Assessing Your Options Post-Assessment

The statutory notice of tax assessment has been issued. In our view taxpayers have four general options in response to the notice of assessment. Those options include 1) appealing the sales and use tax assessment, 2) paying the assessed liability and filing a refund claim, 3) conceding and paying the liability, and, in conjunction with any of the prior three options, 4) lobbing the state legislature to change the sales and use tax law(s) at issue.

This paper details the issues and considerations regarding appealing, handling and litigating a state tax assessment appeal and paying the assessment and filing a tax refund claim.

I. Filing an Appeal - Assessments and Refunds

1. Initial considerations

   A. Statute of limitations

      • In General. States have strict rules and timelines regarding appealing tax assessment notices.

         ✓ Understand completely the practice and procedure to appeal the tax assessment notice.

      • Most states have a three-year statute of limitations period for refund claims. A number of states have a four year statute (i.e. Arizona, Kentucky, Maryland, Michigan, New Jersey, Ohio, Texas, Washington, Wisconsin).

         ✓ Practice point. The limitations period for refunds may be the same as for assessments. In certain states, however, (including Florida, Louisiana, Idaho, North Dakota, South Carolina, and Wyoming) there are different (i.e. shorter) limitations periods for refund claims.

         ✓ Limitations period absolute—Pennsylvania. An auto manufacturer, under Pennsylvania’s lemon law, had to refund the full purchase price, including sales tax, of certain automobiles to the purchasers. The manufacturer then requested a refund of the sales tax that it had collected and paid over to the state. The Commonwealth Court held that the three-year statute of limitations on refund claims was absolute—even though the manufacturer’s right to refund did not accrue until after the limitations period had expired. As a result, the manufacturer’s sales tax refund claim was denied. DaimlerChrysler Corp. v. Commonwealth, 279 F.R. 2004 (Pa. Cmwlth. 2005) (appeal filed Dec. 27, 2005).

      • Tolling the statute of limitations

         ✓ Waivers. If the taxpayer signs a waiver tolling the statute of limitations on assessments, the statute of limitations for refunds will be also tolled in most states. In certain states, however, (including Rhode Island, South Dakota, Minnesota, Iowa, Florida, and D.C.) a waiver will not extend the refund period.

         ✓ Effect of pending refund or assessment claims

         • A pending refund or assessment claim will not typically keep the statute of limitations open for other overpayment issues not
raised in the original claim. Attaching a general list of potential issues to your claim may provide some protection, however, against statute of limitations defenses in case you later identify additional issues that would otherwise be time barred.

• **Problem state—Texas.** Effective June 20, 2003, the only administrative proceedings that will toll the statute of limitations are formal administrative refund or redetermination hearings, and the tolling is limited to the contested issues raised. Moreover, § 111.1042(d) Texas Tax Code expressly provides that the time period in which a refund claim is informally reviewed does not toll the statute of limitations for any subsequent claims. Note that before the statutory change, if a refund claim filed prior to June 20, 2003 was being informally reviewed, then that claim tolled the statute of limitations for all refund issues that the claimant could file for the same tax type and same period. See STAR Accession No. 200508202L (August 2, 2005).

• Traps and problem states
  
  ✓ **Refunds of paid assessments.** In some states, the limitations period is different where the refund involves payment of an assessment. For example, in Connecticut, if a refund claim relates to tax paid for an assessment made under Conn. Gen. Stat. §12-415 or §12-416, the claim must be filed within six months after the assessment becomes final. Section 12-418 provides that an assessment becomes final 60 days after service of the notice of assessment on the taxpayer, unless a petition for reassessment is filed. If a protest is filed, the assessment becomes final one month after service on the taxpayer of the Department's final determination of the protest. So a refund claim that relates to tax paid for an assessment under Conn. Gen. Stat. §12-415 must be filed within 60 days plus six months from the date of the first billing of the audit assessment. However, if the taxpayer pays the tax and protests the assessment, the refund claim must be filed within seven months (one month plus six months) from the date of the Appellate final determination letter.

