

# Best Practices for Creating, Maintaining, and Protecting State Income Tax Audit Files

By Pilar Mata and Richard C. Call

## Introduction

This decade has brought significant change to the legal landscape facing large, multistate taxpayers. The Sarbanes-Oxley Act of 2002 created sweeping rules that increased financial oversight and forced taxpayers to reevaluate the provision of non-audit services by public accounting firms. Management must now evaluate income tax positions for financial statement purposes using the heightened more-likely-than-not standard of *FASB Interpretation No. 48* (FIN 48). These changes have led taxpayers to create and maintain more detailed documentation to support their income tax return positions.

As the volume of tax-related documentation has increased, taxpayer expectations of maintaining any protection from the disclosure of those documents have eroded to the point that many taxpayers now assume that all documents must be turned over in the context of state tax litigation. The First Circuit's recent decision in *United States v. Textron*<sup>1</sup> has furthered this perception. Work-product protection, however, remains a fundamental component of the American judicial system and qualifying documents can retain protection — even in the context of state taxation.

## Background: The Attorney-Client Privilege and Work-Product Privilege

In recent years, numerous courts have considered the extent to which confidential information may be protected from disclosure to the Internal Revenue Service (IRS). Case law interpreting the scope of the federal attorney-client privilege and work-product privilege provides a starting point for taxpayers seeking to protect information during a state tax audit.<sup>2</sup>

### A. Federal Attorney-Client Privilege

The attorney-client privilege protects confidential communications between a client and the client's attorney made for the purpose of providing the client with legal advice.<sup>3</sup> The purpose of the attorney-client privilege is to encourage open and candid communications between the attorney and his or her client.<sup>4</sup> Only communications pertaining to the legal advice — as opposed to the underlying facts discussed — are protected by the privilege.<sup>5</sup>

The attorney-client privilege is generally waived if the communication is disclosed to third persons without the need to know such information.<sup>6</sup> Communications within a company generally will not constitute disclosure if the communications are limited to employees with a substantive need for the information.<sup>7</sup> Disclosure to employees who do not have a need to know such information, however, may waive the privilege.

The attorney-client privilege will not be waived simply because the communication is disclosed, in confidence, to an external non-

lawyer if the purpose of that communication is to assist the attorney in providing legal advice. If the disclosure is made for another purpose — for example, to aid external auditors in a financial statement audit — the privilege will be waived.<sup>8</sup> This limitation on the attorney-client privilege materially affects how taxpayers should treat state tax audit files.

### B. Federal Work-Product Privilege

While the attorney-client privilege is intended to protect communications between a client and his or her attorney, the work-product privilege is designed to protect the adversarial process. Rule 26(b) of the Federal Rules of Civil Procedure codifies the federal rule, which was articulated by the Supreme Court of the United States in *Hickman v. Taylor*.<sup>9</sup> Rule 26(b)(3) provides, in relevant part:

- (A) **Documents and Tangible Things.** Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:
  - (i) they are otherwise discoverable under Rule 26(b)(1); and
  - (ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.
- (B) **Protection Against Disclosure.** If the court orders discovery of those materials, it must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation.

Unlike the attorney-client privilege, work-product protection is only waived by disclosure to an adversary or a conduit to a potential adversary.<sup>10</sup>

What constitutes documentation prepared "in anticipation of litigation" (as used in Rule 26) is perhaps the most important question with respect to the work-product privilege, and the federal circuit courts are split as to the appropriate test for making this determination. At least one circuit has applied a narrow "primary motivating purpose" test.<sup>11</sup> This standard provides that in order to obtain protection, the document must be created primarily to assist in future litigation. Thus, the "primary motivating purpose" test considers the most important reason for generating the document and only protects documents that are primarily created for litigation.<sup>12</sup>

Most other federal circuits have adopted the "because of" test.<sup>13</sup> The "because of" test generally examines whether the document was created because of potential or anticipated litigation, and pro-

vides that the protection will not be waived simply because the document was created for purposes that are in addition to potential or anticipated litigation.<sup>14</sup> Thus, so-called dual purpose documents are entitled to protection under this standard.

In the recent case of *United States v. Textron*, the First Circuit purported to apply the “because of” test but interpreted the test in a manner that provides even less protection than the “primary motivating purpose” test.<sup>15</sup> The court held that Textron’s tax accrual workpapers did not constitute documents prepared in anticipation of litigation because the documents were not “case preparation materials” and “were not prepared for use in possible litigation.”<sup>16</sup> The *Textron* decision was followed by a hearty dissent, criticizing the majority for articulating a new legal standard and calling upon the Supreme Court “to intervene and set the circuits straight” on the issue.<sup>17</sup> In December 2009, Textron filed a petition for certiorari with the Supreme Court providing an opportunity for the Court to address the split of authority between circuits on the appropriate test for what constitutes “in anticipation of litigation.”

