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FIN 48: A FLAWED SOLUTION TO A NON-EXISTENT PROBLEM¹

I. A Litigator's Overview of FIN 48.

A. When Some Folks Break The Law, We All Get More Laws.

We have seen this movie before: A pattern of astonishingly corrupt conduct, as typified by Watergate, the savings & loan crisis, Enron, and other miscreant enterprises, causes profound damage and the loss of confidence in our governmental, financial, or business institutions. In each case, the conduct violated existing law, prosecutors sent the most deserving to prison, courts awarded damages to the victims when appropriate, and the perpetrators became the subject of scorn and contempt.

Because the existing legal standards prohibited the wrongdoing and provided criminal and civil remedies, we might reasonably conclude that the behavior was not the result of insufficient rules and sanctions, but rather the bad character and motivations of those who had so egregiously violated them. We might also fairly conclude that these episodes demonstrated the need for more effective internal and regulatory oversight and enforcement of the law.

History proves, however, that legislative bodies and regulatory agencies will inevitably respond to the gross violation of existing laws by imposing far more onerous

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standards.² It should not be surprising, therefore, that after the SEC reviewed Enron's financial reporting of its absurdly abusive tax shelters, it was not content to treat that phenomenon as aberrant and sufficiently addressed under current law. It was also not satisfied merely to call upon the FASB to adopt tighter tax position reporting rules for aggressively tax-sheltered transactions. Rather, it commissioned the FASB to adopt new standards for the reporting of all income tax positions, no matter how benign or vanilla they might be.

B. What Was Wrong With FAS 109 and FAS 5?

Prior to FIN 48, most companies reported their FAS 109 income tax liabilities on the basis of their filed tax returns, as long as they and their auditors were satisfied that additional tax liabilities were not "probable" (to a 70-75% or greater likelihood) for FAS 5 loss contingency purposes. If, on the other hand, it was 70-75% or more likely that a disputed tax return position would not be sustained if attacked, the enterprise was obligated to reserve for that potential liability on its financial statements. This "probable" standard was also consistent with international accounting standards as reflected in IAS 12.

To justify subjecting every enterprise applying generally accepted accounting principles to its new income tax position reporting regime for all transactions, activities, and events, the FASB asserted that corporations had been inconsistently and inaccurately applying existing FAS 109 income tax position reporting rules. In neither its published materials leading up to FIN 48 nor in FIN 48 itself, however, did the FASB cite any

² As Lord Chesterton observed, "[w]hen you break the big laws, you do not get liberty; you do not even get anarchy. You get the small laws."

tangible evidence that law-abiding enterprises were misleading their auditors, investors, creditors, or regulators in their applications of these accounting principles. Few cases of alleged financial misreporting had centered on income tax positions, and Enron-type fraud (hardly confined to its tax reserve reporting) was the distinct exception, not the norm.

The FASB never explained how the adoption of FIN 48 would more effectively deter rogue enterprises from fraudulently applying its standards. Would it have mattered at all to Enron whether its tax positions had to satisfy a “more likely than not standard,” rather than only a “probable” standard? Moreover, because Congress had already imposed Sarbanes-Oxley’s enhanced corporate governance requirements and sanctions long before the FASB adopted FIN 48, the reasons why any new income tax position reporting standards might be needed were also less than clear.

C. Do FIN 48’s Benefits Outweigh Its Costs and Burdens?

There is, to be sure, a cost to the administration of any set of more rigorous rules that displaces the existing structure. Regulation has its own law of Newtonian economics: for the adoption of every more burdensome rule there are corresponding increases in out-of-pocket compliance costs and lost opportunities, as management spends ever-increasing amounts of money and time on rule compliance, rather than improving the quality of services, products, or efficiency of administration.

As enterprises that have grappled with applying FIN 48 can attest, the cost of compliance has been enormous. In some cases, formulating a single FIN 48 position, depending upon the complexity and importance of the tax position to the enterprise’s

overall financial condition, has run well into the six (or seven) figures in out-of-pocket legal and accounting costs alone. The FASB itself recognized that FIN 48 would impose greater administrative costs on companies than FAS 109 had previously required. The question is whether FIN 48 provides the investing public, creditors, and regulators with informational benefits greater than these added compliance costs.

The basis for the FASB's conclusion that FIN 48's benefits would outweigh its costs was neither scientific nor compelling. The sum and substance of the FASB's cost-benefit analysis is stated as follows in Appendix B to FIN 48:

The Board acknowledges that this Interpretation may increase the costs of applying Statement 109. The expected benefit of this Interpretation is improved financial reporting resulting from a more consistent application of Statement 109 in the recognition of tax benefits. Financial statements of different enterprises will be more comparable because the uncertain tax positions that are within the scope of this Interpretation and their related income tax effects will be accounted for more consistently.

Why, however, should anyone assume that different companies would apply a MLTN standard with any more consistency than they had a probable standard? Why would two companies with the same issue reach the same reserve analysis result? The evidence supporting the FASB's asserted grounds for FIN 48—greater consistency and accuracy—was never apparent from its published materials.

