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Focus on Tax Controversy

Waiver of Privilege: Disturbing Trends

By Jean A. Pawlow

Several recent cases have given the government the upper hand in the battle over protection of privileged communications. Arguing that taxpayers cannot use the attorney-client and tax practitioner privileges and work product protection as both a "sword" and a "shield," courts have increasingly required taxpayers to disclose tax advice prepared by their accountants and lawyers.

The attorney-client and tax practitioner privileges are waived when the privileged material is shared with any third person. That waiver then applies to "all other communication relating to that same subject matter." *Fort James Corp. v. Solo Cup Co.,* 412 F.3d 1340, 1349 (Fed Cir. 2005). Work product protection is waived when confidential material is shared with an adversary or a conduit to an adversary. The scope of waiver of work product immunity is more nuanced, depending on the type of work product. The waiver of work product, however, also extends to all non-opinion work product concerning the same subject matter. *In re EchoStar Comms. Corp*., 448 F.3d 1294, 1302 (Fed. Cir. 2006). Several recent opinions illustrate the application of these waiver rules and the potential ramifications of relying on privileged tax advice as a defense to proposed Internal Revenue Service (IRS) penalties.

In *Salem Financial, Inc. v. United States*, No. 10-192T (Fed. Cl. Jan. 18, 2012) (opinion and order on motion to compel discovery), as part of its defense to IRS penalties, the taxpayer contended that it had reasonable cause for claiming foreign income tax credits associated with a financial transaction known as STARS (Structured Trust Advantaged Repackaged Securities). Specifically, the taxpayer relied upon "extensive KPMG and Sidley tax opinions, PwC's conclusion that reliance on these opinions was reasonable, and [the taxpayer's] own internal review and approval of the proposed transaction." The taxpayer therefore "put the advisor's advice at issue."

The government, predictably, first sought to obtain the taxpayer's tax reserve workpapers. The taxpayer attempted to distinguish between PwC's "technical analysis of STARS" and the information and analysis that resulted in the taxpayer's tax reserve position. The taxpayer specifically noted that it considered factors other than PwC's technical analysis as part of determining its tax reserve position. The court, however, held that PwC's technical evaluation of the strengths and weaknesses of the transaction "influenced" the taxpayer's analysis of its litigation and settlement positions. By relying on PwC's advice as a defense to the IRS penalties, therefore, the taxpayer waived any work product protection that may have applied to its tax reserve documents.

The court next addressed certain documents that contained KPMG's advice concerning proposed changes in law and the "unwinding" of the STARS transaction. The taxpayer sought to distinguish "pre-closing" advice from KPMG, including the formal tax opinion on which it relied as a defense to penalties, and this "post-closing advice" from KPMG. The court, however, was not persuaded and required the disclosure of the KPMG documents because they related to the same subject matter: the proper tax treatment of the transaction.

The court reached a slightly different but ultimately no less troubling result in *Santander Holdings USA, Inc. v. United States*, No. 09-11043-GAO (D. Mass. Aug. 6, 2012) (opinion and order on motion to compel discovery). As in *Salem Financial*, the taxpayer in *Santander* entered into a STARS transaction and obtained an opinion from KPMG and advice from Ernst & Young (EY). Again the taxpayer relied on the opinion as a defense to penalties asserted by the IRS, and again the government sought to obtain the tax reserve workpapers and KPMG's and EY's post-closing advice.

The court in *Santander* first summarily held that the tax accrual workpapers must be disclosed. Either the documents were not protected by the work product doctrine in the first place because they were provided to assist EY in assessing the adequacy of the reserves, or, if not provided to EY in its capacity as independent auditor, the disclosure amounted to a waiver of work product. The court did not discuss whether EY was an "adversary" for this purpose.