### C. Multiple States – Multiple Doctrines

Although federal work-product protection has received much attention, taxpayers should be aware that states have enacted and interpreted several different types of state law work-product protection. For example, some states, such as New York and California, have codified work-product protection rules that are more expansive (and taxpayer friendly) than the federal rule. For example, California’s rule states that writings reflecting attorney impressions and conclusions are “not discoverable under any circumstances”<sup>18</sup> and that other “attorney work-product is not discoverable.”<sup>19</sup> Similarly, New York law provides that “[t]he work product of an attorney shall not be attainable.”<sup>20</sup>

Other states, such as Massachusetts, adopt a statutory standard that is substantially similar to the federal rule and have applied the rule in a manner that mirrors various federal court decisions. For example, the Massachusetts Supreme Judicial Court recently held that the more common, traditional “because of” standard should be used when applying the work-product privilege and concluded that a memorandum prepared to advise the company’s in-house tax attorney of the “pros and cons of the various planning opportunities and the attendant litigation risks” was entitled to protection because the company had the prospect of litigation in mind when such advice was requested.<sup>21</sup> The court reached this conclusion even though the taxpayer requested the analysis in order to make an “informed business decision” that turned upon the likely tax consequences of the proposed transaction. Although the Massachusetts Supreme Judicial Court looked to federal case law in making its decision, federal case law remains only persuasive authority for states that have codified work-product protection in a manner similar to the federal rule. This distinction may be important for Massachusetts taxpayers because the Court relied, in part, upon a prior *Textron* decision that has since been overturned.<sup>22</sup>

Finally, some states have adopted an extremely narrow work-product standard. For example, Illinois law provides: “[M]aterial prepared by or for a party in preparation for trial is subject to discovery only if it does not contain or disclose the theories, mental

impressions, or litigation plans of the party’s attorney.” In other words, Illinois only protects opinion work-product of an attorney prepared “for trial.” It may not protect a non-lawyer’s theories or mental impressions.<sup>24</sup> Thus, Illinois’s rule resembles the test applied in *Textron*.

## Best Practices

It is not practical to develop a “one-size fits all” approach for creating and maintaining state income tax audit files. Thus, taxpayers should consider a set of best practices in tailoring their own conduct. The underlying goal of these proposed practices is three-fold: to create a robust audit file, to aid the taxpayer in litigation, and to protect the taxpayer’s confidential legal analyses.

### 1. Start Internally — Identify Internal Roles, Responsibilities, and Procedures

A major difficulty faced by tax departments is workload. Budget allocations for state tax planning, compliance, and controversy may be significantly smaller than the resources needed for these efforts. Regrettably, efforts to combine or shortcut these processes may increase the chance that the attorney-client privilege or work-product protection will be lost.

With this in mind, an important best practice is to assign the right tasks to the right people, and to educate employees regarding the requirements for asserting the attorney-client privilege and work-product protection. Three primary tasks may generate or involve confidential tax documentation: planning, compliance and controversy, with some actions falling into more than one category. Accordingly, adherence to all generally applicable rules for each relevant category will maximize the potential for protection.

**Planning:** Planning refers to the analysis that is performed before or in connection with the execution of a transaction or the issues associated with a corporate structure.

Because planning documents are generated in connection with a transaction or corporate restructuring, legal analyses created during the planning process may not constitute documents prepared “in anticipation of litigation” or “trial” under a more narrow interpretation of the work-product privilege. Accordingly, taxpayers should plan to protect planning analyses pursuant to the attorney-client privilege. Where possible, such documents should be created by counsel, designated as an “Attorney-Client Privileged Communication,” and stored in electronic and physical files that are restricted to personnel with a need for such information. They should only be disclosed to persons with a need to know such information, and should not be disclosed to independent auditors.

Separate files should be created for documents that are not protected by the privilege. The content of these files should include all documents that may be relevant to demonstrate and document the taxpayer’s position if the matter were to proceed to litigation. For example, the taxpayer should retain copies of all relevant contracts and correspondence relating to the transaction. Where appropriate, the taxpayer should document the purpose, intent, and facts of the transaction with internal memoranda that will serve as contemporaneous documentation. The taxpayer should retain press releases that discuss the intent behind the transaction. Documents present-

ed to the board of directors and other decision-makers, and board minutes also should be preserved in these files.

