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# Legal and Ethical Issues in Records Retention for Tax Professionals

## Emerging Issues in Records Retention

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# Document Preservation - Why Do We Care?

- For want of a nail ...the kingdom was lost
- Stakes may be higher than a kingdom
- Legal Stakes
- Ethical Stakes
  - IRPC 3.4(a)(1)
  - IRPC 8.4(a)(3), (4), (5)

# The Destruction of Arthur Andersen

- Shredding and the document retention policy
  - Only stopped upon *formal investigation and subpoena*
- What did DOJ indict AA for doing?
  - AA was *not* indicted for shredding documents itself
  - AA was indicted for allegedly corruptly persuading *others* to destroy evidence
- Clients fled based upon the indictment alone

# Document Preservation – Life *Before* Sarbanes-Oxley

- Criminal Obstruction of Pending Judicial Proceedings
  - 18 U.S.C. § 1503 punishes:
    - Anyone who, in connection with a pending judicial proceeding, “corruptly or by threats or force, or by any threatening letter or communication, *influences, obstructs, or impedes, or endeavors to influence, obstruct, or impede, the due administration of justice...*”
- Criminal Obstruction of Pending Agency Proceedings
  - 18 U.S.C. § 1505 punishes:
    - The same in connection with “the due and proper administration of the law under which *any pending proceeding is being had before any department or agency of the United States*, or the due and proper exercise of the *power of inquiry under which any inquiry or investigation is being had* by either House, or any committee of either House or any joint committee of the Congress.”
- Criminal Obstruction of Justice
  - 18 U.S.C. 1512 § punishes:
    - Anyone who “knowingly uses intimidation, threatens, or corruptly *persuades another person...* or engages in misleading conduct toward another person, with intent to alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding...”

# Document Preservation – Life *Before* Sarbanes-Oxley

- DOJ did not indict AA for the act of document shredding because it thought it had no case under the pending action requirement of old law
- AA was convicted for “knowingly, intentionally and corruptly” persuading other persons to destroy documents
- Supreme Court reversed conviction
  - It is not “corrupt” within meaning of statute cited in indictment to merely “impede” a regulatory proceeding
  - Defendant must contemplate obstruction of a “particular official proceeding” – a mere guess that the defendant might was not enough

# Document Preservation – Life *After* Sarbanes-Oxley

- 18 U.S.C. § 1519 now punishes:
  - Anyone who **knowingly** alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object **with the intent** to impede, obstruct, **or influence** the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States... **or in relation to or contemplation of any such matter or case.**

# Document Preservation – Life *After* Sarbanes Oxley

- New statute directed at old “pending” or “imminent” requirement
- Legislative history: “This statute is specifically meant not to include any technical requirement, which some courts have read into other obstruction of justice statutes, to tie the obstructive conduct to a pending or imminent proceeding or matter by intent or otherwise.”
- Knowledge is enough – no corruption required
- Influencing the investigation is enough – impeding or obstructing not required

# Document Preservation – Life *After* Sarbanes-Oxley

## Illinois Disciplinary Rules

- IRPC 3.4(a)(1): May not “alter, destroy or conceal a document or other material having potential evidentiary value”
- IRPC 8.4(a)(3): May not commit a criminal act “that reflects adversely on the lawyer’s honesty, trustworthiness or fitness as a lawyer in other respects”
- IRPC 8.4(a)(4): May not engage in “dishonesty, fraud, deceit or misrepresentation”
- IRPC 8.4(a)(5): May not “engage in conduct that is prejudicial to the administration of justice”



# The Problem ... Records are Everywhere

- Where is King Canute when you need him?
- Would he be up for the job?

# E-Documents

- Statistical Overview:
  - 92% of all new human information is stored electronically
  - 17.5 trillion estimated electronic documents by 2005
  - By the end of 2006, 60 billion e-mail messages sent each day
  - 60% of business-critical information is stored within corporate e-mail systems, up from 33% in 1999

# E-Documents

- Statistical Overview:
  - Less than 1/3 of all electronic data is ever printed (going down each year)
  - Nearly \$2 billion spent annually on electronic retrieval and review within a litigation context
  - Between 1994 and 2000, there were more reported spoliation cases than in the previous 200 years

So Where Do We Start?