D. Compliance With FIN 48 May Itself Impose Greater Tax Liabilities on Enterprises.

The costs implicit in FIN 48 include the effect upon the enterprise's position in actual or potential tax controversies with the government. As discussed below, FIN 48 compliance generates information that the IRS and other tax collection agencies may

demand be produced to them during tax audits and litigation. Although the FASB was aware that a company's analysis and the auditing of FIN 48 reserves would create documentation enormously intriguing to the government, it was unmoved by any resulting prejudice to taxpaying enterprises.

The FASB sought, as a threshold matter, to downplay the possible harm to companies from the creation of these analysis files by observing that FIN 48 reserves are reported on financial statements in the aggregate and not item-by-item. Of course, this aggregate reporting will hardly deter the IRS or the Department of Justice Tax Division from seeking disclosure of the reserve files relating to any specific income tax position that interests them. If any tax position is "material," the government can simply demand production of the FIN 48 files relating to it.

The FASB further comforted itself with the observation that an unnamed taxing authority in the United States relied upon tax and book reconciliations to identify potential audit issues. That assertion, however, is patently irrelevant in IRS audits, not to mention contrary to the IRS's stated intentions to seek FIN 48 workpapers whenever it deems appropriate.

More to the point, however, the FASB consciously preferred the IRS's interests to those of taxpaying entities as evidenced by the following declaration:

...the Board does not equate a taxing authority with a counterparty in a lawsuit. A counterparty in a lawsuit is acting in its own particular interest, while a taxing authority is acting in the broader public interest in regulating compliance with self-reporting income tax laws.

That assertion, of course, ignores the reality that the IRS, no less than any other litigation “counterparty,” is often fiercely (and unjustifiably) adversarial in asserting “it own particular interest.” Congress and the courts, as arbiters of the tax law, have already given the IRS more than adequate means for obtaining information necessary to defending the integrity of the tax laws, while also recognizing the circumstances in which the government’s desire for information must be tempered by taxpayers’ interests in confidentiality. Exactly why the FASB felt disposed to weigh in on the proper balancing of IRS and taxpayer interests in the context of a tax dispute is unclear.

The unfortunate irony, of course, is that the mere creation of FIN 48 analysis files may induce the IRS to assert deficiencies that it otherwise might not. The company may conclude that an issue does not merit a reserve, but its FIN 48 analysis will often point to the potential grounds for attacking it, nonetheless. Indeed, the more rigorous and honest the analysis is, the more likely it is that the IRS may use it as the basis for asserting a proposed deficiency, if the FIN 48 files are discoverable. Whether or not the FIN 48 analysis results in a reserve, nothing precludes the IRS from using the company’s analysis (and that of its auditors) against it as the basis for a proposed deficiency.

The question whether FIN 48 files are discoverable will likely continue to be litigated vigorously, as evidenced by the recent decision of the federal district court in U.S. v. Textron, Inc., 507 F. Supp. 2d 138 (D. R.I. 2007), appeal pending in the First Circuit Court of Appeals, and IRS’s harsh public response to Textron.

A Department of Justice Tax Division representative has stated that “[i]f management is relying on an opinion for some part of its analysis for the reserve, that

becomes part of what the auditors will insist on seeing....They should not expect confidentiality for opinions that become part of the tax reserve file.” See BNA Daily Tax Report, May 9, 2006, at G-7. Although the Acting IRS Commissioner recently promised that the IRS would not change its “policy of restraint in requesting tax accrual workpapers,” such assurance was quickly qualified by a memorandum issued by the IRS’s Large and Midsize Business Division. See Hanson, Tull, and Singleton, “FIN 48, IRS Enforcement, and the Policy of Restraint, TAX Notes, November 5, 2007. There, the LMSB made clear that it was re-evaluating its “policy of restraint” and that examining agents could ask a taxpayer about the existence and amounts of reserves without a showing of “unusual circumstances.”

Sobering also have been the IRS Chief Counsel’s recent public statements criticizing Textron as wrongly decided and asserting that the decision will not change the IRS’s position on seeking tax accrual workpapers. Consequently, enterprises should assume that the IRS will, whenever it wants, seek disclosure of FIN 48 and other tax accrual workpapers, at least until the courts have established a sufficient body of law to preclude its doing so.

II. FIN 48 is Inadministerable.

Even assuming some palpable need for reporting reform, the question arises whether FIN 48 can be administered in a way that is likely to improve the accuracy and consistency of reporting. For the reasons stated below, the FASB’s belief in the enterprise’s ability to predict the outcome of any disputed application of the tax laws to specific transactions and events is breathtakingly wrong. Indeed, FIN 48 is likely to

generate far greater inaccuracy, inconsistency, and outright confusion than ever existed under the prior reporting rules and practices.

After flirting with a proposed standard that would have required the enterprise to report a reserve for any tax position that did not have at least a 70-75% likelihood of being sustained, the FASB opted for a modified FAS 5 “gain contingency” approach pursuant to which tax positions are treated as generating potential “assets,” rather than potential liabilities. Those assets can be reported on the company’s financial statements only if, after applying the “technical merits” of the position, it is MLTN to be sustained.

