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LEGAL ALERT

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U.S. District Court Orders Disclosure of Tax Accrual Workpapers, but Protects Opinion Work Product Information

On June 4, 2013, the U.S. District Court for the District of Minnesota held that certain information contained in tax accrual workpapers must be disclosed by the taxpayer pursuant to an Internal Revenue Service (IRS) summons, but that other information was protected by the work product doctrine or the attorney-client privilege. *Wells Fargo & Co. v. United States*, No. 10-57 (D. Minn. 2013).

The court in *Wells Fargo* held that the IRS was entitled to certain documents and portions of documents prepared by the taxpayer, including FIN 48 memos analyzing individual uncertain tax positions (UTPs) (with or without a cover memo from a Wells Fargo attorney), spreadsheets and interest calculation spreadsheets identifying UTPs, meeting agendas from quarterly meetings with the taxpayer's accounting firm, and emails between the taxpayer and its accounting firm identifying specific UTPs. The court also held that the IRS was entitled to examine documents prepared by the taxpayer's accounting firm which identified UTPs, reserve percentages or reserve amounts.

The court held, however, that the recognition and measurement analysis reflected in the tax accrual workpapers was "opinion work product," which enjoys special protections. Because the IRS had not demonstrated the "very rare and extraordinary circumstances" necessary for discovery of this information, the court refused to order disclosure.

Accordingly, the court held that the documents required to be disclosed should be redacted so that they provided only the following information:

- Identification of UTPs
- Historical facts underlying the taxpayer's federal UTPs (including, specifically, the transactions associated with the UTPs)
- The taxpayer's process for identifying its federal UTPs
- Other opinions and materials generated by the taxpayer's accounting firm regarding the UTPs, as well as opinions and materials generated by any other non-lawyer, unless this information incorporates the legal analysis of the taxpayer's attorneys

Specific redactions to protect opinion work product included:

- The FIN 48 analysis determining whether it is more-likely-than-not that the tax benefit derived from the tax position will be sustained upon examination
- The measurement of the largest amount of tax benefit that is greater than 50% likely to be realized upon settlement with a tax authority
- Regarding specific UTPs, the qualification of the monetary amount that the taxpayer recorded as a reserve
- Information regarding the units of account under FIN 48
- Other materials containing legal analysis, such as the taxpayer's discussions of settlement positions or its accounting firm's restatement and approval of the taxpayer's settlement analysis

The court's 100+ page opinion was issued nearly two years after a four-day evidentiary hearing was held in the summer of 2011. The opinion is important because it holds that opinion work product contained within a document prepared for business reasons may be protected but that ordinary work product contained within such a document may not be protected.

Background

From 1997 through 2003, Wells Fargo engaged in a number of transactions the IRS characterized as "Sale-in-Lease-Out" transactions or SILOs. Since 2005, SILOs have been listed transactions. Wells Fargo unsuccessfully litigated the SILO issue for its 2002 taxable year. *Wells Fargo v. United States*, 641 F.3d 1319 (Fed. Cir. 2011).

For taxable years 2005 and later, Wells Fargo did not claim the benefit of the SILO transactions on its originally filed returns. For 2005 and 2006, Wells Fargo filed a claim for refund alleging that it was entitled to the benefits of the SILO transactions. Wells Fargo initially notified the IRS that it would file a similar claim for 2007 and 2008, but in 2011, after a final adverse judgment on its case by the U.S. Court of Appeals for the Federal Circuit, Wells Fargo notified the IRS that it would not file the claims.

In 2010, while the SILO litigation was still pending, the IRS issued Information Document Requests (IDRs) requesting Wells Fargo's tax accrual workpapers for 2007 and 2008, as well as testimony describing Wells Fargo's processes for identifying UTPs. The IRS said its request was appropriate under the applicable Internal Revenue Manual "policy of restraint" because Wells Fargo had engaged in multiple listed transactions.[1] Wells Fargo refused to provide the tax accrual workpapers in response to the IDRs, and in 2010 the IRS issued three summonses, two to Wells Fargo and one to KPMG, its accounting firm.

