# Bond Case Briefs

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## District Court Holding 'Eviscerates' Work Product Protection.

A district court holding that the work product doctrine does not protect a tax memo prepared by an accounting firm from disclosure to the IRS "eviscerates" the doctrine, a practitioner told Tax Analysts May 29.

Rachel Leigh Partain of Caplin & Drysdale said the analysis by the U.S. District Court for the Southern District of New York in its May 28 holding in Schaeffler v. U.S., No. 1:13-cv-04864 (S.D.N.Y. 2014) was hard to comprehend.

"Frankly, I don't understand how work product exists after this opinion," Partain said. "I don't know what would satisfy this court that a tax memo is work product."

In Schaeffler, the court denied the petitioner's motion to quash an IRS administrative summons on the grounds that it called for privileged materials. As part of a complex debt refinancing and corporate restructuring done to address solvency issues, the Schaeffler Group, a German manufacturer, hired EY to provide it with tax advice on the U.S. tax implications of the transaction. EY prepared tax memoranda and in accordance with an agreement it shared its analyses with a consortium of banks that had financed the original transaction that was being refinanced and restructured.

In the agreement, both parties expressed a desire to share privileged, protected, and confidential documents and analyses without waiving those privileges. As part of the refinancing, the banking consortium also agreed to subordinate its claims to Schaeffler Group owner Georg F.W. Schaeffler's personal tax liabilities and provide an additional line of credit to pay the liabilities. Also, the parties agreed that the consortium would have the opportunity to advise on any contesting or settlement of a tax dispute, which the taxpayer expected was possible at the earliest planning stages of the refinancing and restructuring.

Regarding the work product doctrine, the court held that although the protection was not waived after disclosure with the consortium because of the parties' similar interests as well as the contractual obligation to keep the information confidential, the privilege still did not apply. The court reasoned that the EY tax memo would have been created in an essentially similar form had litigation not been expected. The fact that the memo weighed the chances of success in court for some tax positions did not indicate that the document would have been created differently, the court held.

Partain took exception to the court's rationale.

"This court treats a tax memo as a document that would have been prepared for other reasons," Partain said. "The court said the taxpayer would have received a 321-page memo regardless of whether it anticipated being audited or not. Not only that, the memo would have looked exactly the same." Partain added that it is uncommon for taxpayers to receive a tax memo of such a length and form unless they expect litigation.

The court cited Circular 230's stipulation that tax practitioners not allow the possibility that a tax return will remain unaudited to affect the advice they give.

Judge Gabriel W. Gorenstein said in his opinion, "When tax practitioners give advice to clients, they must ignore the actual possibility of an audit — and, by extension, litigation — in opining on the tax implications of a transaction. Thus, when providing legal advice on the tax treatment of the restructuring and refinancing transactions, the Ernst & Young advisors had a responsibility to consider in full the relevant legal issues regardless of whether they anticipated an audit and ensuing litigation with the IRS."

Partain said that the court's interpretation of Circular 230 is incorrect. Circular 230 stands for the proposition that an adviser cannot "take the audit lottery into account" when providing tax advice to a client, she said.

Under Circular 230, an adviser has to assume the taxpayer will be audited, Partain said. "The fact that this taxpayer obtained a Circular 230-compliant memo rather than a non-compliant memo demonstrates that the memo was prepared because of the anticipation of audit and litigation," she said.

Does Not Comport With Adlman

Partain said that because the court's holding does not comport with the liberal standard of work product protection enunciated in United States v. Adlman, 134 F.3d 1194, 1196 (2d Cir. 1998) , she would not be surprised if the decision was overturned on appeal. Adlman holds that a document used for other purposes can still receive work product protection if it is prepared in such form because of the prospect of litigation, Partain said.

Robin L. Greenhouse of McDermott Will & Emery LLP said that although the court used the language of Adlman in setting forth the legal standard, it appeared to be applying the Fifth Circuit's narrower "primarily-to-assist-in-litigation" standard when determining if a document should be afforded protection. That standard, however, was rejected by the Second Circuit in Adlman.

The Schaeffler court "is looking for some sort of memo that addresses litigation strategy," Greenhouse said. "For example, it would say, 'If we go to litigation, we will move for summary judgment, or we are going to do this discovery.'"

When the Schaeffler court is applying the portion of Adlman that says if a document would have been prepared in essentially the same way then it is not work product, what Adlman is really referring to is business documents, Greenhouse said. Such documents might include a step plan, but not a tax memo that addresses the likelihood of success on the merits, she said.

Although the court's opinion could be seen as being limited by the facts and circumstances, if it was to be applied more broadly it could mean that the work product doctrine and the attorney-client privilege were mutually exclusive, which is clearly wrong and contrary to the Adlman case, Greenhouse said.

Attorney-Client Privilege Waived

Regarding the attorney-client privilege, the court held that although the privilege is not waived when disclosures are made to parties who are engaged in a common legal enterprise, which is known as the common interest rule, that rule does not apply to a relationship that is mainly an economic one, as was the case in Schaeffler, and therefore that privilege likewise does not apply.

The consortium's "enormous stake" in the tax consequences of Schaeffler's refinancing and restructuring did not equate to a common interest and therefore the disclosure of documents to the consortium waived the privilege, the court said.

"It is not enough that the Bank Consortium had a desire for Schaeffler to succeed in a dispute with the IRS. What is lacking is any common legal stake in Schaeffler's putative litigation with the IRS. If the Bank Consortium could have been named as a co-defendant in the anticipated dispute with the IRS, the result would undoubtedly be different," Gorenstein said.

The court likewise gave no credence in terms of its application to the attorney-client privilege to the agreement the consortium and the Schaeffler Group made before the litigation that sought to preserve privilege while sharing tax memoranda.

Partain said that although the case likely does not move the needle on common legal interest rule, given that not many favorable common legal interest decisions exist, every decision helps to further refine the parameters of the waiver exception.

The Schaeffler decision comes on the heels of AD Investment 2000 Fund LLC v. Commissioner, 142 T.C. No. 13 (2014) . In that decision, the Tax Court held that taxpayers forfeit the protection of attorney-client privilege on tax opinion letters from a law firm if they seek to avoid accuracy-related penalties by asserting affirmative defenses of good faith and state of mind.

by Andrew Velarde