Bloomberg BNA

Daily Tax Report®

Attorney-Client Privilege

Brian Kittle, Christine Hooks and James Kelly of Mayer Brown look at the Second Circuit's decision in *Schaeffler v. United States*, which reversed a district court ordering a taxpayer to produce its advisers' tax opinions regarding a large restructuring and refinancing transaction to the IRS. The authors say the ruling provides ''much needed clarity'' and offers lessons for taxpayers evaluating their own privilege claims.

Latest Turn in 'Schaeffler' Gives Privilege Boost to Taxpayers

BY BRIAN KITTLE, CHRISTINE HOOKS AND JAMES KELLY

Over the past decade, the Internal Revenue Service has—with some success—attempted to access tax opinions and other confidential, pre-transactional analyses prepared by taxpayers' advisers.

The IRS scored a major victory in 2014 in *Schaeffler v. United States* (*Schaeffler I*).[1] There, the U.S. District Court for the Southern District of New York required a taxpayer to produce tax opinions regarding a large restructuring and refinancing transaction. The *Shaeffler I* result led some tax professionals to conclude that privilege may no longer apply to tax opinions.

However, on Nov. 10 the U.S. Court of Appeals for the Second Circuit reversed (*Schaeffler II*), holding that both the tax practitioner privilege and the work product doctrine applied.[2]

While it is unlikely to be the last word on the subject, *Schaeffler II* gives taxpayers a much-needed boost in staving off the IRS's efforts to undermine the privileges protecting pre-transaction analyses and opinions. As explained below, it also gives much needed clarity by supplying taxpayers with some key facts to look to in evaluating their privilege claims.

Background

The *Schaeffler* cases involve two doctrines relevant to all taxpayers—the work product and ''common legal interest'' doctrines.

The work product doctrine prevents one side in litigation from using the work of their adversary against them. It does so by protecting materials ''prepared in anticipation of litigation'' from disclosure.[3] Under the majority rule, materials are prepared ''in anticipation'' of litigation if they are ''prepared or obtained because of the prospect of litigation.''[4] Under this test, documents that also serve non-litigation purposes—such as tax opinions—are protected unless they would have

[1] *Schaeffler v. United States*, 2014 BL 147275, 22 F. Supp.3d 319 (S.D.N.Y. 2014).

Brian Kittle is co-leader of Mayer Brown's Tax Controversy practice and is based in New York.

Christine Hooks, in Washington, D.C., and James Kelly, in New York, are associates in the Tax Controversy practice.

Kittle, Hooks and Kelly represent clients in every facet of tax controversy and litigation—from IRS examinations and administrative appeals, through litigation, including trial and appellate review.

[2] *Schaeffler v. United States*, 2015 BL 369990, 2d Cir., No. 14-1965-cv (11/10/15).

[3] See Fed. R. Civ. P. 26(b)(3).

[4] *United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998). For other, minority rules, see *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009) (applying a ''to assist in'' litigation standard), and *United States v. El Paso Co.*, 682 F.2d 530, 542-43 (5th Cir. 1982) (applying a ''primary purpose'' standard).

 ISSN 0092-6884

been prepared in ''essentially similar form'' without the pending litigation.[5]

The common legal interest doctrine, on the other hand, isn't an independent protection. Instead, it is an exception to the ordinary waiver rules for the attorney-client and tax practitioner privileges.[6] Disclosure to third parties generally waives these privileges because they protect only ''confidential'' communications. The common legal interest doctrine prevents waiver in certain situations where multiple clients may share a common interest in a single legal matter.[7]

Although the tests vary by jurisdiction, the doctrine generally applies ''where a joint defense effort or [legal] strategy has been decided upon and undertaken by the parties and their respective counsel.''[8]

Over the last decade, the IRS has sought taxpayers' internal and external analyses under a number of different theories.

Both doctrines are important to tax professionals because of how tax opinions are used. Work product protection is especially important because it isn't waived as easily as other privileges.

For example, some independent financial auditors require taxpayers to disclose tax opinions so the auditors can evaluate tax reserves. Because the auditors are third parties, doing so can waive attorney-client and tax practitioner privileges. For work product, however, most courts hold that disclosure to an auditor doesn't waive the protection because the auditor is neither an adversary nor a conduit to an adversary.[9]

As a result, work product protection may be the only protection for tax opinions disclosed to an auditor. The common legal interest doctrine can be similarly important where advisers for different clients (such as counterparties) need to share information about the tax treatment of a transaction.