Next the *Santander* court disagreed with the *Salem Financial* court and held that identifying the subject matter broadly as "tax advice about the STARS transaction" was "too general an assessment of the nature of the subject matter." Therefore, the court held that the attorney-client and tax practitioner privileges and work product protection had not been waived as to documents involving advice relating to changes in U.S. and UK law and advice relating to the unwinding of the STARS transactions.

Unfortunately, the court reached a different result with respect to documents categorized broadly as "advice relating to the IRS audit of the STARS transaction." As part of its document productions, the taxpayer intentionally produced a post-closing KPMG "economic substance" memorandum. The memorandum reflected advice tendered by KPMG to the taxpayer and EY in connection with the IRS audit. The memorandum indicated that KPMG continued to stand by its opinion and that the STARS transaction should withstand IRS scrutiny, and differentiated the taxpayer's transaction from other transactions. The government argued that the taxpayer could not selectively disclose documents helpful to its case, and that "all other privileged documents relating to advice tendered to the taxpayer during the IRS audit to assess the legitimacy of the transaction" should be considered together with this KPMG memorandum. The court agreed, holding that the memorandum clearly fell within the scope of the privilege, but that by voluntarily disclosing it, the plaintiff waived the privilege as to it and other KPMG and EY documents discussing the same subject matter, "which includes the IRS positions regarding the audit." This portion of the decision is striking because, of course, it is not unusual for taxpayers to rely on opinions from accounting and law firms as a defense against penalties, and to continue to work with those advisors throughout the course of the audit.

In *AD Investment 2000 Fund LLC v. Commissioner*, 142 T.C. No. 13 (April 16, 2014), the Tax Court went one step further in extending the waiver doctrine. The case is a partnership-level action involving what the IRS describes as a Son-of-BOSS tax shelter. The IRS asserted penalties alleging a substantial understatement, a gross valuation misstatement, and negligence and disregard of the rules and regulations. The taxpayers, in their Tax Court petitions, asserted as an affirmative defense that they "reasonably believed" that the tax treatment was more likely than not correct, that the underpayment was due to "reasonable cause" and that they acted in "good faith." These are common defenses that are pled in almost every case where the IRS proposes penalties.

The IRS then sought to obtain tax opinions the partnerships received from the law firm Brown & Wood. The taxpayers argued that, although the partnerships received the opinions prior to the filing of the returns, the taxpayers did not rely on them. The Tax Court held that this was beside the point:

> The point is that, by placing the partnerships' legal knowledge and understanding into issue in an attempt to establish the partnerships' reasonable legal beliefs in good faith arrived at (a good-faith and state-of-mind defense), petitioners forfeit the partnerships' privilege protecting attorney-client communications relevant to the content and the formation of their legal knowledge, understanding, and beliefs.

One might suspect that judges are more likely to tip the scales in favor of the government in tax cases involving perceived "tax shelters." One recent case, however, has taxpayers and practitioners scratching their heads as to just how far afield a court can go. In *Schaeffler v. United States*, No. 1:13-cv-04864 (S.D.N.Y. 2014) (opinion and order on motion to quash summons), the taxpayer acquired shares of a German automotive supplier. As a result of adverse economic conditions, the taxpayer undertook substantial debt refinancing and corporate restructuring. The taxpayer hired outside tax and legal advisers at Dentons and EY because of the complexity of the U.S. tax issues and the material amounts potentially at issue. The taxpayer, EY and Dentons worked closely with a consortium of banks in effectuating the refinancing and restructuring and in analyzing the tax consequences, signing a common interest agreement they referred to as an Attorney-Client Privilege Agreement. The IRS issued a summons to EY, and the taxpayer moved to quash.

The court first held that the attorney-client and tax practitioner privileges were waived when the taxpayer and its lawyers and accountants shared documents with the bank consortium. The parties were found to have a common commercial interest, rather than a common legal interest. The court next held that the taxpayer had not waived work product protection because the disclosure to the bank consortium was not to an "adversary" and did not materially increase the likelihood of disclosure to an adversary. Indeed, the taxpayer had taken the step of entering into the Attorney-Client Privilege Agreement to preserve the confidentiality of the EY documents and lessen the possibility that the IRS could obtain the confidential information.