  ✓ **Problem state—Pennsylvania.** If the taxpayer is subject to an audit and the auditor does not grant a credit for a sales or use tax overpayment, the taxpayer must file a refund claim within six months of the mailing date of the assessment notice or else the taxpayer's right to refund is forfeited. 72 P.S. § 10003.1(b).

  ✓ **Practice point—bad debt.** The procedures may be different for vendor claiming a refund of sales tax collected and paid over to the state on worthless accounts. For example, in Massachusetts, vendors may not claim a bad debt deduction when remitting sales and use taxes to the state. Rather, reimbursements are paid annually without interest and must be claimed by filing Form ST-BDR on or before the due date, including extensions, of the vendor’s federal income tax return for the prior fiscal year. Sec. 33, Ch. 64H, G.L.; Technical Information Release 00-3, Mass. Dept. of Rev. (Feb. 10, 2000).

B. Use tax accruals
Separate refund claim may not be required. In some states, taxpayers may be able to request a refund of over-acquired use tax by simply making a reversing entry on a subsequent use tax return.

Practice point—audit exposure. Use tax reversals are one of the first things auditors review. So if you decide to make a reversing entry, be sure to properly document the basis for the reversal and maintain all documentation (invoices, proof of payment, etc.) until the statute of limitations period for assessments has expired.

C. Overpayments to vendors

In general. In many states, the refund procedure is more complex where the taxpayer is seeking a refund of tax paid to the vendor. The issue is whether the refund must be requested from the vendor or from the state.

Requesting refund from state

Customer initiated versus vendor initiated claims. Some states do not allow taxpayers to file a refund claim with the state to recover tax paid to vendors. Rather, the vendor must file the claim. For example, a taxpayer lacked standing to file a Missouri sales tax refund claim because the tax for which it sought a refund was remitted to the state by the taxpayer’s vendors and not by the taxpayer. The statute allows a refund to a person legally obligated to remit the tax. As the taxpayer paid the tax to its vendors and not directly to the state, it was not the person legally obligated to remit the tax and therefore had no standing to claim a refund. See Sprint Communications Co. LP v. Missouri Director of Revenue, Missouri Administrative Hearing Commission, No. 05-1518 RS (Feb. 9, 2006).

Assignment of rights. About half of the states that require vendors to file refund claims allow the vendor to assign their rights to the purchaser. For example, Florida typically requires a purchaser to request a refund of over-collected sales tax from the vendor; however, it will permit the purchaser to file a refund claim directly with the state if it submits an assignment of rights from the vendor. By contrast, California does not allow refund claims to be brought in the purchaser’s name; however, it will allow the purchaser to file a refund claim on the seller’s behalf.

Practice point—what if state doesn’t allow assignment? If the state requires the vendor to file the claim, the purchaser should make the process as simple as possible. Ideally, all that the vendor should have to do is sign the claim. The purchaser should also ask the vendor to forward all state inquiries to the purchaser’s tax department. Obviously, the vendor is more likely to be cooperative if you’re an existing client, so it’s preferable to proceed on refund claims while there is still an ongoing customer relationship.

Requesting refund from vendor. Other states require the purchaser to request a refund from the vendor. For example, in Missouri, purchasers who make erroneous tax payments to vendors must claim refunds from the vendors rather than the state. The vendors may then submit refund claims to the state (on Form 472B).
Problem state—Arizona. The Arizona Court of Appeals held that there was no statutory obligation for a vendor to pay over sales tax refunds to the customer. As a result, guided river rafting operators that paid transaction privilege (sales) tax on rafting expeditions that were determined to be not subject to tax were entitled to unconditional refunds of the tax paid and were not required to pass those refunds on to their customers. Regardless of whether the taxpayers included the tax in the total amount charged to their customers or added the tax as a separate item, all of the tax remitted was refundable and the Department’s refusal to grant refunds unless the tax was returned to the purchaser was without merit. Canyoneers, Inc., et al., Arizona Court of Appeals, Div. One, Nos. 1 CA-TX 00-0016, 1 CA-TX 00-0017, 1 CA-TX 00-0018, and 1 CA-TX 00-0019 (May 17, 2001). Thus, to obtain a refund from the vendor, the purchaser may have to proceed under civil statutes if the vendor refuses to cooperate.