As defined in FIN 48, the “technical merits” “derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law),” as well as the taxing agency’s practices and precedents. Absent from those “technical merits,” however, are the factors that are often powerfully determinative of any controversy, tax and non-tax alike, including how the court or jury will (1) resolve disputes regarding the intent, purpose, and characterization of the underlying transaction or event; (2) decide disputes regarding facts occurring over years or decades; (3) assess the credibility of witnesses; (4) apply the law to the facts; and (5) determine the relevance and effect of any non-Code tax contentions, such as the substance-over-form and step-transaction doctrines. All of these factors are weighed in the context of the court’s and jurors’ underlying prejudices and predilections in a case pitting a corporate entity against the IRS.

A tax dispute involves nothing more than or less than a controversy regarding a business transaction, activity, or event that is run through the meat-grinder of the Internal

Revenue Code, rather than, say, the Uniform Commercial Code or the Securities Act of 1933. It involves litigation, pure and simple, regarding often-complex transactions, complete with the uncertainties of proof and the application of the law to that proof. The dispute process is, by its nature, uncertain and imprecise. Disputes are resolved by everyday people applying generic legal concepts to uncertain and disputed facts, not by scientists applying the immutable laws of physics and chemistry in the laboratory. The outcome of a tax dispute is decided in the context of the dispute resolution process, with all of its flaws, burdens, and inaccuracies, and not (as FIN 48 seemingly assumes) in the quiet of the tax law section of a library.

In most disputes, of course, the adverse parties will have radically opposing views of the merits of their respective positions. Each may be absolutely convinced of the righteousness of its position and correspondingly contemptuous of its adversary's. Nonetheless, FIN 48 assumes that one party to the dispute, here the taxpaying enterprise, will have the ability to analyze the merits of its position with an objectivity and foresight that no other litigant could possibly possess in any other type of controversy.

To make the exercise and consequences of predicting tax position outcomes all the more exciting for corporate taxpayers, FIN 48 obligates them and their auditors to analyze and quantify the risks and merits even in the absence of an actual audit or lawsuit. Consequently, without knowing the full contours of a possible IRS/Department of Justice attack on a particular tax position, the enterprise is nonetheless directed to anticipate and evaluate each conceivable argument that the government could formulate.

Any lawyer who purported to predict, with any degree of certainty, the likely outcome of an existing uncertain tax dispute, let alone one that was still purely hypothetical, would be insane. On what basis could the most divining mind conclude that a tax position had, say, a 55% chance of prevailing, rather than only a 45% chance of doing so? Nevertheless, the FASB further assumes that an enterprise can rationally determine the likely terms and range of a settlement with the government, even before the government has begun the audit, let alone formulated a settlement position. FIN 48, however, assumes that such ability exists, with enormous consequences turning on the decisions reached.

Were these threshold MLTN reserve recognition problems not sufficiently impossible, FIN 48, as evidenced by Table A21, magnifies the problem by imposing the added burden upon the company of attempting to apply a sliding scale of percentage probabilities of a successful outcome against a sliding scale of potential additional liability amounts. The assumptions and obligations outlined in the Table transport the enterprise from terra firma into the outer reaches of the ozonesphere.

Enterprises, their auditors, and lawyers can, at best, rationally opine regarding outcomes that are either “probable” winners or losers for FAS 5 gain and loss contingency purposes, but it is fanciful to assume that they can reasonably and reliably predict the outcomes of the vast majority of tax disputes that fall between those extremes and are, by definition, “uncertain.”

Precisely for such reasons, lawyers are barred under the terms of an ABA/AICPA treaty from rendering opinions to an enterprise’s auditors that are any more refined than

whether a loss or win is “probable,” with “probable” again meaning at least a 70-75% degree of certainty. While the ABA/AICPA treaty on tax opinions therefore confines and conforms the lawyer’s opinion regarding any dispute, tax or otherwise, to FIN 5’s “probable” loss or gain contingency rules, FIN 48’s MLTN standard dictates that the lawyer’s client make the very prognostication that no fully-informed, experienced, and skilled trial or tax lawyer can make.

The FASB has never explained why an enterprise can predict the likely outcome of a tax position with any greater precision than it can predict the likelihood of its incurring additional defective product, food and drug, securities reporting, immigration, OSHA, or labor and employment liabilities. Nonetheless, fundamental to FIN 48 is the FASB’s assumption that an enterprise can realistically and accurately handicap the likely outcome of a tax audit of any “uncertain” tax position, though it never explains why tax disputes are more amenable to precise risk analysis than any other potential liability.

The exercise of management’s informed judgment is, of course, routine in all aspects of the company’s affairs. Speculation regarding what might happen to change the calculus of risk for an event that cannot be reliably predicted is, however, a wholly distinct exercise that poses the potential for providing investors, creditors, and regulators with information that is not only useless, but also inherently misleading. Nonetheless, this is precisely the position in which FIN 48 places the company’s management and its auditors, with the consequences for their guessing wrong potentially great.