Unfortunately, the taxpayer won the battle but lost the war. The court also concluded that work product did not attach to the EY documents in the first instance. The taxpayer argued that work product protected each of the approximately 10,000 responsive documents that EY prepared in furtherance of the restructuring and refinancing measures. The only document that the taxpayer described in any detail was an EY "tax memo"—a 321-page document that contained a detailed legal analysis of the federal tax issues implicated by each of the transactional steps that EY proposed for the refinancing and restructuring. The court accepted the taxpayer's assertion that "litigation was highly probable" in light of the significant and difficult tax issues that were raised by the planned refinancing and restructuring. Relying on *United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998), however, the court considered whether the EY tax memorandum "would have been created in essentially similar form" had litigation not been anticipated. The court concluded that it would have, because the taxpayer would have wished to obtain advice to comply with the tax law in the most favorable way possible. The court noted that the memorandum did not discuss actions "peculiar to the litigation process" or "settlement strategies that might be considered." This appears to be a misreading of the standard in the Second Circuit, which does not require documents to have been prepared "primarily to assist in litigation" (the Fifth Circuit applies this test). The result is disturbing because taxpayers that enter into complex transactions regularly and routinely obtain similar "tax memos" from accounting and law firms to help them assess the strengths and weaknesses of their tax position. It is one thing to suggest that the protection afforded these kinds of documents can be waived. It is another thing altogether to suggest that they are not protected by the work product doctrine at all.

The lesson to be learned from these recent cases is that taxpayers must be to some degree prescient in anticipating how and when the government will seek to obtain privileged and confidential documents, and must be diligent in protecting them. Waiver, even inadvertent waiver, is a very real risk that can have unexpected consequences. Privilege battles can be time consuming and expensive, and it is never too early to think through the ramifications of sharing confidential documents or putting tax advice at issue.

New Repair Regulations Affect All Taxpayers

By Dwight N. Mersereau and Kevin Spencer

The Internal Revenue Service (IRS) recently issued final regulations (Repair Regulations) that determine when taxpayers may deduct costs to acquire, produce or maintain tangible property. In 2014 all taxpayers must follow these new rules, which generally will require them to change their method of accounting with the IRS.

General Capitalization Rules for Maintenance of Property

The Repair Regulations generally require taxpayers to capitalize all costs that "improve" their property and equipment. Property and equipment is improved if the taxpayer "betters" the property, "restores" the property, or adapts the property to a new or different use. Whether the taxpayer has improved property is determined by looking at the effect of the repairs to the "unit of property." Under this determination, the larger the unit of property is, the less likely an expenditure will improve the property. The determination is based on all of the facts and circumstances.

The Unit of Property Explained

A unit of property includes all "functionally interdependent" components. Generally, if one component of property cannot be used without another component of property, the two components are functionally interdependent. There are several exceptions intended to reduce the size of the unit of property. For example, if a component performs a discrete and major function, it is a separate unit of property from all the other property and equipment, even if the component is otherwise functionally interdependent with the other property and equipment.

A special rule applies to buildings. Although the unit of property of a building includes the building and all of its structural components, to determine whether an expenditure "improves" the building, the regulations require the taxpayer to look at the numerous discrete systems, such as the heating and air conditioning systems, the plumbing system, the electrical system, etc. A repair to one of these discrete systems is more likely to be an improvement than if the taxpayer made the determination by looking only to the building.

Finally, if a taxpayer separately depreciates a property, the taxpayer must treat it as a separate unit of property.

Betterments

A betterment is work that ameliorates a material condition or defect that existed prior to the acquisition or production of the property, or contemplates a material addition or improvement to the property, including its enlargement, expansion or extension. A betterment is reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the property.

