and 7525

Historical basis for attorney-client privilege

- Protects the client's inquiry to encourage candid communications with counsel
- Protects the attorney's advice to maintain the client's confidences

Key Elements of the A/C Privilege

- Communication between client and attorney
- For the purpose of seeking legal advice
- Client must have a reasonable belief that the communication is confidential
- Disclosure of the privileged information would reveal the client's underlying communication to the attorney
- No Waiver

IRC § 7525

- Extends attorney-client privilege to certain communications between a taxpayer and its "federally authorized tax practitioner"

Limitations on 7525

- Only applies to federal tax advice asserted in federal tax proceedings
- Same limitations as A/C privilege, including that the privilege is unavailable for tax return preparation
- "Tax shelter" exception
- Does not apply to non-U.S. accountants
- Does not apply in criminal tax proceedings

Attorney-Client Privilege: In Practice

- Communications between client and outside counsel
 - Strongest protection; presumed to be for obtaining legal advice
 - Some courts emphasize that it is the communication *from* the client *to* the attorney that is the core of the attorney-client privilege
 - » These courts point out that advice from the attorney to the client is only privileged to the extent that it might reveal the confidential communication from the client
 - *Caution:* Lawyers at accounting firms; non-U.S. advisers
- Communications with in-house lawyers in business divisions
 - Presumed to be for purpose of furthering business, not for obtaining legal advice
 - Work to clearly establish attorneys in business units serving in legal capacity
- Communications between employees conveying legal advice
 - Will be protected, but reference to legal advice must be clear and there must be support for privilege claim
 - Employees must be under the “need to know” umbrella

Attorney-Client Privilege: Confidentiality

- Reasonable expectation of confidentiality?
- Intent for confidentiality can be shown by **segregating** and **restricting** access to the information
- Privileged information can be shared within a corporation among employees who “need to know”
 - “Need to know” group can be defined narrowly or broadly
 - Presumption in favor of privilege if:
 - » Distribution is limited
 - » Distributees admonished against further dissemination
 - » Document relates to recipients’ corporate responsibilities

Attorney-Client Privilege: Kovel Arrangements

- The attorney-client privilege extends to confidential communications with experts assisting the lawyer in providing legal advice. United States v. Kovel, 296 F.2d 918 (2d Cir. 1961)
- **Key Elements of Kovel Arrangement**
 - The expert engaged must be necessary, or at least highly useful, for effective consultation between client and lawyer
 - » More recent cases have required heightened showings of need. Cavallaro v. United States, 284 F.3d 236 (1st Cir. 2002) (“The involvement of the third party must be nearly indispensable”)
 - Expert/consultant must be employed by, and acting at the direction of, the attorney, not independently or at the direction of the client
 - Procedures must be followed
 - » Separate engagement letter, billing and file maintenance
 - » Limit direct communications between expert/consultant and client
 - » Privilege only applies to communications after the date of the engagement

Waiver of Attorney-Client Privilege

Waiving Attorney-Client Privilege

- Waivers occur either when advice is disclosed to someone outside the “privilege circle” or when privileged advice is put “at issue”
- Waivers of attorney-client privilege are generally irrevocable
- Waiver of attorney-client privilege can be inadvertent
- No waiver if disclosure was the result of a third party’s unauthorized act (i.e., theft)
 - The privilege belongs to the client, and only the client may waive it
 - Limits government’s or other regulators’ use of “tainted” information (e.g., whistleblower disclosures)
- Once a communication or subject matter has been deemed waived in one controversy, it may be considered waived in subsequent controversies

Issues Raised if Two Opinions Obtained

From: In-House Attorney
To: Tax Department, Accounting Department, Approval Committee
Subject: Summary Analysis

Attached is my summary of **Transaction X**, based on my own analysis and that of our Outside Counsel. It is organized as follows:

- 1) Pertinent Facts
- 2) Business / Commercial Reasons for Entering the Transaction
- 3) Tax Minimization achieved through the transaction
- 4) Analysis of Tax Risk
- 5) Analysis of Structural and Accounting Risk
- 6) Comparison of **Law Firm A** and **Law Firm B** legal opinions
- 7) Final Pros / Cons of Executing Transaction

