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MOFO
INTERNATIONAL TAX DISPUTES INSIGHTS

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IN THIS ISSUE

WELCOME TO MOFO'S INTERNATIONAL TAX DISPUTES INSIGHTS NEWSLETTER

Our inaugural issue focuses on a truly transnational and important rule of law: the attorney-client privilege and related protections against disclosure. While this is a topic common to all areas of law, the tax arena at times generates important discussions and developments such as in the cases we discuss herein. In the United States, two decisions, *Microsoft* and *Sanmina,* offer especially dynamic opportunities to consider the contours of the privilege and other American protections. In the United Kingdom, *Sports Direct Group* considers the application of a specific type of protection, the litigation protection, similar to the work product protection in the United States. The rules of privilege and work product are essential features of legal systems that utilize adversarial efforts to produce just resolutions. Without such protections, persons subject to the law would be reluctant to obtain advice from counsel and hesitant to carry on a robust discussion of competing legal positions leading up to a dispute. Such protections are all the more important the more complex and onerous a legal system is.

As with this issue, our future issues will focus on important tax controversy developments around the world to assist taxpayers on a global scale.

MICROSOFT AND *SANMINA* – CAUTIONARY LESSONS FOR SUCCESSFULLY PROTECTING NON-ATTORNEY-PREPARED DOCUMENTS

Last year witnessed two significant tax decisions in the United States addressing privilege and related issues. The first, *United States v. Microsoft Corp.*,[1] dealt with the taxpayer's opposition to documents sought by Internal Revenue Service (IRS) examining agents in the course of a multibillion-dollar transfer pricing audit. The second, *United States v. Sanmina Corp.*,[2] involved a similar procedural dispute in the context of an audit of a $503 million worthless stock deduction. In each case, the IRS sought documents relating to the consideration of, and preparation leading up to, the taxpayers' determination to report items of income and loss on their respective returns. A key common factor was the material involvement of non-attorneys in the preparation of the documents at issue and the impact of that involvement on attorney-client privilege and work product protection. We first give an overview of work product as an aid to the case discussion.

OVERVIEW OF WORK PRODUCT DOCTRINE

Under Federal Rule of Civil Procedure 26(b), work product protects documents and tangible things from discovery if they are prepared (1) in anticipation of litigation (2) by a party or that party's representative. Thus, materials prepared by a party itself or by agents for the attorney as well as those prepared by the attorney are protected under this doctrine. A document created expressly to prepare for litigation (e.g., a draft brief to be filed in court) easily qualifies as protected by work product. However, there is no requirement that a party be in active litigation or even on the cusp of litigation for a document to be prepared in anticipation of litigation.

In the tax context, work product can arise even before a return is filed. The Second Circuit in *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), acknowledged that a transactional pre-return document prepared by the taxpayer's outside accounting firm could be prepared in anticipation of litigation and entitled to work product protection, notwithstanding non-litigation purposes for the document, e.g., facilitating the implementation of a business transaction.

The Ninth Circuit followed *Adlman* in *United States v. Torf* (*In re Grand Jury Subpoena*), 357 F.3d 900 (9th Cir. 2003), in which a private investigator prepared documents to assist a company under investigation by the Environmental Protection Agency (EPA). Unrelated to the investigation, the business responded to an EPA CERCLA information request using these documents to frame its response. The Ninth Circuit concluded, properly, that the documents did not lose work product protection because they had been used for a non-litigation purpose (i.e., the CERCLA request). The "threat [of litigation] animated every document Torf prepared" at the direction of their attorney, and that litigation purpose was inextricable from the non-litigation purpose. Where a document has a dual purpose, most courts focus on whether the document was prepared "because of" the potential litigation, regardless of whether the document's primary purpose was litigation-related or not. If so, a dual purpose document would be treated as having been prepared in anticipation of litigation and thus deserving protection as work product. *See, e.g.*, *Roxworthy v. United States*, 457 F.3d 590 (6th Cir. 2006) (finding work product protection applied to tax memoranda created by KPMG with analysis of insurance loss transaction and discussion of IRS challenges thereto, despite business use of the memoranda).