**Compliance:** Compliance refers to activities relating to the preparation of the taxpayer's tax returns and financial statements. Compliance documents often contain information documenting the taxpayer's filing position and the manner in which such calculations have been determined.

To the extent that compliance documents involve legal analyses or the taxpayer's assessment of legal issues, such documents should be prepared by attorneys to maximize potential protection. Such documents should be designated as "Attorney-Client Privileged Communication" and "Attorney Work Product." They should be disclosed only to employees with a need to know such information and stored in restricted electronic and physical files. If such documents are disclosed to independent auditors, the attorney-client privilege will be lost and work-product protection may be compromised in certain jurisdictions.

Taxpayers should not seek to protect documents that do not involve legal analyses or assessments. Non-privileged compliance documents commonly include the tax return, schedules, workpapers, and internal memoranda documenting the manner in which certain transactions are reported, and may be subject to discovery. Non-privileged compliance documents should be segregated from other, privileged compliance documents to ensure that protected documents are not inadvertently produced.

**Controversy:** Controversy involves all phases of an audit, administrative or judicial proceeding, and activities conducted in anticipation of these proceedings. To the extent taxpayers have not already done so in connection with the planning or compliance processes, separate files should be created for all documents that are not protected by privilege or the work-product privilege. Documents generated during the controversy process may be protected under the attorney-client privilege and work-product privilege and should be prepared by a lawyer or at the direction of the lawyer, and be designated as "Attorney-Client Privileged Communication" and "Attorney Work Product." Controversy documents should be disclosed only to persons with a need to know such information and stored in restricted electronic and physical files. If such documents are disclosed to independent auditors, the attorney-client privilege will be lost and the work-product protection may be compromised in certain jurisdictions.

## 2. Define Roles and Responsibilities for Consultants

Information shared with consultants who assist the attorney in providing legal advice will be protected by the attorney-client privilege. Thus, in addition to defining roles, responsibilities, and practices for maintaining documentation internally, taxpayers should communicate the company's objectives to consultants if they will be exposed to confidential information.

For example, in the event the attorney determines that an external consultant, such as an economist, will aid the attorney in rendering legal advice, the attorney should retain the consultant directly. This relationship should be established before any work is performed by the consultant in order to make it clear that the consultant is aiding the lawyer in providing legal advice, rather than

providing separate, non-legal services.

The attorney should specify the consultant's role in the engagement and limit the consultant's responsibilities to activities that pertain specifically to the consultant's area of expertise. If the consultant performs other, non-legal services for the client, all communications and invoices should segregate the two services and they should be covered by separate engagement letters. If outside counsel engages an external consultant, the consultant should bill the attorney rather than the client for services related to the legal engagement.

Although the attorney is not required to be involved in every communication between the consultant and the client, the attorney should oversee all communications between the consultant and the client. The consultant should only be provided with confidential information that is necessary for the consultant to perform his or her responsibilities.

Finally, all communications, whether written and oral, with an expert who will testify at trial will be subject to discovery. Therefore, a separate expert should be employed if it is necessary to protect communications with a consultant.

## 3. Prepare and Communicate a Work-Product Protection Plan for External Auditors

Given the IRS's efforts to obtain access to material from accounting firms, taxpayers, tax advisers, and external auditors understand the importance of work-product protection at the federal level. However, given the many state variations of the work-product privilege, the same understanding does not exist regarding the scope and breadth of state work-product protection.

This uncertainty can be addressed by creating a work-product protection plan and meeting with external auditors to educate them regarding the sensitivity of protecting documents at the federal and state level, to establish mutual expectations, and to provide procedures to resolve issues that may arise.

The work-product protection plan should address specific issues, such as the type of documentation that is available, the personnel involved in establishing and reviewing confidential information, and procedures for accessing the company's documentation. It is important to discuss these issues in advance, not only for maintaining protection, but for resolving unforeseen, potentially contentious issues that may arise in the course of preparing financial statements.

## 4. Narrow the External Auditor's "Ask"

External auditors are charged with the responsibility for reviewing the adequacy and reasonableness of the taxpayer's reserves. As a result, external auditors benefit from all information in the company's possession that addresses state tax positions and the company's financial reporting position, and will request to see "all" of the company's documents pertaining to state tax issues. The external auditor's desire for this information must be balanced against the company's need to protect confidential documentation. Thus, the taxpayer should counter broad requests for information that the external auditor may "want" with the information they actually "need."