Restorations

Similarly, taxpayers must capitalize all restorations costs. A restoration includes replacing component parts, repairing significant damage to property, returning property that was nonfunctional to its ordinary efficient use, rebuilding property to like-new condition, and replacing a "major component or substantial structural part."

Adapt to New or Different Use

If work on a property adapts it for a new or different use, the taxpayer must capitalize those costs. The regulations contain numerous examples with helpful guidance outlining the contours of this rule.

The *De Minimis* Rule Offers Taxpayers Flexibility

Under the *de minimis* rule, each year taxpayers may elect to expense costs they would otherwise have to capitalize under the above rules. To take advantage of this treatment, the taxpayer must have a written expense policy at the beginning of the year and must expense for non-tax purposes the costs in accordance with that policy.

The regulations provide a "safe harbor" for costs of an invoice (or an item specifically listed on the invoice) up to $5,000 for taxpayers that issue audited financial statements. For taxpayers without such statements, the amount is reduced to $500. The regulations acknowledge that taxpayers may demonstrate that they should be allowed to expense amounts in excess of the safe harbor amounts based upon specific facts and circumstances.

Importantly, if a taxpayer elects the *de minimis* method, it must use this method for all amounts properly expensed under its written policy.

Routine Maintenance

The Repair Regulations permit taxpayers to deduct expenses incurred to maintain property in its ordinarily efficient operating condition. These expenses are deemed not to improve the property if the taxpayer expects to incur them more than once during the life of the property (more than once in a 10-year period for buildings). Exceptions to the rule are extensive and may make the safe harbor largely irrelevant for most taxpayers.

Casualty Losses

The Repair Regulations permit a taxpayer to deduct the cost of repairs after a casualty, but only the amount that is above the loss the taxpayer claims on the damaged property. In other words taxpayers can claim a deduction that covers the entire cost of the damages, but they cannot deduct both the loss on the damaged property and the overlapping cost of the repairs.

Treatment of Materials and Supplies

Materials and supplies include items such as fuel, lubricants and similar property expected to be used and consumed within 12 months or less, and a unit of property with a useful life of 12 months or less. Additionally, "materials and supplies" include so-called rotable, temporary and standby emergency spare parts.

Generally, a taxpayer may deduct the costs of materials and supplies when they are "used or consumed," unless the materials and supplies are “incidental.” In that case, the taxpayer can deduct the cost of the material and supply when it purchases the item. A material and supply is incidental if the taxpayer does not otherwise track it and expensing it will not grossly distort the taxpayer’s income.

If a material and supply is not incidental, a taxpayer can still deduct its cost when it purchases it, if the taxpayer properly elected the *de minimis* rule and the material and supply costs less than the *de minimis* amount.

If a taxpayer uses a material and supply to improve a unit of property, however, the taxpayer must capitalize the cost of the material and supply into the cost of the improved property.

Flexibility for Rotables

Generally, a taxpayer may deduct the cost of rotable, temporary and standby emergency spare parts when it disposes of the spare parts (at which point they are considered used and consumed). This general rule, however, could defer the deduction for a very long time if, for example, the spare part has a long life or is not needed for a long time. Recognizing this, the Repair Regulations provide taxpayers with several options to recover the costs of these spare parts:

- Use the “Optional Method”
- Capitalize and depreciate the spare parts
- Elect the *de minimis* method

The Optional Method

The optional method permits a taxpayer to expense the entire cost of the rotable and temporary spare part when the taxpayer installs it. When the taxpayer removes the rotable, the taxpayer must include its fair-market value in income. Additionally, the taxpayer must add to the basis of the rotable the costs of removing and repairing it. If and when the taxpayer reinstalls the rotable, the taxpayer may deduct its new basis in the rotable. When the taxpayer finally disposes of the rotable and temporary spare part, the taxpayer may deduct any remaining basis.

Many taxpayers with rotables use this method for financial reporting purposes, so the availability of the optional method minimizes book/tax differences (in this same regard, the Repair Regulations allow taxpayers to elect to capitalize otherwise deductible costs in order to minimize book/tax differences).