In adopting the MLTN standard, the FASB took comfort that tax lawyers often render such opinions to clients. What the FASB failed to note, however, is that those

opinions are normally applied to a limited set of assumed facts that the lawyer accepts as reasonable and assumes to be true before the transaction is implemented. In essence, the opinion is premised on facts that assume away most of the uncertainty that accompanies disputed fact-finding and characterizations of the transaction after it has occurred and become subject to audit. It is a wholly distinct proposition, however, to render a MLTN opinion regarding the merits of the enterprise's tax position **after** the transaction has been performed, often over a period of several years, and the position has become contested and "uncertain." The FASB ignored the context in which MLTN tax opinions traditionally have been given and why that standard cannot be applied with any similar confidence to a completed transaction.

FIN 48 compounds the uncertainty and burden of applying its MLTN standard by imposing a continuing obligation upon the enterprise to recognize and de-recognize disputed tax positions based upon the relevant facts as they become known over time to management. Under FIN 48, the enterprise must recognize or de-recognize the tax treatment of any previously-reported position as of the reporting date for the period in which its understanding of the facts warrants a change in its calculus of whether the position is MLTN to be sustained. In so stating, however, the FASB ignores the Form 8-K disclosure obligations of public companies to report promptly any event that may materially affect the enterprise's financial condition, including tax controversies.

FIN 48 also ignores the reality that a tax audit and any resulting litigation can endure for five to ten years or longer and involve the study of tens of thousands of documents and the debriefing or examination of numerous witnesses. Management may

take genuine comfort in the merits of its position on Day One when the court denies the government's motion for summary judgment. On Day Two, however, a witness testifies adversely to the enterprise's position. On Day Three, another witness destroys the credibility of the prior witness. On Day Four, the IRS increases the enterprise's exposure by assessing a 20% accuracy-related penalty on the asserted ground that the tax position purportedly lacks "substantial authority." On Day Five, the IRS issues a revenue ruling relating to an analogous transaction that the enterprise deems favorable to its position. The dispute is, in short, a dynamic aggregation of numerous positive and negative events (for both taxpayer and tax collector alike) until it ends.

The burden of this exercise aside, the constant re-assessing of the merits of the company's MLTN conclusions is fundamentally unhelpful, and potentially misleading, to those who rely upon the enterprise's financial statements. What is unreserved today may be reserved for tomorrow, and unreserved again the following day. The effect of any particular development in the dispute may be transient and inconsequential in the light of later developments, but is necessarily magnified under a MLTN standard. Were a company to apply this recognition/de-recognition requirement literally, readers of its financial statements might reasonably wonder whether it has a clue regarding the merits and likely outcome of the dispute, as they witnessed the shifting assessments of the case over the months and years of the controversy.

Under a FAS 5 loss contingency approach, however, these day-to-day developments would not mandate constant review and consideration because only a truly significant development or series of events could alter a prior "probable" conclusion.

Because the MLTN standard is far more sensitive and elusive than a “probable” standard, however, FIN 48 heightens the potential significance of any dispute-related event, rather than only those that are demonstrably important to the likely outcome.

In imposing these obligations, FIN 48 opens the door, as it never was in the past, to shareholder, creditor, and/or regulatory agency second-guessing and litigation in the event that the company and its auditors guess incorrectly regarding their tax liability reserve assessments. For example, Paragraph 21d of FIN 48 requires disclosure of the (1) nature of any potential uncertainty regarding the need for a change in a reported position within the next 12 months; (2) the nature of the event that might cause the change; and (3) an estimate of the range of the potential change. Whenever a public company makes these disclosures, it can expect skeptical inquiries from the SEC and shareholders seeking explanations why those uncertainties and events were not disclosed earlier.

Of course, these Paragraph 21d disclosures are also must-reading for the IRS in its search for potential tax deficiencies. These disclosures may generate self-inflicted wounds for the company based upon little more than its own speculation regarding future events. Paragraph 21d of FIN 48 thereby poses a healthy dose of potential regulatory, shareholder, and tax-related liabilities for any tax position with some potential for a future change in projected reserves.

III. IN 48 Jeopardizes Taxpayer Privileges in Tax Controversies.

To understand how FIN 48 threatens the enterprise’s position in dealing with the IRS or other tax collecting agencies, we first consider the privileges that have

traditionally applied in connection with the tax compliance and dispute resolution process.³

A. The Attorney-Client Privilege.

The attorney-client privilege protects communications between the client and the lawyer made for the purpose of enabling the lawyer to provide legal advice or other legal services to the client, provided that they intend that the communications will remain confidential and the purpose of the communication is not to further a crime or a fraud. U.S. v. BDO Sideman, LLP, 2005-1 USTC ¶50,264 (N.D. Ill. 2005); U.S. v. Evans, 113 F.3d 1457, 1461 (7th Cir. 1997). Consequently, if an enterprise requests tax law advice from its in-house or outside counsel, the advice is (with some qualifications discussed below) privileged, no less than is any other legal advice communication regarding any other subject.