Assuming there are no additional comments, I would like to formally submit this for the August meeting of the Approval Committee



Disclosure of Legal Opinions

- If a taxpayer discloses one legal opinion, it likely waives protection over all other opinions related to the same subject matter
- Selectively disclosing one opinion that has a higher level of confidence in its conclusions while withholding a less confident opinion would be unfair
 - “A party should not be allowed to rely on self-serving documents in its defense while withholding potentially damaging information under the guise of the attorney-client privilege.” Micron Separations, Inc. v. Pall Corp., 159 F.R.D. 361, 365 (D. Mass. 1995)
- Advice received that was not memorialized in an opinion
- Internal legal advice
- Files of your counsel



International Privilege Considerations

- Privilege safeguards are different across jurisdictions
 - Which country's laws should apply?
 - Scope of protection
 - » Privilege vs. merely laws protecting confidentiality
 - » When does the privilege attach (prior to involvement of attorney?)
 - » Are in-house counsel covered?
 - » Extent of any waiver upon limited disclosure
- Section 7525 privilege does not apply in most jurisdictions
- If foreign non-attorney advisors are involved, a Kovel arrangement should be considered

Chart of Global Privilege Laws

Table 1: A/C Privilege Exists in Some Form				
Who it Applies To:	Outside and In-House Counsel		Outside Counsel Only	
Foreign Attorneys Covered	Yes/In Some Instances	No/Unclear	Yes/In Some Instances	No/Unclear
	Australia Canada England* Hong Kong Ireland* Netherlands* New Zealand Norway Peru Portugal* Singapore South Africa United States	Argentina Brazil Mexico Venezuela	Finland* Switzerland Turkey	Austria* EU/ECJ* India Malaysia Spain* Sweden*

*Indicates EU member state subject to laws of ECJ, including the *Azko Nobel* decision, during investigations under ECJ jurisdiction.

Table 2: No Privilege, But Confidentiality Provisions				
Who it Applies To:	Outside and In-House Counsel		Outside Counsel Only	
Foreign Attorneys Covered	Yes/In Some Instances	No/Unclear	Yes/In Some Instances	No/Unclear
	Germany* Japan Poland* South Korea Thailand	Taiwan		China France* Italy* Russia Saudi Arabia

*Indicates EU member state subject to laws of ECJ, including the *Azko Nobel* decision, during investigations under ECJ jurisdiction.

- From “Attorney-Client Privilege in an Interconnected World, Nina MacPherson and Theodore Stevenson, published in *Litigation*, Vol. 42, Number 4, Summer 2016



Communications within Taxpayer

From: Treasury
To: Tax Department Employees
Subject: Cash Flows for Transaction X

Attached is the cash flow model I have put together for **Transaction X**. I have used the updated LIBOR numbers and adjusted the total amounts of the different instruments.

By the way, I have also performed a computation that takes into account the tax, regulatory, and accounting risk that the transaction doesn't work.

Risk Assessments

- Tax, Accounting, and Regulatory groups often create memoranda analyzing the risks and proper reporting of transactions
- Used to inform Approval Committees
 - GC, Treasury, Legal, Credit, etc.
- Discussed and approved by Approval Committee
 - Minutes nearly always turned over
- Memoranda contain:
 - Internal risk assessment by lawyers
 - Assessment by outside counsel
- Internal Investigations / Audits
 - Involvement of internal / external counsel
 - Capital One case (E.D. Va. 2020)

Avoid Inclusion of Privileged Information in Minutes of Approval Committees

Approval Committee Minutes of Meeting For [Transactions A, B, and C]

- 1) Approved [Transaction A]
- 2) Approved Tax Minimization [Transaction B] based on:
 - Presentation from Tax Department on why interest in SPV is an equity (not debt) interest for U.S. tax purposes
 - Presentation from Accounting Department on why interest in SPV is debt for U.S. accounting purposes
- 3) Approved [Transaction C] on condition that:
 - Law Firm X agrees with in-house counsel's view on regulatory capital treatment

Work Product Doctrine

Work Product Doctrine

- Work product protects documents prepared “in anticipation of litigation”

In anticipation of litigation?