# Document Retention Policies

- “Document retention policies, which are created in part to keep certain information from getting into the hands of others, including the Government, are common in business. . . . It is, of course, not wrongful for a manager to instruct his employees to comply with a valid document retention policy under ordinary circumstances.”
  - *Arthur Andersen LLP v. United States*
- “Must a corporation, upon recognizing the threat of litigation, preserve every shred of paper, every e-mail or electronic document, and every back-up tape? The answer is clearly, ‘no.’ Such a rule would cripple large corporations . . . that are almost always involved in litigation.”
  - *Zubulake v. UBS Warburg*

# Document Retention Policies

- Properly implemented, a document retention policy shields employees from claims of improper document disposal
- The policy should:
  - Be based on legitimate business needs of the company
  - Be neutral
  - Be inclusive: electronic data, including emails, calendars, home computers, backup tapes
  - Be monitored to ensure compliance
  - Include a procedure for notifying all employees of a legal hold
- Policy Practicalities: What, where, and how?

# Document Retention Policies

- So many masters to serve
- Government requirements
  - IRS audits
  - Circular 230 ethical rules governing practice before Internal Revenue Service
  - Other governmental agency investigations (e.g., FDA)
  - Outside auditor
- Ethical Limitations
  - IRPC 3.4(a)(1)
  - IRPC 8.4(a)(3)-(5)

# Document Retention Policies

- Coordination Required
  - In-House and Outside Counsel
  - Tax
  - IT
  - Other: HR, Manufacturing (ISO 9000 and Safety Records), R&D, Finance, Sales
- Potential conflict between general counsel's need to follow policy and tax department's need to preserve documents.



# Document Retention Policies

- Living, *Breathing* Document
  - Must be **implemented!** (*see Zubulake V*)
    - Policy must be adequately explained to employees ***and followed*** on a regular basis
  - Must be followed **consistently** (*see Phillip Morris*)
  - Regular **review and updating required**, based on experience

# Document Retention Policies

- Records Management
  - Establish company-wide procedures for document/file custodians
    - Electronic and Hard Copy
    - Example: HR, Tax, Marketing, Legal can throw away their copies of the Financial Statements because everyone knows Mary Smith in Finance keeps the file
  - New Employee – Orientation
    - Provide a copy of the Retention Policy at orientation
    - Notify new employees of current litigation holds
  - Departing Employee – Exit Interview
    - Identify records
    - Explain disposition (transferred/archived/destroyed)

# Document Retention Policies

- Keep in Mind What Happens to Documents...
  - During a merger
  - During a move to a new facility
  - During downsizing
- Outside advisers (lawyers, accountants, consultants)
- Off-site storage
- Joe's garage

# Document Retention – Privilege Issues

- Best Practices for Privileged Documents:
  - Segregate privileged documents from non-privileged documents in filing system
  - Take care in emailing privileged advice
    - Waiver is easy
- Possible approaches to privileged information in emails
  - Routine advice
  - Mission-critical advice

# Document Retention – Privilege Issues

- New problems with privilege
- So many prying eyes
  - Demands from auditors
  - IRS and tax-accrual workpapers

# **CLE Code**

## **TAX629**

# Limits of Document Retention Policies

- E-Documents
- IRS Audit
- IRS Development of Issues and Spoliation
- Foreign Audit

# Limits of Document Retention Policies – E-Documents

- “Electronic data are the modern-day equivalent of the paper trail. Indeed, because of the informalities of e-mail, correspondents may be less guarded than with paper correspondence”
  - *Coleman Holdings v. Morgan Stanley*, 2005 WL 674885, at p. 10 (Palm Beach Co. Cir. Ct., Fla.) (Order dated March 1, 2005)
- Electronic mail is “the functional equivalent of eavesdropping”
  - *Inside Eliot’s Army*, New York Magazine (January 10, 2005)