In September 2010, Wells Fargo filed a petition in federal district court in Minnesota seeking to quash the summonses. The IRS filed a counter motion to enforce the summonses.

The court addressed four issues: whether the summonses were issued for a permitted purpose; whether any of the summoned material was protected by the work product doctrine; whether certain documents were protected by the attorney-client privilege; and whether certain documents were relevant at all to the federal income tax examination of Wells Fargo.

Summons Issued for a Permitted Purpose

Despite a pre-hearing directive from the court to focus their arguments on work product protection and not on any allegedly improper purpose in issuing the summonses,[2] both parties presented evidence on the purpose for the summonses. To win on this issue, Wells Fargo was required to "disprove the actual existence of a valid civil tax determination or collection purpose." Wells Fargo attempted to meet this heavy burden by asserting that: (i) the requested information was available by other means, principally the Schedule M-3 and the Form 8886 Reportable Transaction Disclosure Statement; (ii) the IRS intended the summonses as "punishment" for previous transactions of Wells Fargo that "the IRS did not like"; and (iii) the IRS had violated its own policy of restraint, since Wells Fargo had not claimed the benefits of any listed transactions during the audit period. The court rejected Wells Fargo's arguments and held that,

[1] I.R.M. 4.10.20.
[2] *Wells Fargo v. United States*, at 57 n.32.

whether or not the policy of restraint had been violated, the stated purpose of verifying the accuracy of Wells Fargo's tax returns was legitimate, especially since Wells Fargo had engaged in what the IRS characterized as "abusive tax avoidance transactions" in the recent past.

Sutherland Observation: The court's holding on this issue points out both the difficulty of proving an improper purpose for a summons and the fact that, in the absence of a statute or constitutional provision mandating particular procedures, taxpayers generally cannot compel the IRS to follow its own procedural rules. *See United States v. Caceres*, 440 U.S. 741 (1979); *Foxman v. Renison*, 625 F.2d 429 (2d Cir. 1980).

Work Product Protection

The *Wells Fargo* court distinguished between two types of work product: (1) "opinion work product," *i.e.,* the mental impressions, conclusions, opinions or legal theories of an attorney, and (2) "ordinary work product," which is any other work product, such as raw factual information strategically selected or organized by an attorney. Ordinary work product prepared in anticipation of litigation is not discoverable unless the requesting party has demonstrated a substantial need for the material and cannot obtain the equivalent through other means without undue hardship. The court stated that opinion work product "enjoys a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances."

Sutherland Observation: Opinion work product is accorded special protection because of the inherent unfairness and potential harm to the judicial process when an attorney's mental impressions and analysis of legal theories are disclosed to an adversary. *Hickman v. Taylor*, 329 U.S. 495, 512 (1947); *Upjohn Co. v. United States*, 449 U.S. 383, 398-402 (1981).

The court relied heavily on the U.S. Court of Appeals for the Eighth Circuit's decision in *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th Cir. 1987). In *Simon*, the Eighth Circuit held that aggregate reserve documents were prepared for a business purpose and not in anticipation of litigation, but nevertheless held that individual case reserve figures within the documents, which revealed the mental impressions, thoughts and conclusions of an attorney, were protected opinion work product.

Relying on *Simon*, the district court analyzed two issues with respect to Wells Fargo's tax accrual workpapers: (1) whether the list of UTPs and the procedures by which the taxpayer identified UTPs were prepared in anticipation of litigation and thus were protected as ordinary work product, and (2) whether the tax accrual workpapers contained protected opinion work product prepared in anticipation of litigation.

The Identification of UTPs and Corresponding Information Was Not Work Product Because It Was Not Prepared in Anticipation of Litigation

Wells Fargo identified UTPs at the time it entered into the relevant business transaction, and attorneys were not initially involved in the identification. Attorneys became involved only when requested to analyze the tax positions and assist in structuring the business transactions to reduce tax risk. The district court held that identification of UTPs was not made in anticipation of litigation, but rather in the ordinary course of business.