D. Separate refund appeal or offset of assessment?

- Handling a refund claim in the context of an assessment appeal has the potential advantages of 1) extending the normal statute of limitations period to the period covered by the audit and 2) allowing the taxpayer to utilize the auditor’s sampling method to project a refund.

- Practice point—settlement negotiations. If your company is faced with a significant assessment, you should consider a reverse audit to identify potential overpayments. The overpayments will enhance your bargaining power at the negotiating table. That is, the overpayments may be a way to reach a walk-away settlement whereby the state concedes the assessed tax if the taxpayer concedes the refund claim.

2. Preparing the claim

A. Appeal Documents – Follow in detail the state’s statutory and regulatory guidance regarding the filing of a proper assessment appeal. Generally this will include an appeal petition (signed by a corporate officer or authorized representative), a copy of the statutory notice being appealed and a detailed statement regarding your disagreement with the tax assessment.

- A statement attempting to raise all issues (all potential underpayment and overpayment issues) is generally a good idea in the event a new issue arises during the audit.

- Many issues will need to be raised in a general, non-specific manner.

B. Sampling

- Few states have promulgated a rule that allows use of sampling in connection with taxpayer-initiated refund claims. One state that has codified such a rule is Texas: under §151.430 Texas Tax Code, a holder of a sales tax permit or a use tax collection permit who overpaid tax to the state or to another retailer may compute their refund using a projection based on a sampling of transactions. The method used must comply with generally accepted sampling methods.
• Other states have informal policies that allow taxpayers to use sampling techniques in refund claims.¹
  
  ✔ **Allowed for accruals and payments to vendors:** Alabama; California (payments to vendors only for tax-paid purchases-resold transactions); Iowa; Maryland; Mississippi; Nebraska; New York; North Carolina; Oklahoma; Tennessee; Utah; Virginia; Washington; Wisconsin.
  
  ✔ **Allowed for use-tax accruals only:** Florida; Illinois; Kansas; Kentucky.
  
  ✔ **Allowed on case by case basis only:** Idaho; Louisiana; Missouri (use tax only); West Virginia.
  
• **Practice point.** Of the states that don’t allow sampling of overpayments for taxpayer-initiated refund claims, many will allow sampling in the context of state-initiated audits. Therefore, if you are on a regular audit cycle, you can reduce costs and resources by performing an overpayment review in connection with the auditor’s sample of underpayments.

• **Problem state—Pennsylvania.** In *McNeil-PPC, Inc. v. Commonwealth*, 834 A.2d 515 (Pa. 2003), the Pennsylvania Supreme Court held that the Department of Revenue has a duty to consider both underpayments and overpayments during an audit because the purpose of an audit is to determine the proper amount of tax due, not to just find underpayments. As a result, the Department now has the duty to review each transaction (subject to applicable sampling procedures) and determine the proper amount of tax due by taking into account tax overpayments during the audit period. The Department’s policy, however, is that the auditor will not review overpayments unless the taxpayer specifically brings them to the attention of the auditor. In addition, the Department’s policy is that it will not project overpayments—even if the transactions were included in the auditor’s sample. (See *Sales Tax Bulletin 2004-02*.) This policy is inconsistent with the *McNeil* decision. Therefore, taxpayers may want to consider not conducting a complete overpayment review and asserting that their overpayment should be computed using the auditor’s sampling method. At a minimum, taxpayers should compare the amount of their overpayment computed using a complete review versus the amount computed using the auditor’s sampling method. If the sampling method would give you a better result, taxpayers should raise this issue in their claim.