- Taxpayer audit history
- Nature of transaction
- Contemporaneous expressions of anticipated controversy
- Contemporaneous actions (litigation hold)
- Expected JCT scrutiny
- Clarity of legal authority

- Three tests:
 - “Because of” test (majority rule)
 - “Primary purpose” test (5th Circuit)
 - “For use” test (1st Circuit)
- Expands privilege protection
 - May protect documents created by the taxpayer or any agent or representative, including a lawyer, accountant or other consultant

Waiving Work Product Protection

- Work product is more difficult to waive than attorney client or 7525 privilege
 - Disclosure to third parties generally permissible unless third party is an adversary or a conduit to an adversary
 - But, disclosure to one government agency typically (but not always) waives work product as to other government agencies
- Generally, no subject matter waiver unless work product is placed directly “at issue”
 - Work product is “at issue” “where the party raises an issue which depends upon an evaluation of the legal theories, opinions, and conclusions of counsel.” Coleco Industries (S.D.N.Y. 1986)
- Example:
 - Calling an attorney as an expert witness, Herrick Co. v. Vetta Sports (S.D.N.Y. 1998)

Communications with Financial Auditors

Sharing Opinions with Auditors

From: Outside Auditor

To: Accounting Department Employee, Tax Department Employee

Subject: XYZ Transaction

It looks as if you are claiming a significant loss on XYZ Transaction, but there is no corresponding book loss. We would like to get more comfort with the accounting and tax treatment of the transaction and the apparent disparity. Did you receive an outside tax opinion for the transaction? Do you have memorialized accounting analysis? Please provide.



What Are Tax Accrual Workpapers?

- Tax accrual workpapers include many things:
 - Reserve adequacy spreadsheets and calculations
 - Outside tax opinions or analyses used to support reserve calculations
 - Internal tax analyses (memos, emails, spreadsheets, etc.) performed to support reserve calculations
- Tax accrual workpapers can be created by:
 - Outside attorneys and/or tax advisors
 - Internal tax department (lawyers and accountants)
 - Financial auditors

The IRS Wants Tax Accrual Workpapers

- The IRS has historically followed a policy of restraint and only requested tax accrual workpapers in “unusual circumstances” (Internal Revenue Manual 4.10.20.3)
- IRS Announcement 2002-63
 - If one listed transaction is present, the IRS will request only workpapers related to that transaction; if multiple listed transactions are present, the IRS will request all workpapers
 - Updated for Uncertain Tax Positions (Schedule UTP) in IRS Announcement 2010-76
 - » Anything provided to financial auditors that is otherwise privileged will not be sought during IRS exam.
 - » But all bets are off in litigation.

Are Tax Accrual Workpapers Protected?

- Tax reserve analyses are typically provided to outside auditors to support the adequacy of reserves
- Auditors frequently assert they must obtain any tax opinion on which a client relies in a material matter
- Disclosure to your auditor will likely waive the attorney-client and § 7525 privileges
- Does disclosure waive work product protection?
 - (1) Does work product protection apply to tax accrual workpapers?
 - (2) If so, does a taxpayer waive protection by sharing workpapers with an outside auditor?

Emerging Privilege Issues

Privilege issues emerging from recent cases

- Consequences of assertion of reasonable cause defense
- Common interest doctrine

Reasonable Cause Defense

- Relying on the advice of counsel will most likely result in a waiver of all advice on the same subject matter – no “sword and shield”

What Could Be Waived? Potentially EVERYTHING

- Opinions (including drafts)
- Emails between advisor and client
- Advisors’ internal emails
- Emails between lawyers and economists
- In-house communications
- Communications with financial auditor

- “Defendants cannot use opinions from two attorneys to establish that it relied in good faith on opinions from counsel without disclosing the opinions of their third attorney.” *SEB, S.A. v. Montgomery Ward & Co.*, 412 F. Supp. 2d 336, 348-49 (S.D.N.Y. 2006)
- Type of protection (attorney-client versus work product) can impact the scope of waiver

Claiming Reasonable Cause = Waiver?