MICROSOFT – A JUDGE MISDIRECTED

In *Microsoft*, a Puerto Rican manufacturing subsidiary of Microsoft Corporation (Microsoft) faced closure in 2004 due to an expiring tax credit that would significantly reduce the subsidiary's profits upon expiration. Microsoft considered how it might protect its subsidiary's profits through application of other tax benefits. Microsoft retained KPMG to assist. Ultimately, Microsoft decided to enter into a cost-sharing arrangement with its subsidiary whereby the subsidiary, in return for payment, would acquire a license to certain intellectual property that would enhance the subsidiary's manufacturing capabilities, increase its profitability, and reduce Microsoft's overall tax burden. KPMG provided Microsoft tax consulting services, including a feasibility analysis to enable Microsoft to understand the potential tax benefits of the cost-sharing arrangement. Moreover, Microsoft entered into an arrangement with KPMG pursuant to which KPMG was to provide Microsoft's in-house counsel, Mr. Boyle, with tax advice so that he could provide legal advice to Microsoft.[3] Furthermore, Microsoft stated that it anticipated an IRS audit and

1 125 AFTR 2d 2020-547, 2020 U.S. Dist. LEXIS 8781 (W.D. Wash. Jan. 17, 2020).

2 968 F.3d 1107 (9th Cir. 2020).

continued on page 3

dispute over the cost-sharing arrangement and that the materials received from KPMG were prepared in anticipation of such a dispute. True to Microsoft's expectation, the IRS subsequently opened an audit and focused on the cost-sharing arrangement.

In the course of its audit, the IRS issued a series of administrative summons for 174 documents relating to the KPMG consultation process and to the implementation of the cost-sharing arrangement. Microsoft ultimately agreed to provide one of those documents but asserted various objections to disclosure of the remaining documents based on work product protection, attorney-client privilege, and Internal Revenue Code section 7525 tax practitioner privilege (Section 7525 privilege). The IRS filed suit in federal district court to enforce the summons. Microsoft, as the party seeking protection, bore the burden of proving these various protections. To carry that burden, Microsoft produced a log which categorized each document and explained the basis for protection.[4]

While the court's assessment of the attorney-client and Section 7525 privileges was relatively straightforward, its consideration of the scope of the work product protection was analytically dubious. The court correctly repeated the dual purpose rule adopted in the Ninth Circuit and agreed that "Microsoft anticipated ligation *because* it was electing to take an aggressive tax strategy that it knew was likely to be challenged by the government" (emphasis in original). In fact, the district court stated, Microsoft's legal compliance considerations (litigation- related) "appear entirely intertwined with . . . creat[ing] the smallest tax liability possible" (non-litigation-related).

Despite the foregoing, the court offered that it was the KPMG advisory documents themselves that gave rise to the litigation expectation: "Microsoft's documents were not created in anticipation of litigation. Rather Microsoft anticipated litigation because of the documents created." But documents do not give rise to tax litigation; tax return positions do. The only question then for work product purposes should be: did Microsoft's anticipation of litigation *inform the creation of those documents* or were they created in the same way as if litigation were not anticipated. The court did not consider that question. Instead, the court was distracted by an irrelevant concern that Microsoft did not show it would face litigation had it not engaged in the cost-sharing transaction. The district court's failure to consider how the litigation purposes of Microsoft informed the creation of the KPMG documents amounted to a rejection of the dual purpose rule embraced by a majority of the circuits, including the Ninth Circuit. The court highlighted its error by offering that there was a difference between planning a legally defensible transaction and defending against a legal dispute, as if only the latter situation would give rise to work product. The district court seems to not have comprehended that, given the complexity of the Internal Revenue Code, virtually any transaction undertaken by a taxpayer where the Code might be interpreted and applied differently could give rise to litigation. Indeed, what seems to be underlying the entire decision is the district court's distaste for the transaction itself, which the court viewed as a "tax shelter."[5]