1. The Lawyer or Client May Retain Accounting Advice Without Losing the Attorney-Client Privilege.

To assist the lawyer in understanding the enterprise's books and records and facilitate the giving of tax advice to the client, the lawyer or client may retain the services of an accountant. In that event, the client's and lawyer's communications with the accountant remain protected by the attorney-client privilege because the accountant is effectively serving as an interpreter who fosters the communications between the lawyer and client. U.S. v. Kovel, 296 F.2d 918 (2d. Cir. 1961). On the other hand, if the lawyer or the client retains an accountant because the client needs accounting or tax return

³ For a further discussion of the applicable privileges available to a taxpayer, see Steven Z. Kaplan, "Privilege Meets Transparency: Can We Practice Safe Tax?", The Tax Executive, May 2006.

preparation services unrelated to the lawyer's rendering of legal advice, the communications with the accountant are not privileged.

If the lawyer communicates with a third-party to increase his knowledge of the transaction, as, for example, when the lawyer confers with an investment banker to understand the terms of a proposed merger, the communications will not be protected under the attorney-client privilege. U.S. v. Ackert, 169 F.3d 136 (2d Cir. 1999). In that case, the lawyer is educating himself to the transaction so that he can later provide legal advice, but his pre-advice information gathering and study is not protected under the attorney-client privilege (though it may well be protected, in whole or in part, under the work-product privilege discussed below).

2. In-House Tax Department Advice.

The courts have adopted a rebuttable presumption that in-house tax department lawyer advice is not privileged on the theory that it is likely “business advice” or “accountant’s work” instead of “legal advice.” U.S. v. Chevron Corp., 1996-1 USTC ¶150,201 (N.D. Cal. 1996); U.S. v. KPMG, LLP, 237 F. Supp.2d 35 (D. D.C. 2002). In such case, the enterprise bears the burden of showing that the advice given by its in-house tax lawyer was the equivalent of tax law advice that it could have received from its general counsel’s office or its outside counsel. Id. Conversely, if the tax advice is given by outside counsel or the enterprise’s general counsel’s office, the rebuttable presumption is that the advice is privileged “legal advice” and not unprotected “business advice” or “accountant’s work.”

3. Tax Return Preparation Advice.

As the foregoing suggests, not all tax-related advice that even an outside lawyer gives a taxpayer is privileged. A lawyer's advice in connection with the preparation of a tax return is not "legal advice" if its nature and content is no different than that which a tax return preparer or tax accountant would give the taxpayer for purposes of preparing a return. U.S. v. Frederick, 182 F. 3d 496, 500 (7th Cir. 1999); U.S. v. Randall, 1999-1 USTC ¶150,596 (D. Mass. 1999); KPMG, supra. Needless to say, the distinction between "legal advice" and "tax return preparation" advice may be difficult to divine in a given case.

B. The Section 7525 Tax Advice Privilege.

Section 7525 of the Code created, as of July 22, 1998, a privilege for tax advice rendered by a non-lawyer tax professional to a taxpayer under conditions in which the same advice, if given by a lawyer, would be protected under the attorney-client privilege. Frederick v. U.S., supra. Congress recognized that the vast bulk of tax advice is given by accountants and not lawyers, but that, at common law, no accountant-taxpayer privilege existed. Section 7525 sought to redress that imbalance in the law of privilege.

The issue arises, of course, whether the accountant's advice is related solely to the preparation of a tax return or is, instead, protected tax law advice of the same type that a lawyer would give to a taxpayer inquiring about the proper tax treatment of a transaction. Moreover, if the advice has a "dual purpose," one being the giving of tax law advice and the other being the giving of tax return preparation advice, Frederick and the cases

following it hold that the communication is not privileged whether it is given by a lawyer or an accountant. U.S. v. KPMG, LLP, 316 F. Supp. 2d 30, 34 (D.C. D.C. 2004).

As Frederick also makes clear, Section 7525 does not create a work-product privilege for the accountant and taxpayer, and it also does not protect an accountant's communications made in the course of promoting a tax shelter. The statute also provides no privilege when the advice is sought in the circumstance of a criminal investigation or prosecution. John Doe v. Wachovia Corporation, 268 F. Supp.2d 627, 636-37(W.D. N.C. 2003).

C. The Work-Product Privilege.

The law recognizes the need for confidentiality whenever a party anticipates that litigation is likely or, after litigation has commenced, begins preparing for trial. See Rule 26(b)(3) of the Federal Rules of Civil Procedure. Actual or potential litigants, whether or not aided by their lawyers, must have a zone of confidentiality in which they can prepare for anticipated litigation and trial without concern that the adverse party can gain access to and obtain a "free ride" on their work product, analyses, and strategies. Hickman v. Taylor, 329 U.S. 495 (1947).