The taxpayer should not provide the external auditor with information for which the taxpayer expects to claim privilege or protection. The taxpayer should thus work with the external auditor to explore whether other information might satisfy the auditor's request for supporting documentation. For instance, rather than providing copies of state tax opinions, it is becoming a common practice to arrange for conference calls with state tax advisers who have prepared opinion letters for the purpose of discussing the state tax issues.

#### **5. Limit Details Presented in Documents That May Not Qualify for the Work-Product Privilege under *Textron***

Taxpayers generally take two approaches when preparing documentation in support of their financial statements. The first approach includes all information necessary to analyze the taxpayer's position for litigation purposes. This approach is grounded on the theory that an all-inclusive analysis is more likely the type of documentation that is prepared in anticipation of litigation, and thus serves a purpose broader than documenting the basis for the taxpayer's financial reporting position.

The second approach, which adopts a more protective stance, limits the information provided to external auditors to the minimum amount necessary to secure the auditor's sign off on the taxpayer's financial statements. This approach protects against the risk that there will be no protection. In light of the various state forms of the work-product privilege and the *Textron* decision, it is more prudent to limit information provided to the external auditor.

For example, tax accrual workpapers typically include a memorandum analyzing the strengths and weaknesses of the taxpayer's position and a schedule listing the uncertain positions and the taxpayer's likelihood of prevailing on each issue. A memorandum analyzing the strengths and weaknesses of the taxpayer's position is more likely to constitute a "case preparation material" protected under the work-product privilege in *Textron* compared with a spreadsheet listing various potential liabilities and probabilities of success. These documents should be prepared and maintained separately, and the information contained in the spreadsheet should be summary in nature. Thus, even if the summary document is disclosed, the more thorough analysis of the strengths and weaknesses of the taxpayer's position will be protected.

#### **6. Maintain Company Documents on a State-by-State and Issue-by-Issue Basis**

The disclosure of attorney-client communications will waive the attorney-client privilege. Moreover, protection under the work-product privilege will be lost if the documents are disclosed to adverse or potentially adverse parties. Both of these factors militate toward limiting the disclosure of information. We thus recommend that taxpayers create separate documents addressing questions on a state-by-state and issue-by-issue basis.

For example, assume that a taxpayer is assessing its economic nexus position and a business/nonbusiness position in 10 states, including California and New York. If the taxpayer creates a single analysis that addresses its economic nexus position in all states, and the external auditor requires more information regarding the

taxpayer's position in New York for financial statement purposes, the analyses for all states will have been disclosed, putting the taxpayer at risk of losing work-product protection for all states, including California. Similarly, if the taxpayer prepares an analysis addressing both its economic nexus and business/nonbusiness positions in California, and the external auditor requires more information regarding the taxpayer's economic nexus position only, the taxpayer is at risk of losing its protection for both issues. Such unnecessary waivers can be avoided by creating separate analyses.

#### **7. Limit Information Contained in the External Auditor's Workpapers**

The company and external auditor also should agree upon the types of documentation that will be generated by the external auditor during the course of the audit. The ultimate goal of work-product protection is to prevent an adversary from obtaining access to the company's legal analysis, strategies, and theories. This objective will be thwarted if outside auditors memorialize sensitive details regarding these issues in their workpapers, notes, memoranda, spreadsheets, or correspondence, because the external auditor's workpapers are not entitled to protection under the attorney-client privilege or work-product protection.

Furthermore, at least one court has determined that the disclosure of the taxpayer's tax accrual analysis via the external auditor's workpapers may waive work-product protection for the tax accrual workpapers.<sup>25</sup> This possibility underscores the desirability of limiting the information presented in workpapers generated and retained by external auditors.

#### **8. Control Access to Documentation**

When it is necessary to provide documents to external auditors, access should be temporary and controlled. An agreement should be reached between the taxpayer and external auditors regarding the type and quantity of information needed by external auditors. Auditors should not be permitted to retain originals or copies of the documents in their files unless previously agreed to by the taxpayer. If an extranet or other electronic medium is used to provide the documents, the system should permit only temporary viewing and not enable users to download, copy, or modify documents. Furnishing computers to visiting auditors for viewing purposes provides a means to ensure that electronic copies of documents are not retained or circulated.

Documentation that is provided to the external auditor will no longer be entitled to protection under the attorney-client privilege. Accordingly, the company should evaluate whether the document qualifies for protection under the work-product privilege before allowing external auditors to view such information.