All Taxpayers Must Change Their Methods of Accounting

Because of the significant differences between the new Repair Regulations and current law, taxpayers should expect to change their methods of accounting. Taxpayers should consult with their tax professional immediately to implement the new regulations and file an accounting method change to adopt the most favorable accounting methods. Taxpayers under audit should expect the IRS to examine the issue.

Closing Thoughts

The Repair Regulations provide welcome guidance in what was a murky, disjointed set of rules relating to the treatment of tangible property. Undoubtedly, however, these new rules will increase the administrative/recordkeeping burden for taxpayers. In addition, the lack of bright-line rules and the fact that many of the rules rely on a facts and circumstances determination likely will create tensions between the IRS and taxpayers. Nonetheless, with good planning the Repair Regulations will provide taxpayers with clearer treatment of their costs.

Unclaimed Property – It Is Not a Tax, but It Can Feel Like One

By Diann Smith

For the past two decades, unclaimed property (also called abandoned property or escheat) compliance and defense has slowly but surely become an increasing risk for businesses. Today, any company that is not on top of its unclaimed property obligations faces significant liability hazards that can reach back almost 30 years. Even companies that think they are following the law may be surprised during an audit by the onerous documentation auditors require to accept that a credit or voided check is not unclaimed property. All businesses, regardless of industry, geographic location or customer base, should keep abreast of current developments in unclaimed property enforcement.

Background

Every U.S. state (and some foreign jurisdictions) has a law that requires businesses (known as holders) possessing intangible property remaining unclaimed by the actual owner to remit that property to the government. While several uniform statutes have been drafted addressing unclaimed property, state laws still vary significantly regarding what is considered unclaimed property and when property is considered abandoned by the actual owner. Some states, such as Delaware, rely on unclaimed property remittances as a revenue raiser supporting the state's general fund.

Unclaimed property is property, held or owed by a business to someone else, for which the actual owner has not, during a certain period specified by law, taken some action that indicated an awareness of an ownership interest in the property. When this "abandonment" occurs, it becomes the obligation of the party holding the property to report and pay over such property to the state. Unclaimed property may include almost every type of intangible property imaginable, including stocks, gift card balances, uncashed vendor or payroll checks, and customer credit balances.

Many states do not have a statute of limitations on when a business can be assessed for unremitted unclaimed property, even if the company has routinely filed an unclaimed property report with the state. As a result, unclaimed property audits have gone back as far as 1981 in some instances. At a minimum, many states require that a holder maintain records related to unclaimed property for at least 10 years.

The Supreme Court of the United States set out the following rules for determining which state is entitled to take custody of property when the owner cannot be located:

- Where the last known address of the creditor (*i.e.*, owner of the intangible personal property) is known, the state in which that address is located has the right to escheat (primary rule).
- Where the last known address of the owner is unknown, or is in a state that "does not provide for escheat of the property owned," the state in which the debtor is incorporated is awarded the right to escheat (secondary rule).

Some states have adopted, controversially, a third priority rule that provides that if neither of the first two priority states claims the property, the state in which the transaction that gave rise to the property occurred may claim the funds (the transaction test). While many states have codified the transaction test, it is not widely enforced, and at least one court has ruled that it is unconstitutional. This leaves holders in a continuing dilemma regarding the enforceability of the transaction test.

Current Developments

REVISION OF UNIFORM ACT

The Uniform Law Commission is the author of three historic versions of the Uniform Unclaimed Property Act—1954, 1981 and 1995. It is currently undertaking a project to revise the Uniform Act and is expected to address many of the compliance and enforcement issues that have surfaced since the last revision. Written comments are now being filed with the drafting committee, and an initial draft of the revision is expected prior to the drafting committee's meeting in November 2014. The states, through the National Association of Unclaimed Property Administrators, are very active in this drafting process and filed significant comments with the drafting committee on May 9, 2014. Holders should become involved in the drafting process by either filing comments or participating in the meetings (directly, through counsel or through interested trade associations). Many holders believe that the 1995 Uniform Act too heavily favored state and third-party auditor interests. The revision is an opportunity for holders to fix problems that have developed as a result of aggressive audit positions by states and their third-party auditors, as well as changes in business practices and technology.