C. Maximizing your recovery: gathering evidence

• From contacts within the company. A company’s tax department may have little information about the types of purchases being made. In this case, your tax department personnel or consultant will need to contact someone in the company who can describe the purchase in detail. In most companies, the invoice itself should list the persons who approved the purchase. Those people are typically the best place to start.

• From the vendor. If you don’t have a record of a transaction, try calling the vendor. The sales representative should be listed on the invoice. If you don’t have the invoice, try the accounts receivable department of the vendor. They

¹ Based on *Summary of State Sampling Practices*, Federation of State Tax Administrators (updated January 2004).
typically can send you a copy of the invoice and put you in touch with the right people to talk to.

- **Internet resources**
  
  - **Google.** If a vendor has gone out of business and there is no internal information about a purchase, information obtained from the Internet may be sufficient to support a refund claim. For example, if computer services are non-taxable in a particular state, information about that vendor that shows its business was solely providing computer services should be enough to support a claim. This can be especially helpful if you don’t have a copy of the invoice and only have accounts payable data.

  - **Use of quotes.** Add power to your searches by putting the vendor’s name in quotes. Narrow your search even further by adding the vendor’s telephone number or address to your search terms.

  - **Cache pages.** If the current version of the web page doesn’t have the information you’re looking for, click on the cache link. This will show you the contents of the web page when it was last indexed.

  - **Site specific searches.** You can focus your search to a particular Internet site. For example, to limit a search to the IPT website, simply type: “site:www.ipt.org/” and add this to your search terms.

  - **Image search.** Google has an index of photographs and images (see http://images.google.com/). This can be useful in supporting a refund claim—state auditors and hearing officers take comfort in seeing color photos of the purchase at issue. For example, if claiming a manufacturing exemption on a particular piece of equipment, you may be able to find an online photo of that equipment using this search tool.

  - **Internet archive.** If your vendor has gone out of business and no longer has a functioning website, or if the equipment at issue is no longer listed on a website, you can still obtain information about the vendor or equipment using the Internet archive. This tool provides a snapshot of how particular websites looked as far back as the mid-1990s. (See http://www.archive.org.)

D. Perfecting the claim

- **Statutory Appeal Documents**

  - **All documents required by the state statutory and regulatory authority and Department policy guidance to properly and correctly appeal the tax assessment.**

  - **You don’t want to give the state an argument that the appeal was not properly filed.**

- **What to submit**
Basic elements of claim:

- **Cover letters and forms.** If the taxpayer is requesting the refund in a stand-alone claim, they should submit a cover letter to the taxing agency. The letter should be signed and dated and state that a refund is being requested pursuant to the state law permitting such claims. The taxpayer should request that a date-stamped copy of the claim be returned to them or send the claim return-receipt requested to prove that the statute of limitations requirements have been met. Before sending a claim by FedEx, UPS, or other carrier, check whether the state agency allows deliveries other than by U.S. Postal Service or hand delivery.

- **Description and basis of claim.** The taxpayer should provide a detailed analysis of each aspect of the claim. The analysis should include: an explanation of the company's business; a detailed description of the purchases at issue; and the legal justification (including citations) for the claim. Rather than grouping transactions just by vendor, group them by issue: each issue should be assigned a number that can be cross referenced to the transaction schedules.

- **Summary and detailed transaction schedules.** Each issue and vendor combination should be listed and categorized on a summary schedule. Detailed schedules with vendor name, invoice numbers and dates, purchase and tax amounts, and purchase descriptions should also be provided. Some states have model schedules that should be followed. In addition, some states require schedules to be submitted electronically. Even if this is not a formal requirement, taxpayers should typically submit schedules electronically to aid the hearing officer's review.