The court rejected Wells Fargo's assertion that it anticipated and prepared for litigation with respect to all of its UTPs. Because Wells Fargo witnesses had testified that the company would not enter into a transaction unless there was a 70% or greater chance of success in litigation, the court found it unlikely that the company anticipated that *every* UTP would be litigated. The court stated that there could come a point when Wells Fargo would begin to anticipate more than a "hypothetical possibility" of litigation. However, because Wells Fargo had not produced evidence with respect to the anticipation of litigation with respect to specific UTPs, Wells Fargo had not met its burden of proving that it anticipated litigation.

Sutherland Observation: Proving anticipation of litigation with respect to particular UTPs may be possible even from the time of initial identification, especially when the disputed documents contain opinion work product. *See United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006); *Regions Fin. Corp. v. United States*, 2008 WL 2139008 (N.D. Ala. 2008).

Recognition and Measurement Analysis Was Protected Opinion Work Product Even Though Incorporated into Documents Prepared for Business Purposes

After an *in camera* review, the court held that the recognition and measurement analysis contained in Wells Fargo's tax accrual workpapers was protected work product that had been prepared in anticipation of litigation. The recognition and measurement analysis reflected the legal analysis conducted by Wells Fargo's attorneys in preparation for litigation. Wells Fargo was actively participating in litigation or IRS Appeals on many of the UTPs and, for others, litigation appeared likely. The court noted that the analysis reflected in the tax accrual workpapers appeared to have been pre-existing and not merely created for FIN 48. The fact that the analysis was incorporated into a document intended as part of the financial statement process did not deprive the information of protection, because to allow the IRS to see the information would provide "a window into the legal thinking of Wells Fargo's attorneys on active litigation strategy," which would defeat the purpose of the work product doctrine.

The court cautioned that the ruling was limited to the "unique circumstances" presented by the Wells Fargo case, where the company had substantially limited the number of UTPs subjected to FIN 48 analysis and had specifically proved its anticipation of litigation with respect to the UTPs at the time it created the tax accrual workpapers. The court specifically rejected the position, urged by Wells Fargo and amici, that all tax accrual workpapers are created "because of" litigation because FIN 48 requires a taxpayer to assume that UTPs will be litigated. (Although not discussed by the *Wells Fargo* court, this position was accepted by the district court in *Regions* and by the district court in *United States v. Textron, Inc*., 507 F. Supp. 2d 138 (D.R.I. 2007), *aff'd in part and rev'd in part*, 533 F.3d 87 (1st Cir. 2009), *and vacated* 577 F.3d 21 (1st Cir. 2009) (en banc), *cert denied* 130 S.Ct. 3320 (2010)).

Sutherland Observation: Under Eighth Circuit precedent, opinion work product, "by [its] very nature" is considered prepared in anticipation of litigation and protected from discovery, even if contained in documents prepared for business reasons. *Simon*, 816 F.2d at 401. The U.S. Court of Appeals for the D.C. Circuit has agreed with this principle. *See United States v. Deloitte LLP*, 610 F.3d 129, 138 (D.C. Cir. 2010). The basis for this view appears to be that the content of a document rather than its function determines whether the document is protected as opinion work product. *See id.* at 137. The U.S. Court of Appeals for the First Circuit in *Textron* appears to disagree with this principle ("[It is not] enough that the materials were prepared by lawyers or represent legal thinking. . . . It is only work done in anticipation of trial that is protected.") *United States v. Textron, Inc*., 577 F.3d 21, 29-30 (1st Cir. 2009) (en banc).