The work-product privilege, unlike the attorney-client privilege, is qualified and not absolute. Consequently, work-product material may become discoverable if the adverse party can show a compelling need for factual information that is not otherwise available to it. If, for example, a party interviewed a potential witness before litigation began and that witness is no longer alive or competent to testify during the litigation, the

adverse party may be able to obtain the party's summary of the factual information that the witness communicated during that interview.

On the other hand, so-called "opinion work-product" that reflects a lawyer's opinions, conclusions, mental impressions, or trial strategies, enjoys a near-absolute privilege and is essentially inviolate. U.S. v. Adlman, 134 F.3d 1194, 1203 (2d Cir. 1998).

D. The Settlement Offer "Privilege".

Rule 408 of the Federal Rules of Evidence makes inadmissible at trial any offers to settle the dispute. Although Rule 408 speaks in terms of excluding such material from evidence at trial, the courts have broadly interpreted Rule 408 in conjunction with the work-product privilege to preclude discovery of a party's internal consideration of a potential or actual settlement offer.

E. The Waiver of Privilege.

Because the need for confidentiality between lawyer and client is the basis for the attorney-client privilege, the presence of a third-party who is not a lawyer or a client during those communications may, as a threshold matter, negate the creation of the privilege.

Likewise, the intentional disclosure by the lawyer or client of a privileged communication to a third-party may also destroy an existing privilege. For example, the client's disclosure of an attorney-client communication to a plaintiff in a shareholder dispute will likely enable the IRS to claim that the privilege has been waived for purposes of a tax audit or litigation. U.S. v. Massachusetts Institute of Technology, 129 F. 3d 681

(D. Mass. 1997); cf., Diversified Indus. v. Meredith, 572 F. 2d 596, 611 (8th Cir. 1978) (adopting a “selective waiver” doctrine that precludes discovery of a party’s privileged information even after it has given it to a government agency).

If, however, the disclosure of a privileged document is unintentional, as may occur in litigation when thousands of pages of documents or massive amounts of electronic data are produced to the adverse party, the privilege may not be lost if the disclosing party was otherwise diligent in its efforts to protect the privileged documents from disclosure.

IV. Privilege and Waiver Problems Arising From FIN 48 Compliance.

A. The IRS Audits the Taxpayer’s Returns.

To understand the privilege problems that FIN 48 presents, we can consider the following hypothetical:

A corporate taxpayer claims various research tax credits on its returns for three years. Before filing its returns, it retained experts who performed studies to help the company determine whether the expenditures qualified for the credits, and, if so, in what amounts. Based on those expert reports and its own study of the facts and law, the taxpayer claimed the credits in the aggregate amount of \$25 million on its returns. The IRS then commences an audit of those credits for those three years.

To represent its interests in the IRS audit, the company retains outside tax and litigation counsel. Those lawyers, in turn, retain additional experts in various disciplines who conduct their own studies and confirm the merits of the reported credits. Counsel also periodically provides the taxpayer with analyses of the strengths and weaknesses of the case, including assessments of the thoroughness and persuasiveness of the company’s

experts' work, a comparison of the quality of that work with the work of the IRS's experts, and the factors that may impact the court's or jury's findings of fact, including the company's overall reputation in the community in which the case could be tried.

Counsel's analyses do not express a percentage likelihood of success on the merits, but conclude that the company's tax position is strong. These analyses include recommendations regarding the pros and cons of filing a refund suit in the company's home jurisdiction and requesting a possible jury trial, versus those of filing a petition with the Tax Court. Counsel notes that the IRS has been adamant in denying the types of research credits at issue and advises the company that a satisfactory settlement with the IRS or the Department of Justice Tax Division may be exceedingly difficult to accomplish.

B. The Taxpayer's Reserve Decision.

Based upon its own assessment of the case, including the analyses it has obtained from its outside counsel, the company determines that its position satisfies the MLTN standard. It therefore creates no FIN 48 reserve for any of the claimed tax credits. It does, however, provide a detailed disclosure in its financial statements regarding the nature and financial consequences of the tax dispute.

C. The Auditors' Information Requests.

The company's auditors have not been involved in the reporting of the tax credits or in the IRS examination. They are now charged, however, with determining whether the financial statements are accurate and, in particular, whether the tax credit dispute is

one that the company is MLTN to win. The auditors recognize that, absent a settlement, the tax credit claims present an all or nothing proposition.

At the outset, the auditors request access to the company's outside tax and litigation counsel's analyses and the reports of all of the experts, including those whom counsel has retained. Counsel's analyses contain, after all, the most detailed and presumably reliable assessment of the strengths and weaknesses of the dispute, along with discussions of how the law may be applied in a bench or jury trial. Any auditing firm would want these materials as part of its FIN 48 due diligence work and review.

D. The Corporation's Dilemma.

The auditor's request, however, poses an enormous problem for the company and its counsel because it raises the question whether production of the legal analyses, expert reports, and related documents in counsel's files and those of the company will lose their attorney-client and/or work-product privileges. If they lose that protection, of course, these materials will become fair game if the IRS or Department of Justice later requests them, and, if discoverable, will afford the government an invaluable insight into the company's candid assessment of the strengths and weaknesses of its arguments and proof. Moreover, the company and its counsel realize that the files the auditors themselves develop as part of their FIN 48 review may become the subject of an IRS summons or a litigation subpoena.