The district court also rejected the work product claim of Microsoft on another basis. Recall that a work product document must be created by "a party or that party's representative" under Rule 26(b). Under *Torf* and *Adlman*, an agent of a party or party's representative can also prepare work product. Here the court accepted that Microsoft's in-house counsel hired KPMG to "help Microsoft prepare its defense to the IRS's challenge." However, the district court criticized the idea that KMPG's work could be treated as work product if Microsoft did not contemplate using KPMG as a witness at trial. Furthermore, the court characterized KPMG's engagement as one for tax advice, not legal advice. These points are irrelevant to work product protection, which applies regardless of whether a party's agent mandate includes giving legal advice or testifying in court. That an agent aids an attorney preparing for anticipated litigation is sufficient to protect a document, as was the case in *Torf*. *Adlman* also teaches that the critical focus is whether a document prepared by the party or agent would be the same whether it was in anticipation of litigation or solely for a business purpose, not whether the creator of the document will appear for trial or give legal advice.

The district court further highlighted as grounds for denying the documents protection that: (1) Microsoft had failed to preserve several documents requested by the IRS; and (2) Microsoft asserted protection for documents created before 2004, the date when Microsoft said it became aware of the IRS challenging other taxpayers' transfer pricing transactions. The court did not specify how these factors directly contributed to denying work

3 This arrangement is generally known as a *Kovel* arrangement, which protects non-attorney communications to a taxpayer's attorney under the attorney-client privilege, so named because of the seminal attorney-client privilege case *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961), in which the court decided that the attorney-client privilege covered communications with a forensic accountant who was assisting an attorney in preparing pro forma tax returns.

4 A well-prepared log includes sufficient information to establish a prima facie case for protection, such as the identity of the author and recipients, date, length of document, a brief and general description of the nature of the document's subject matter, and finally an assertion of one or more protections, *e.g.*, attorney-client privilege or work product.

5 This bias appears to arise in the court's discussion of whether the Section 7525 privilege can apply as a protection separate from work product. We do not here discuss in any depth that analysis other than to say that the district court improperly broadened an exception to the privilege for written communications "in connection with the promotion of . . . any tax shelter."

continued on page 4

product protection, but they generally appear to have eroded the court's belief that Microsoft had asserted the protection in good faith.

SANMINA – BE WARY OF DISCLOSURE

A taxpayer should expect to provide an IRS auditor with supporting documentation for any claimed credits or deductions. With respect to transfer pricing and valuation audits, it is advantageous for a taxpayer to have certain types of supporting analysis ready to provide to the auditor upon request. As *Sanmina* teaches, such documentation should be carefully segregated from documents that the taxpayer does not want to produce to IRS auditors.

In *Sanmina*, the taxpayer's voluntary disclosure of valuation documentation gave the IRS grounds for arguing waiver of asserted protections for certain related documents that the taxpayer had not provided to the IRS. Sanmina determined that its Swiss subsidiary stock had become worthless and claimed an ordinary income deduction of over $500 million on its tax return for 2008. Generally, to support a worthless stock deduction (WSD), a taxpayer must show that the stock had indeed become worthless in the tax period in which the deduction was claimed. Sanmina retained DLA Piper (DLA), a law and valuation firm, to provide a valuation study that concluded that the fair market value of the stock was negative $49 million. In a footnote, DLA referred to, but did not attach, two memoranda from Sanmina's in-house counsel. Sanmina had shared the in-house memoranda with Ernst & Young, KPMG, LLP, and DLA. The memoranda "were provided to Ernst & Young … and KPMG" to support the WSD and both those firms "provided tax advice related to Sanmina's decision to take the worthless stock." Sanmina further explained that:

> Given the significance of that tax treatment, Sanmina proceeded with the expectation that [the] IRS would likely call upon Sanmina to defend the worthless stock deduction. Anticipating the possibility that the Service might adopt an adverse position, Sanmina sought advice from DLA Piper, Ernst & Young and KPMG concerning the propriety of the deduction.

On audit Sanmina offered the valuation report to support its deduction. The IRS reviewed the document and requested the referenced memoranda. Sanmina declined to produce the memoranda on the grounds that they were protected both by attorney-client privilege and work product though it did provide additional "non-privileged" documents on which the memoranda were based. The district court found that the memos were protected by attorney-client privilege and work product but that Sanmina had waived those protections by disclosure of the valuation study to the IRS and by disclosure of the memoranda to DLA. Sanmina disagreed and appealed to the Ninth Circuit.