The IRS Did Not Prove "Extraordinary Circumstances"

The protection afforded to opinion work product in the Eighth Circuit is "nearly absolute," but it can be overcome in rare and extraordinary circumstances. The auditing Revenue Agent stated that his primary interest in obtaining the tax accrual workpapers was to identify Wells Fargo's UTPs, which would enable the IRS to conduct its own analysis. No IRS witness explained why the IRS would have a significant interest in obtaining Wells Fargo's opinion work product. Accordingly, the court held that the opinion work product contained in the workpapers would be protected.

No Waiver of Work Product Protection by Disclosure to Accounting Firm

The court also held that Wells Fargo had not waived work product protection by disclosing the workpapers to KPMG. Under Eighth Circuit precedent, work product protection is waived only when a party intends to disclose protected material to an adversary. The IRS argued that KPMG was a potential adversary because there could potentially be litigation between Wells Fargo and KPMG. Wells Fargo presented evidence that litigation between clients and auditors was rare, and the court held that there was not a high enough risk of an adversarial relationship to treat KPMG as an adversary. KPMG took steps to protect the confidentiality of client information and did not disclose the workpapers to any third party. Finally, KPMG was not a conduit to an adversary, even though in some circumstances it might be expected to disclose confidential client information to the Securities and Exchange Commission or the Public Company Accounting Oversight Board. The IRS had presented no evidence about how often auditors make such disclosures or that KPMG in particular had ever made such disclosures. Because the possibility of disclosure was so remote, KPMG could not be treated as a conduit to an adversary.

Sutherland Observation: The D.C. Circuit is the only federal court of appeals to hold that disclosure to an auditor does not waive work product protection. *See Deloitte*, 610 F.3d at 139. *Wells Fargo* joins the majority of other district court cases holding that work product protection is not waived by disclosure to an auditor. A list of the cases is included in the D.C. Circuit opinion in *Deloitte*. *Id.*

Attorney-Client Privilege Applied to E-Mail Communications, Including Draft Tax Accrual Workpapers

Wells Fargo asserted attorney-client privilege as a basis for protecting eight e-mails in which a Wells Fargo in-house lawyer was either a sender or recipient, and none of which had been disclosed to KPMG or anyone else outside of Wells Fargo. The court determined that these eight documents were privileged

because they were communications made by corporate employees to counsel to secure legal advice. The court rejected the IRS's argument that e-mails transmitting draft versions of tax accrual workpapers were not protected because final drafts of the workpapers were eventually disclosed to KPMG. The court noted that disclosure of a final draft of a document does not erase attorney-client privilege with respect to earlier versions. The court also noted that it was "troubled" that one of the eight documents appeared to contradict (or partially contradict) trial testimony, but that under Eighth Circuit precedent, such a conflict was not enough to show a waiver of the privilege.

State and Local Tax Accrual Workpapers and Workpapers of a Subsidiary Not Included in the Consolidated Return Were Irrelevant to Federal Tax Liability

Finally, the court held that the IRS could not obtain tax accrual workpapers related to Wells Fargo's state and local tax UTPs or to the tax liability of Wachovia, a subsidiary that was newly-acquired and not included in the consolidated tax returns for the audit period. The court held that the IRS had not presented a prima facie case that any of these workpapers were even potentially relevant to the IRS's examination of Wells Fargo's federal tax returns.

Sutherland Observation: The decisions in *Wells Fargo* and *Deloitte*, which focus on the content included in tax accrual workpapers rather than the function of the documents as a whole, represent an encouraging development. Enhanced protection of opinion work product is appropriate, even when such information is contained in business documents, because of inherent unfairness and harm to judicial process which may result from disclosure of an attorney's mental impressions and theories.

The *Wells Fargo* case is consistent with the U.S. Supreme Court's guidance in *Hickman v. Taylor*. There, counsel for the party seeking the other side's opinion work product explained that he wanted this information "to make sure he overlooked nothing." 329 U.S. at 517. But the Supreme Court held that when a party has been supplied with the relevant facts, counsel cannot build the party's case on his adversary's notes. He must instead prepare his own analysis. *Id.* at 518.

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