Though aware of the IRS's purported "policy of restraint," the company is also aware of the far less comforting statements from the IRS and Department of Justice personnel that portend future government attempts to reach FIN 48 files.

Against this background, the company and its counsel confront the following questions:

1. If the company produces the requested files to the auditors, will it lose the attorney-client and work-product privileges that protect their highly-sensitive contents, thereby providing the government with a priceless “road map” to the company’s analysis of the strengths and weaknesses of the disputed tax position?

2. Irrespective of whether the opinions and analyses of counsel are provided to the auditors, will the company become exposed to potential shareholder suits if it and its auditors conclude that no reserve is needed, but the case is eventually lost?

3. On the other hand, because a reserve for the total potential liability may negatively affect the market value of the enterprise, will establishing a reserve open the company and its auditors to suit by existing shareholders if the company later prevails on the merits of its tax position?

4. Will the company’s exposure be greater, however, if the analyses and opinions are withheld from the auditors because their review will purportedly be hampered by their lack of access to them? On the other hand, is counsel exposed to potential shareholder and/or any regulatory liability if the auditors do obtain the legal analyses and opinions and rely upon them?

5. If the company refuses to produce all of the files that the auditors request, will the auditors respond by requiring a reserve for all or some part of the potential tax liability?

6. Other than providing the auditors with direct access to the company’s and lawyer’s files, are there other ways to satisfy their information needs?

After weighing all of these concerns, the company declines to give its auditors access to its FIN 48 files or those of its counsel. It does, however, provide them with the expert witness reports, realizing that it will, in any event, likely have to give them to the government in any future litigation. It also conducts meetings at which the auditors ask questions of company personnel and counsel regarding the relevant facts (as then known)

and applicable legal standards, as well as the perceived strengths and weaknesses of the tax position.

The auditors take extensive notes of these meetings for their files, conduct their own review of the relevant business records, and have their own tax lawyers analyze the applicable law and the merits of the case. Essentially, the company leaves it to its auditors to make their own findings and conduct their own legal analysis, albeit with the active assistance of the company and its counsel.

After expending hundreds of hours of review work (and billing the corporation \$500,000 in fees), the auditors conclude that the corporation has the better of the argument. They concur that the corporation's position satisfies the MLTN standard, but also recognize, as do the company and its counsel, that how the government will respond in the impending tax litigation or how the court or jury will react to each side's proof and arguments is uncertain. Somewhat reluctantly, the auditors decide that no reserve is required.

E. The Government Seeks Production of the FIN 48 Files.

After exhausting all settlement efforts within the IRS, the company proceeds to litigation with the government to establish its right to the reported tax credits. The government serves a request for production of documents on the company and a document subpoena on the auditors seeking the contents of their respective FIN 48 files. It also serves deposition subpoenas on the personnel who performed the FIN 48 review for the company and its auditors, respectively.

The files are a treasure trove of lawyer and accountant analyses that highlight every perceived strength and weakness of the case, including the amounts that the company might ultimately be willing to pay in a settlement. The company and the auditors seek protection precluding the production of their FIN 48 files and related workpapers and any reserve-related testimony on the grounds of the attorney-client, Section 7525 tax advice, and work-product privileges.

F. The Textron Decision.

Whether the government can obtain these files likely rests on whether the federal district court in United States v. Textron, Inc., *supra*, correctly applied the rules of privilege and waiver. In Textron, the taxpayer had been frequently audited and, on a number of occasions, had appealed adverse examining agent determinations to the IRS appeals office. On three occasions, the disputes carried over into litigation.

During the audit (which focused on a tax-sheltered transaction), the IRS served a summons on Textron for its “tax accrual workpapers,” defined in the summons as:

all financial workpapers or documents created or assembled by the Taxpayer, an accountant for the Taxpayer, or the Taxpayer’s independent auditor relating to any tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to any footnotes disclosing reserves or contingent liabilities on audited financial statements.

They include, but are not limited to, any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes....

Those “tax accrual workpapers” included opinions of Textron’s counsel regarding uncertainties in the tax law, possible challenges by the IRS, estimates of the likelihood of

Textron prevailing in any litigation, and the dollar amount of the reserve reflecting Textron's possibility of losing in the litigation. In addition to the opinions of its outside counsel, the files also included the opinions of Textron's in-house counsel. The files did not, however, include any transactional documents or business records relating to the tax positions.

The district court found that Textron's purpose in maintaining these "tax accrual work paper" files was to ensure that it had adequately reserved for "any potential disputes or litigation that would happen in the future" and to satisfy its auditors that it had properly reported its contingent liabilities. Textron, 507 F. Supp. 2d at 143. Textron had permitted its auditors to review those files with "the understanding that the information was to be treated as confidential." Id.