PROOF OF REMEDIATION

When a holder is audited, it must demonstrate that items that might otherwise be considered unclaimed property, such as voided checks or account receivable credit balances, are not actually due and owing. This process is called remediation. Auditors are very strict regarding the type of proof acceptable to demonstrate that the property is not actually owed to someone. For example, if a holder issues a check to cover the fee for an employee to attend a conference, but the employee decides not to attend the conference and therefore the check is voided, the holder may lack the historic evidence to prove that the voided check was actually not due to the conference organizer. Under audit, the company may have to find the conference organizer (if possible) and get a signed letter that the fee is not due. This process may need to be repeated for all of the possible voided, but not actually due, checks that a company may have on its ledgers. Similarly, a company may issue a credit to a customer for use against a future order as part of a customer satisfaction program. If the customer never places another order, what proof can the company offer that the credit was not refundable in cash (if this is even a valid defense)? Remediation can be expensive and extraordinarily time consuming, and can cause a significant drain on employee resources during an audit.

STATUTE OF LIMITATIONS

As noted above, many states (and the 1995 Uniform Act) do not provide a statute of limitations for assessments of unclaimed property, even if a holder has been routinely filing unclaimed property reports. The lack of a statute of limitations is problematic from both a liability and a record-keeping perspective. Several legal arguments may exist that can limit a holder's historic liability, but these arguments have not yet been tested in court. For example, there may be an argument that an external statute of limitations can be imputed on unclaimed property assessments, such as a state's general statute of limitations that would apply in the absence of a specific provision. Another problem arises from state provisions called anti-private escheat laws. These laws prevent a statute of limitations that would otherwise run against the owner—such as a statutory one found in a law such as the Uniform Commercial Code or a contract provision—from operating against the state for purposes of unclaimed property remittance. Thus, even though an owner may no longer have a claim against the holder for the property, the state may assert that the property must still be remitted to the state. This is another area where legal challenges (for example, that a specific statute of limitations should overrule the general anti-limitations provision or the derivative rights doctrine) might give holders relief, but there has been little litigation, and when that litigation has occurred (such as for the derivative rights doctrine), the results have been inconsistent.

WHISTLEBLOWER ACTIONS

Holders are at risk not only from state-generated audits, but also from third-party lawsuits under state *qui tam*, False Claims Act or private attorney general statutes. While the state statutes vary in scope and language, under this type of action a third party (called a relator) brings a case against a holder claiming that the holder knowingly made false claims to the government regarding unclaimed property; willfully concealed property that was required to be delivered to the government; or knowingly made a false statement to conceal, avoid or decrease an obligation to pay money or property to the government. These actions are particularly threatening, because if the holder is found liable, it can be subject to treble damages plus a per occurrence penalty.

Conclusion

The issues noted above are only a few of the current matters that holders are grappling with regarding unclaimed property compliance and defense. Additional issues include the amount of due diligence sufficient to locate a lost owner or owner address, the scope of indemnification provisions in an acquisition, liability for owners with foreign addresses, and the priority state for unclaimed property determined using sampling and extrapolation. The Uniform Law Commission revision project, litigation and evolving audit techniques will have an effect on all of these issues.

McDERMOTT TAX CONTROVERSY HIGHLIGHTS

McDermott Tax Controversy Practice Continues to Earn Top Rankings in Chambers USA *2014*
McDermott Will & Emery LLP has once again been recognized as a leading firm in 51 areas in the latest edition of *Chambers USA*. This includes practice rankings in 17 national categories, including Tax: Controversy.

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