# Limits of Document Retention Policies – E-Documents

- All Servers
- Desktops
- Laptops
- Hard Drives
- Home Computers
- CD-ROMs
- Voicemail
- PDAs
- iPods
- Cell Phones
- Archived Records
- Metadata
- Back-up Tapes
- Intranet and Internet Sites

# Limits of Document Retention Policies – E-Documents

- The problem of drafts
- Any electronic draft will exist somewhere

# Limits of Document Retention Policies – E-Documents

- Creating Documents: Now is the time to think
  - *Before you type*
  - *Before you write a note*
  - *Before you leave a message*
- Conveying the message
  - *How you convey the message can be as important as the message itself*
  - *Timing of the communication is important*
  - *Examples: AA, Frank Quattrone*

# Limits of Document Retention Policies – E-Documents

- Records Management Software is being developed by several leading software firms that will save only the end document and destroy draft versions
- Legal Implications?
- Ethical Implications?
  - Circular 230 ethical limitations on practice before IRS?
  - Illinois Rules of Professional Conduct Limitations?

# Limits of Document Retention Policies – E-Documents

- Taxpayer must:
  - Be able to prove all facts required to substantiate all items on return
  - Maintain permanent books of accounts sufficient to substantiate its return
  - Bear the burden of substantiating all deductions, offsets and credits, and can lose benefit of these for failure to maintain adequate substantiation and/or books of account
  - Key Cites: §§ 6001, 6111, Rev. Proc. 98-25

# Limits of Document Retention Policies – IRS Audits

- Of course, what you need goes beyond basic books and records
  - Lessons from prior audits
  - New transactions or business practices
- Duty to preserve documents arises before audit begins
  - Pre-Sarbanes and Post-Sarbanes
  - Need to suspend discarding of documents under document retention policy
- Conflict between tax and legal
  - Legal's fight to preserve spring cleaning
  - Tax's need to defend return

# Limits of Document Retention Policies – IRS Audits

- Best Practices

- Educate executive management about the need for retention processes and why tax may be an exception to legal
- Preserve software platforms for archived tapes
  - Electronic documentation retention agreements
- Conduct a post-filing review

# Limits of Document Retention Policies – IRS Audits

- How long to keep documents?
  - Until the period of limitations for the return expires
  - Keep in mind loss carry-forwards
  - Mind the impact of extensions



# Limits of Document Retention Policies – Foreign Audits

- Statute of limitations will vary
- Some jurisdictions impose unlimited statutes on certain activities/documents

# Limits of Document Retention Policies – Spoliation

- What is spoliation?
- “[T]he destruction or significant alteration of evidence, or the failure to properly preserve property for another’s use as evidence in pending or reasonably foreseeable litigation.”
  - *Zubulake v. UBS Warburg LLC*, 229 F.R.D. 422, 429 (S.D.N.Y. 2004)

# Limits of Document Retention Policies – Spoliation

- “Once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a litigation hold to ensure the preservation of relevant documents . . . .”
  - *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 218 (S.D.N.Y. 2003)
- While a litigant is under no duty to keep or retain every document in its possession, even in advance of litigation it is under a duty to preserve what it knows, or reasonably should know, will likely be requested in reasonably foreseeable litigation.”
  - *Scott v. IBM Corp.*, 196 F.R.D. 233, 249 (D.N.J. 2000)
- IRPC 3.4(a)(1): No obstruction of access to evidence.

# Limits of Document Retention Policies – Spoliation

- When does duty to preserve arise?
- At time of planning transaction?
- Before audit?
- During audit?
- Greater duty to preserve for litigation? Or for audit?

# Limits of Document Retention Policies – Spoliation

- Intersection between attorney work product and duty to preserve
  - Argument that duty to preserve for *spoliation* purposes arises if taxpayer claims that litigation is reasonably anticipated for attorney work product purposes
- Can work product be claimed because an administrative dispute, but not litigation, is anticipated?