1. Attorney-Client Privilege Claim.

The files contained documents that, as a threshold matter, were protected by the attorney-client privilege because they contained legal advice regarding the application of the tax laws to specific transactions. The court concluded, however, that Textron had waived any attorney-client privilege claim by permitting a third-party, here the auditors, to gain access to the opinions of its outside and in-house lawyers. The court observed that the attorney-client privilege must be strictly construed and that any disclosure to the auditors of a communication protected under that privilege destroyed the claim of confidentiality.

2. Section 7525 Tax Advice Privilege Claim.

Because Textron’s auditors had participated in advising it regarding its tax liabilities and resulting reserve obligations, including the hazards of litigation, the court found that they had been performing “lawyers’ work” of the type that Section 7525 protects from disclosure.

Even though that advice related to the auditing of the proper financial reporting of Textron’s treatment of a tax-sheltered transaction, the privilege was not abrogated because Section 7525 denies the privilege only in cases in which the tax advisor was itself a promoter of the tax shelter. Because Textron’s auditors had not been involved in the marketing or promotion of the tax-shelter, that statutory exception did not negate the privilege.

3. Work-Product Privilege Claim.

The purpose of the work-product privilege is “to preserve a zone of privacy in which a lawyer can prepare and develop legal theories and strategy with an eye toward litigation ‘free from unnecessary intrusion by his adversaries’” and to preclude the adversary from taking a “free ride” on the lawyer’s thinking and research. U.S. v. Adlman, *supra*, 134 F. 3d at 1196; Frederick, *supra*, 182 F.3d at 500.

The court concluded that the tax accrual files were protected work-product because the taxpayer had prepared them in anticipation of future litigation with the government. Maine v. Dept. of the Interior, 298 F. 3d. 60, 68 (1st Cir. 2002). Here, “but for” the anticipated IRS challenge to Textron’s uncertain tax positions, it would not have generated the files.

The court rejected the IRS's contention that the reason for the creation of the files had not been to prepare for litigation, but only to permit the auditors to review Textron's liability reserves and financial statements, a purpose that was not "in anticipation of litigation." The court rejected that contention, finding that Textron had created the documents "because" of anticipated litigation. Here, because the tax position was likely to be challenged, the court determined that litigation was anticipated.

The court in Textron also perceived, of course, the inherent unfairness of granting the government access to files that would disclose the company's, lawyers', and auditors' perceptions of the strengths and weaknesses of the case, the very reason for application of the work-product privilege. Because Textron had given the auditors access to the files solely for liability reserve and tax advice purposes and the auditors had agreed to keep the files confidential, the court saw no reason to deny the privilege for tax dispute and litigation purposes.

Although the FASB assumed that the government might well obtain FIN 48 files, Textron ironically converts the "uncertainty" of the disputed tax position and the likelihood that such uncertainty would result in future litigation into the grounds for applying the Section 7525 tax advice and work-product privileges.

V. Conclusion.

The district court's decision in Textron notwithstanding, there is no assurance that the First Circuit Court of Appeals will affirm it. Even if it does so, the public (and surprisingly defiant) comments from the IRS regarding the purported errors in the Textron decision evidence the government's commitment to continued litigation with

taxpayers in other district courts and courts of appeal over “tax accrual workpapers,” including FIN 48 files.

Communications between companies, their lawyers, and their auditors have always posed disclosure risks in the context of tax controversies. FIN 48 has, however, raised the stakes exponentially because it mandates far more refined and detailed tax liability analysis than was necessary under FAS 5’s loss contingency rules. Indeed, precisely because the company’s and auditors’ workpapers address the perceived strengths and weaknesses of an “uncertain” tax position in detail, FIN 48 has triggered the IRS’s reconsideration of its previously adopted “policy of restraint” regarding the disclosure of “tax accrual workpapers,” an issue that had largely laid dormant for years.

While the dispute regarding the discoverability of tax reserve files works its way through the courts, companies must continue to pay careful attention to what they and their counsel communicate to the auditors. The goal must be to permit all participants in the reserve analysis process to satisfy their information-gathering responsibilities and reserve analysis needs, while doing so in a manner that will maintain the maximum claims of privilege if and when the government comes knocking in a tax dispute.

If the government prevails in the courts, in-house tax professionals, their counsel, and their auditors will have the unhappy experience of witnessing their own work-product being used against the company. It they may succumb to the inclination to dampen down the explicitness of the opinions and analysis they commit to writing, thereby creating a host of potential other regulatory and shareholder liability issues.

In FIN 48, the FASB has handed companies a mountain. Aside from cursing the darkness, however, they may find it productive (and therapeutic) to light a candle by working through their professional associations to communicate their concerns to the FASB. No doubt, that effort will confront resistance, but the hope must be that the FASB will, in time, objectively assess whether FIN 48 has accomplished its stated purposes. In that effort, the FASB should strongly weigh the views of its international counterpart, the IASB, in determining whether a FIN 48 standard is beneficial and realistically administerable.

Until that re-evaluation might occur and the government sees wisdom in adopting more enlightened reserve analysis discovery policies than it has been willing to embrace publicly, coping with FIN 48 will be a difficult way to make a living.

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