Waiver of protection can occur: (1) inadvertently, such as where a document production mistakenly includes a protected document; (2) intentionally, where a party offers a document to support or enhance a legal position; or (3) by implication, where a party puts into issue an attorney's or other agent's advice. Furthermore, there is a difference between what constitutes a waiver for attorney-client privilege purposes and for work product protection purposes. In general, any disclosure to a party outside of an attorney or agent will waive attorney-client privilege as to the document disclosed and potentially any document on the same subject matter. Most courts view waiver of work product protection more narrowly; generally, it only occurs when a party discloses the document to an adversary or a conduit to an adversary, and is limited to the facts in the document disclosed.

Regarding attorney-client privilege, the Ninth Circuit agreed with the district court that Sanmina's disclosure of the memoranda to DLA constituted a waiver. A key factor in this determination was that Sanmina had retained DLA to provide valuation services and not legal advice. Therefore, even though it operated as a law firm, because DLA was not retained to provide legal advice to Sanmina, it did not receive the memoranda in its capacity of a legal advisor and thus privilege was waived.

The court then considered whether disclosure of (1) the memoranda to DLA or (2) the DLA study to the IRS waived work product protection as to the memoranda. The Ninth Circuit determined that, because DLA was not an adversary or conduit to an adversary, the disclosure of the memoranda to DLA did not constitute a waiver of work product protection. However, with respect to the disclosure of the DLA valuation study to the IRS, the court determined that a partial waiver had occurred:

> [C]ourts appear to have reached a general "uniformity in implying that work-product protection is not as easily waived as the attorney-client privilege" based on the distinct purposes of the two privileges. *United States v. Mass. Inst. of Tech.*, 129 F.3d 681, 687 (1st Cir. 1997). While the attorney-client privilege "is designed to protect confidentiality, so that any disclosure outside the magic circle is inconsistent with the privilege," work-product protection "is provided against 'adversaries,' so only disclosing material in a way inconsistent

continued on page 5

with keeping it from an adversary waives work product protection." *Id.*; *see also United States v. Deloitte LLP*, 610 F.3d 129, 140 (D.C. Cir. 2010).

Thus, the question for the Ninth Circuit became whether the disclosure of the DLA valuation study to an adversary, the IRS, and the consequent disclosure of the existence of the memoranda, were "inconsistent with the maintenance of secrecy against its adversary." Because Sanmina affirmatively planned to produce the DLA study to the IRS in an audit and that study specifically referenced the memoranda, the court decided that Sanmina's decision to produce the DLA study was inconsistent with the purpose of work product protection. However, the Ninth Circuit did not order a full disclosure of the memoranda, but only of the factual content in the memoranda relied upon by DLA in preparing its valuation study. To reach this conclusion the Ninth Circuit appealed to a "fairness principle," such that a party should not be able to gain an unfair advantage against its adversary by disclosing favorable documentation and withholding unfavorable related documentation. Because the parties were only in an audit stage and not in litigation, the court decided that, in fairness, only the factual content of the memoranda should be disclosed to the IRS. The court reasoned that the IRS did not need to review the legal analysis in the memoranda, as the IRS is fully equipped with its own legal department to examine all the facts and formulate a legal conclusion based on those facts. In so judging, the court also protected what is universally considered to have "near-absolute immunity" from disclosure, *i.e.*, the "mental impressions, conclusions, opinions or legal theories" of a party's counsel.

UK TAX CONTROVERSY DEVELOPMENTS

ENGLISH COURT CONSIDERS WHETHER LITIGATION PRIVILEGE CAN ATTACH TO TAX ADVICE

In *The Financial Reporting Council Ltd v. Frasers Group plc* (*formerly Sports Direct International plc*) [2020] EWHC 2607 (Ch), the UK High Court considered a case concerning whether English litigation privilege (similar to U.S. work product protection) could attach to tax advice prepared by accountants. The case stems from an ongoing investigation by the UK audit regulator, the Financial Reporting Council (FRC), on the issue of related-party transactions in the financial statements of Sports Direct International plc (SDI). As part of its investigation, the FRC sought disclosure of tax advice provided by Deloitte.