As explained below, however, in recent years the IRS and others have sought to undermine these protections.

Recent Trends

Over the last decade, the IRS has sought taxpayers' internal and external analyses under a number of different theories. For example, in *United States v. Textron Inc.*, the IRS won access to tax accrual workpapers under the theory that they weren't prepared for use in litigation.[10] In *United States v. Roxworthy*, it unsuccessfully sought tax analysis on the theory that the taxpayer didn't anticipate litigation when the analysis was prepared.[11]

Just in 2014, in *AD Inv. 2000 Fund LLC v. Commissioner*, the IRS won access to six tax opinions on the theory that the partners waived privilege by asserting defenses to penalties, including a reasonable cause defense, that turned on their state of mind, even though they didn't assert an advice of counsel defense.[12]

In addition, actions by whistle-blowers have raised similar challenges. For example, in *Schlicksup v. Caterpillar, Inc.*, a Sarbanes-Oxley Act whistle-blower subpoenaed documents about his employer's establishment of its ''Luxembourg/Bermuda tax structure.'' The district court concluded that the anticipated audit of the structure was part of the ordinary course of business and that the documents would have been prepared anyway, even without the specter of an IRS challenge.[13]

Although the whistle-blower case eventually settled, the damage was done: The documents had already been made public.

'Schaeffler I'—IRS Victory

Against this backdrop, *Schaeffler I* marked a significant IRS victory.

The dispute involved tax and legal analysis shared between the taxpayer and a bank consortium. As the financial crisis took hold, the taxpayer had been in the middle of a tender offer for a minority stake in a German company, Continental AG. Because German law prevented it from withdrawing the offer as the market crashed, the taxpayer ended up with 90 percent of the target, almost immediately putting itself on the brink of insolvency.

To avoid default, the banks and the taxpayer agreed to work together on a restructuring and refinancing plan. The plan could be successful, however, only if it received a particular tax treatment. To facilitate the planning, the taxpayer and the banks agreed to share tax and legal analysis of the transactions.

As the audit progressed, the IRS sought privileged documents exchanged between Schaeffler and the banks. This included documents covered by the attorney-client and tax practitioner privileges, as well as documents covered by work product protection. The IRS's position was that the documents weren't prepared for litigation and that because the parties shared only a commercial, as opposed to a legal, interest, the common legal interest doctrine didn't apply. The IRS eventually went directly to the advisers, issuing a summons to Ernst & Young.

In *Schaeffler I*, the district court ordered production of the summoned documents. First, it agreed with the IRS that the sharing of the legal and tax analysis waived attorney-client and tax practitioner privileges, despite the facts that the parties had a sharing agreement, that the parties worked together to develop the restructuring and refinance strategy, and that the banks agreed to extend credit to cover potential tax liabilities.

[5] *Adlman*, 134 F.3d 1194, at 1202.

[6] The tax practitioner privilege is found in I.R.C. Section 7525. Although this privilege is an extension of the attorney-client privilege, it has many limitations that narrow its application. For instance, it applies only to federal civil tax matters.

[7] See, e.g., *United States v. Schwimmer*, 892 F.2d 237 (2d Cir. 1989).

[8] *Schwimmer*, 892 F.2d 237, at 243.

[9] See, e.g., *United States v. Deloitte LLP*, 610 F.3d 129, 139-43 (D.C. Cir. 2010).

[10] See *United States v. Textron Inc.*, 2009 BL 171820, 577 F.3d 21 (1st Cir. 2009).

[11] *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006).

[12] See *AD Inv. 2000 Fund LLC v. Commissioner*, 2014 BL 105923, 142 T.C. 248 (T.C. 2014).

[13] *Schlicksup v. Caterpillar, Inc.*, 2011 BL 214672 (C.D. Ill. 8/19/11) and 2011 BL 231235 (C.D. Ill. 9/9/11).

  DTR ISSN 0092-6884

Second, the district court agreed that work product protection didn't apply because the taxpayer would have created the documents regardless of litigation, despite the documents' extensive analysis of IRS arguments, counterarguments and potential litigation strategies.