- Should mere invocation of the reasonable cause and good faith defense to the penalties waive the privilege? See, e.g., *Eaton Corp. v. Comm’r*, No. 5576-12 (U.S. Tax Ct., Order of April 6, 2015).
 - This conclusion stems from a broad reading of the court’s holding in *AD Investment 2000 Fund LLC v. Commissioner*, 142 T.C. No. 13 (2014).
 - » Tax Court held that privilege over opinions would be waived if taxpayers “persist in those defenses.”
 - » In other words, it is not until the taxpayer actually uses the privileged information as a sword that waiver occurs
 - > See also *New Phoenix Sunrise Corp. v. Comm’r*, 106 A.F.T.R.2d 2010-7116, at -7123 (6th Cir. 2010); *U.S. v. Micro Cap KY Ins. Co. Inc.*, 246 F.Supp.3d 1194(E.D. Ky. 2017); *Owensboro Dermatology v. U.S.*, 2017 WL 3841684 (W.D. Ky. Sep. 1, 2017).

Common Interest Doctrine and the A/C Privilege

Schaeffler v. United States, 22 F. Supp. 3d 319 (S.D.N.Y. 2014)

- Facts: The taxpayer hired E&Y to provide it with tax advice on the U.S. tax implications of a complex debt refinancing and corporate restructuring transaction

Schaeffler District Court Holding:

- The E&Y memo was not protected by the attorney-client privilege because the document had been provided to a Consortium

Schaeffler Second Circuit Holding:

- Attorney-Client Not Waived:
 - The members of the Consortium shared a “common legal interest” (even though it was not necessarily a common interest in pending or possible litigation) and thus the sharing of the document did not waive the attorney client privilege
 - The court determined that the taxpayers and the bank consortium “had a strong common interest” in obtaining particular tax treatment of the refinancing and restructuring due to the threat of company insolvency and loan default

But see *Ambac Assurance Corp., et al., v. Countrywide Home Loans, Inc., et al.*

- NY State Court of Appeals case decided June 9, 2016
- Common Interest doctrine does not apply unless the communication relates to pending or anticipated litigation

Best Practices

Preserving Protection of Legal Analysis

Preserving Privilege

- **The goal is to formulate procedures that:**
 - Provide maximum privilege protection for communications already created
 - Protect privileged communications made in the future
 - Facilitate the sharing of information without jeopardizing privilege
- **Best Practices for Preserving Privilege:**
 1. Consider whether privilege applies at the outset of each new project
 2. Separate engagement letters for each service provider
 3. Establish when an attorney is acting in a legal, not business, capacity
 4. Careful file management
 5. Avoid unauthorized disclosures
 6. Consider privilege when implementing risk management procedures

Best Practices

1. Consider whether privilege applies at the outset of each new project
 - Will materials produced in the context of a new project be privileged or protected work product?
 - What procedural steps must be undertaken to protect privilege?
 - If non-attorney advisors (or foreign advisors) are involved, is a Kovel arrangement desirable?
 - If litigation is anticipated, document retention should be planned accordingly

Best Practices

2. Separate engagement letters for each service provider
 - Separate engagement letters for different functions performed
 - Separate bills for each engagement
 - Less detailed invoices

3. When an attorney who performs legal and business functions is giving legal advice, establish that the attorney is acting in a legal capacity
 - Segregate work / emails
 - Proper privilege legends

4. Careful file management
 - Segregate files
 - Written communications (memos, letters, e-mails and faxes) containing legal analysis or advice should not contain business or other non-legal advice
 - Avoid discussing more than one transaction in a single document or communication, but do not artificially separate
 - Collect and organize deal documents and other files after transaction closes

5. Avoid unauthorized disclosure

- Identify individuals under the privilege umbrella – those who “need to know” – at the outset of each project
- Do not disclose confidential information to anyone outside the umbrella
- Consider non-waiver agreements when making limited disclosures
- Restrict access to privileged documents on computer networks
- Identify all recipients on the document; no blind copies
- Do not discuss legal advice or tax opinions with third parties
- Do not forward communications with attorneys to third parties
- Avoid e-mail strings; reply only to those who need to know
- Do not cc other advisors (e.g., foreign tax advisors, auditors) on communications with attorneys
- Limit recipients’ ability to forward e-mails

6. Consider privilege when implementing risk management procedures