In response to the disclosure request, SDI provided around 2,000 documents to the FRC but withheld 40 documents on the grounds that they were covered by litigation privilege, which is invoked where: (1) litigation must be in progress or in reasonable contemplation; and (2) the documents in question were prepared for the sole or dominant purpose of litigation. Some of these documents contained advice provided by Deloitte in connection with a structure to: (1) ensure SDI's parent company paid VAT on its sales to EU customers in the UK rather than in the country of each relevant EU customer; and (2) overall reduce the parent company's VAT payment obligations.

The High Court found that SDI could not claim litigation privilege over documents containing tax advice from its accountants because the documents were not created for the sole purpose of litigation. Although SDI and its parent company may have had a bona fide expectation that there would be litigation over its distance selling arrangements, this was not enough to establish that the documents were prepared for use in litigation. The judge explained that, even if it is contemplated that advice was given to withstand potential, future challenges from tax authorities, it does not negate the fact that the relevant entity may want a particular tax structure in place for other reasons. In this case, it was found that Deloitte's advice was "primarily advice as to how to pay less tax" and "not primarily advice as to the conduct of the future possible litigation."

The case judgment is available HERE *(The Financial Reporting Council Ltd v. Frasers Group plc (formerly Sports Direct International plc)* [2020] EWHC 2607 (Ch)).

PRACTICE CONSIDERATIONS

THESE CASES PROVIDE AN OPPORTUNITY TO HIGHLIGHT SEVERAL IMPORTANT PRACTICE CONSIDERATIONS:

- Consider retaining non-attorney advisors under *Kovel* arrangements. This can insulate from disclosure communications among the taxpayer-client, the attorney, and the non-attorney, whether or not there is an anticipation of litigation with respect to the subject of the communications.
- Consider involving in-house counsel in charge of disputes and litigation as part of the company's consideration of potential transactions that may result in tax return positions the taxing authority is likely to focus on in an audit, and seek input from such counsel as to strategy should a return position be examined and/or challenged. This will enhance the litigation orientation of the transaction planning and return position and thus also strengthen the assertion of work product protection.
- Some courts, *e.g.*, *Microsoft*, have questioned the bona fides of the assertion of work product where the taxpayer has not preserved documents related to the transaction or return position. Therefore, be mindful of the application of your document retention policy to such relevant documents.
- Whenever a confidential document is being prepared discussing the pros and cons of the possible tax treatment of a transaction and audit or litigation is anticipated, state such anticipation clearly in the document and include a discussion of tactics in the event an audit dispute arises.
- Whenever a document that may be, or is intended to be, provided to the taxing authority in an audit is in the process of being prepared, carefully consider whether it is necessary to include references to other documents you wish to keep confidential.
- When the determination is made to enter into the transaction or take the return position, either in-house or general counsel or a senior tax officer should contemporaneously memorialize that the company anticipates an audit and litigation in a memorandum that also identifies the objective bases for such anticipation, *e.g.*, the transaction is reflected on Schedule UTP, or the taxing authority is currently challenging similar transactions or return positions or has notified taxpayers that it will audit such transactions or return positions.

HOW OTHER JURISDICTIONS COMPARE TO THE UNITED STATES

United Kingdom/Canada/Australia – similar ACP and work product protections.

Hong Kong – legal advice privilege derived from English common law similar to ACP and litigation privilege similar to work product.

Belgium – legal profession privilege for internal and external counsel.

Luxembourg – legal professional privilege.

Netherlands – legal professional privilege only to communications with locally licensed internal or external counsel.

Germany – legal professional privilege restricted to criminal defense.

EU – legal professional privilege restricted to outside counsel and to EU competition proceedings.

Japan – attorneys have a duty of confidentiality but generally no legal professional privilege is recognized, except for attorney-client privilege in investigations regarding allegations of unreasonable restraint of trade (*e.g.*, cartels and bid-rigging). This privilege will only apply to lawyers qualified in Japan, and in principle advice from in-house lawyers or foreign lawyers is not protected.

China – attorneys have a duty of confidentiality but no legal professional privilege is recognized and attorney communications must be provided to government agencies or court on request.

continued on page 8

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