# Limits of Document Retention Policies – Spoliation

- Preserving privilege and work product protection, complying with pre-litigation duty to preserve and avoiding spoliation require a very careful balancing that should not be overlooked
  - *Rambus, Inc. v. Infineon Techs. AG*, 220 F.R.D. 264 (E.D. Va. 2004)
  - Court examined Rambus’ privilege log to determine when litigation was “anticipated” such that a duty to preserve arose.

# Suspending the Document Retention Policy

- Best Practices
  - Establish an appropriate and defensible “document hold” process to suspend deletion/destruction of documents
    - Identify key employees as soon as possible
    - Cooperation with IT
      - To “freeze” information (*see Zubulake IV*)
      - To suspend routine deletions and recycling of back-ups
  - Coordination with outside counsel
  - Track and monitor process
  - Sooner is better than later

# Document Searches

- Depends on the nature of the request
  - IDR
  - Summons
  - Discovery
- Narrowing the scope
  - Must consider Circular 230 ethical limitations upon practice before IRS



# Document Searches – E -Documents

- How to locate
  - Potential use of outside document recovery vendors
- How much searching is required
- E-document spoliation

# Defenses if Document Retention Challenged

- Document Retention Policy
- Practical Steps
  - Be able to be specific about preservation efforts
  - Identify as soon as possible difficult retrieval issues
  - Be able to speak credibly about the burden of the request
  - Be skeptical
    - Hoarders
    - Garage and bottom drawer
    - Off-site storage
  - Be able to justify specifics of document retention policies
  - Be able to withstand cross-examination

## Circular 230 Disclaimer

- This presentation may not be used to avoid tax penalties under U.S. law.
- This presentation does not render tax advice, which can be given only after considering all relevant facts about a specific transaction. Consult a professional tax adviser for tax advice.

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## Experience

Since joining Mayer Brown in 1990, Tom Kittle-Kamp has represented clients in all phases of tax controversy and litigation. His experience includes the trial and appeal of major corporate cases involving Section 482 allocations, substance-over-form theories, intangible assets, valuation disputes, capitalization questions, Subchapter C issues, and leasing transactions. Tom also represents clients with respect to administrative matters, including IRS audits, IRS Appeals and competent authority negotiations. He also represents corporate clients with respect to tax-sharing disputes.

Tom has deep experience in all aspects of international transfer pricing, particularly matters involving intangible assets and intellectual property. He provides tax planning advice with respect to cross-border transactions involving intangible assets, goods and services; transfer-pricing documentation; and the development, exploitation and disposition of intangible assets. He is co-author of the treatise *Federal Income Taxation of Intellectual Properties and Intangible Assets* (Warren, Gorham & Lamont 1997), which is updated twice a year.

According to *Chambers USA* 2008, Tom is "extremely confident and persuasive in the courtroom and a pleasure to work with." Additionally, he "boasts an impressive record in litigated cases" (*Legal 500* 2008).

## Education

Northwestern University School of Law, JD, cum laude, 1988; Order of the Coif; Associate Editor, Law Review • Bradley University, BA, summa cum laude, 1982

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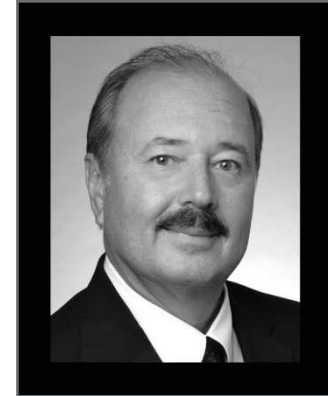
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## Experience

Mr. Dybala is a partner in Mayer Brown's Tax Controversy & Transfer Pricing practice. His experience includes determining and defending pricing programs; counseling clients on United States tax issues concerning dividend planning, subpart F and restructuring of operations to optimize tax strategies; settlement of worldwide audit issues; and structuring international transactions. Mr. Dybala is a former Senior Vice President and Director of Worldwide Tax at Motorola, Inc., where he was responsible for directing all aspects of Motorola's worldwide tax function, including tax planning, compliance and tax litigation. He joined Mayer Brown in 2007 and is also a Certified Public Accountant.

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DePaul University, JD, 1979 • DePaul University, MBA, 1975

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