#### **9. Maintain a Log for Information Provided to Third Parties**

This recommendation pertains to information provided to both the external auditor as well as state tax auditors. Companies should maintain a log of all information provided to external auditors reviewing the company's financial statements, as well as a log of information provided to state tax auditors. This documentation will enable the taxpayer to demonstrate to whom, why, and

when information is disclosed to third parties and when copies of documents have been made. These steps will undergird claims of attorney-client or work-product privilege and enable the company to track issues that state tax auditors have examined and the documents upon which they base their conclusions. Thus, the information contained in these logs will be useful to any company intending to litigate an issue.

### 10. Request the State Tax Audit File at the Completion of the Audit

Finally, the taxpayer should request a full copy of the auditor's file once the state tax audit is complete. The audit file is far more comprehensive than the final audit report, and should contain useful information including the facts determined by the auditor and the auditor's analysis of the issue. This information should help narrow and focus the issues in dispute as the matter proceeds to litigation.

### Conclusion

Although the *Textron* decision may ultimately be overturned, the extant decision should give taxpayers pause and prompt a reexamination of practices and procedures used to maintain state tax audit files. Following the foregoing best practices may strengthen the ability to protect confidential information while creating robust audit files that will both satisfy auditors' requests for information and strengthen the taxpayer's litigation position. 

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1. *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009), *vacating* 507 F. Supp.2d 138 (D.R.I. 2007), *petition for cert. filed*, 78 U.S.L.W. 3375 (U.S. Dec. 24, 2009) (No. 09-750).
2. Congress has enacted a tax practitioner privilege, which provides federally authorized tax practitioners and their clients protection similar to the attorney-client privilege, and subject to the same limitations as

the attorney-client privilege. I.R.C. § 7525. Some states, such as California, have enacted a state tax practitioner privilege that mirrors the federal privilege. Cal. Rev. & Tax. Code §§ 7099.1; 21028. Importantly, this privilege may not provide protection under the work-product privilege for federal and state practitioners. As such, the benefits of the tax practitioner privilege are limited.

3. *See United States v. Amerada Hess Corp.*, 619 F.2d 980, 986 (3d Cir. 1980).
4. *Id.*
5. *See Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).
6. *United States v. Textron Inc.*, 507 F. Supp.2d 138 (D.R.I. 2007).
7. *See United Investors Life Ins. v. Nationwide Life Ins.*, 233 F.R.D. 483, 489 (N.D. Miss. 2006).
8. *See United States v. Kovel*, 296 F.2d 918, 922 (1961).
9. 329 U.S. 495 (1947).
10. *See, e.g., Rockwell Intern. Corp. v. United States Dep't of Justice*, 235 F.3d 598, 605 (D.C. Cir. 2001).
11. *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982).
12. *Id.*
13. *Maine v. United States Dep't of Interior*, 298 F.3d 60, 68 (1st Cir. 2002); *Equal Employment Opportunity Commission v. Madison*, 2007 U.S. Dist. LEXIS 70647 (W.D. Wis. 2007).
14. *Id.*
15. *United States v. Textron Inc.*, 2009 U.S. App. LEXIS 18103 (1st Cir. 2009).
16. *Id.*
17. *Id.*
18. Cal. Cd. Civ. P. § 2018.030(a).
19. Cal. Cd. Civ. P. § 2018.030(b).
20. N.Y. Civ. Prac. L. & R. § 3101(c).
21. *Commissioner v. Comcast Corp.*, 901 N.E.2d 1185 (Mass. 2009).
22. The U.S. District Court for the District of Rhode Island had applied the broader, traditional "because of" test holding that *Textron's* tax accrual workpapers were protected from disclosure under the work product privilege. *United States v. Textron Inc.*, 507 F. Supp.2d 138 (D.R.I. 2007). A panel of the U.S. Court of Appeals for the First Circuit affirmed the District Court's ruling. *United States v. Textron Inc.*, 553 F.3d 87 (1st Cir. 2009). Upon a rehearing of the case by the full First Circuit *en banc*, the panel's decision was reversed by a decision in which the narrower "because of" litigation test described above was applied. *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009), *vacating* 507 F. Supp.2d 138 (D.R.I. 2007). The Massachusetts Supreme Judicial Court relied on the now overturned panel decision of the First Circuit, and not the opinion of that court *en banc*.
23. Ill. Sup. Ct. R 201 (2009).
24. *See Mlynarkshi v. Rush Presbyterian St. Luke's Medical Center*, 572 N.E.2d 1025 (Ill. Ct. App. 1991).
25. *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009), *vacating* 507 F. Supp.2d 138 (D.R.I. 2007).