This IRS victory was alarming for several reasons. First, it relied on the complexity of the transaction as evidence that the taxpayer would have created the documents regardless of litigation, suggesting that work product might never protect such contemporaneous analysis.

Second, it relied on the ethical requirements for tax opinions as evidence that the taxpayer was required to include discussion of litigation strategy and counterarguments in its analysis, again suggesting the work product doctrine might never protect tax opinions.

Third, by concluding that the parties didn't have a common legal interest because—in part—the banks couldn't be a party to the tax litigation, it suggested that the common legal interest doctrine might not be available in tax cases.

'Schaeffler II'—Taxpayer Relief

The Second Circuit reversed the lower court, clarifying the meaning of ''anticipation of litigation'' in tax cases and the proper application of the common legal interest doctrine.

For work product, the Second Circuit addressed the meaning of essentially similar form for dual purpose documents. As explained above, the Second Circuit had previously held that dual purpose documents (such as tax opinions) are protected unless they would have been prepared in essentially similar form regardless of litigation. The court explained that this actually means that documents are protected unless they would be prepared ''in a form that would not vary regardless of whether litigation was expected.''[14] The court reasoned that, otherwise, the district court's interpretation would ''virtually swallow the work product protection.''

The Second Circuit also gave guidance on particular facts that indicate anticipation of litigation in tax cases. The court noted that the type of analysis in the documents before it was squarely in the work product protection's ''area of primary concern—analysis that candidly discusses the attorney's litigation strategies and appraisal of likelihood of success.''[15] The court also noted that ''the size of a transaction and the complexity and ambiguity of the appropriate tax treatment are important variables that govern the probability of the IRS's heightened scrutiny and, therefore, the likelihood of litigation.''

For the common legal interest doctrine, the Second Circuit clarified that parties working on a common legal strategy could fall into the protection, even if only one could be an actual party to the litigation. The court relied heavily on the fact that the parties had agreements to share information and to develop the structure jointly.

And the court rejected the argument that the bank's commercial interest precluded finding a common legal interest, holding that ''[a] financial interest of a party, no matter how large, does not preclude a court from finding a legal interest shared with another party where the legal aspects materially affect the financial interests.''[16]

Lessons Learned

Schaeffler II has several lessons for taxpayers:

- **Work Product for Contemporaneous Tax Analysis.** *Shaeffler II* demonstrates that, under the right circumstances, tax analysis of a proposed transaction can qualify for work product protection if the facts indicate both a subjective and objective basis for anticipating litigation, even if the litigation isn't imminent.

- **An IRS Audit Can Equate to Litigation.** The Second Circuit's opinion implies that anticipation of a dispute with the IRS at the administrative level may qualify as ''litigation.'' This conclusion is consistent with other recent opinions, including *Roxworthy* and *United States v. Eaton Corp.*[17]

- **Proving Anticipation of Litigation.** The Second Circuit's opinion lists a number of facts that supported its conclusion that the taxpayer anticipated litigation, including the size and complexity of the transaction and ambiguity regarding its proper tax treatment. Taxpayers anticipating litigation should consider documenting any similar facts.

- **Sharing Analysis.** *Schaeffler II* demonstrates that—at least in the Second Circuit—the common legal interest doctrine can prevent waiver of attorney-client and tax practitioner privileges when pre-transaction analysis is shared between counterparties so long as they share a common legal interest. The opinion demonstrates the importance of memorializing confidentiality agreements and of documenting how legal issues affect a counterparty's financial interest before sharing privileged information.

Despite the good news, however, taxpayers still must be cautious. The IRS and others are actively attempting to get past taxpayers' privileges. Those privileges are fragile, and missteps can easily waive protection.

In addition, the tests applied for privilege vary by jurisdiction, so case-by-case analysis is always needed to assure privilege and work product protection. And asserting anticipation of litigation as of a certain date may trigger other obligations, such as document preservation. For that reason, taxpayers should pay close attention to these developments and discuss them with their advisers and counsel.

[14] *Schaeffler II*, 2015 BL 369990 at *9.
[15] *Schaeffler II*, 2015 BL 369990 at *10.
[16] *Schaeffler II*, 2015 BL 369990 at *7.
[17] See *United States v. Eaton Corp.*, 2012 BL 206369 (N.D. Ohio 2012).