- **Copies of invoices and other original documents.** These documents might include sales invoices, purchase invoices, purchase orders, exemption certificates, and shipping documents. For large claims, see whether the state will accept a representative sample before submitting copies of invoices and other documents for all of the transactions at issue.

- **Proof of payment.** A purchaser must show that they paid the tax at issue. For tax paid directly to the state, this is typically just a matter of providing copies of the appropriate use tax returns. For tax paid to vendors, this means providing copies of canceled checks. If many transactions are at issue, states will typically allow the purchaser to provide a sample of canceled checks.

- **Supporting evidence.** Evidence that may support your claim includes: statements/affidavits describing the purchase that are signed by the company representative who approved the purchase or who is otherwise familiar with the purchase; statements/affidavits from the vendor; vendor marketing materials (i.e. brochures, website screen prints); and user manuals or photographs of the purchases at issue.

**Sufficiency of claim**
To avoid statute of limitation issues, you should be as specific as possible. Otherwise, your claim can be rejected for failing to satisfy the statutory sufficiency requirements. In that case, you may not be able to refile your claim if the statute of limitations period has expired. The typical standard is that the claim must set forth in detail the grounds upon which a refund is claimed and facts sufficient to apprise the state of the exact basis of the claim.

**Problem state—New Jersey.** Under proposed N.J.A.C. 18:2-5.8(d)(3) (proposed March 6, 2006), sales tax refund claims “shall include copies of all receipts for transactions that are the subject of the refund claim.” The proposed regulation does not define the term “receipt,” but appears to require the submission of copies of documents, such as invoices, that describe the transaction and written proof of payment to show that the charges for the goods or services, and the related tax, have been paid. As currently proposed, taxpayers who fail to submit “written receipts” at the time the claim is filed could later find out their refund claim is void for purposes of meeting the statute of limitations or determining when interest begins to accrue. The Division of Taxation is currently considering whether the proposed language should be revised to clarify that a claim will be valid for statute of limitations and interest purposes as long as it “set[s] forth in detail each ground upon which a refund or credit is claimed and facts sufficient to appraise the Division of the exact basis thereof.” The Division is also considering what taxpayers should do in the case of electronic invoices where no paper copy is generated.

3. **Handling the appeal**

**A. Meeting with state officials.** States typically provide for some type of informal conference. This is an opportunity to identify which issues the hearing officer may have problems with. Based on these discussions, the taxpayer can submit additional information or evidence to address the hearing officer’s concerns.

**B. What if the state says no?**

- Further administrative review

  - **Appeal periods.** If your assessment appeal or refund claim is denied, you’ll typically have a short appeal window. These are bright-line rules that must be strictly complied with.

  - **Developing the record.** During the administrative process, be aware of where the record will be developed. That is, will subsequent tribunals make their decision based solely on the facts established at the administrative levels or will the taxpayer have the opportunity to introduce new evidence in support of their claim.

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2 This is the current standard under N.J.A.C. 18:2-5.8(g).
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- **Settlement negotiations.** In some states (for example, California), appeals can be compromised for a percentage at the administrative level. In other states (for example, Michigan) settlements based on risk of litigation can only be negotiated once the claim has been appealed to court.

- **Appeals to court and litigation strategy.** If assessment appeals or refund claims are denied at the administrative level, appeal to court may be necessary. Of course, the vast majority of appeals never proceed to litigation, but filing an appeal to court allows the negotiation process to continue (usually with one of the state deputy attorney generals). In states where the administrative agency is not empowered to enter into percentage settlements based on risk of litigation, appeal to court will almost always be necessary to negotiate relief on “gray” issues.

  ✓ **Practice point—facts alleged in court filings.** The standards for sufficiency of a administrative appeal filing may be different than the standards that apply to court filings.

  ✓ **Practice point—skipping the administrative appeal process altogether.** In some states, you can avoid stages of the administrative review process or even skip it altogether. For example, in Washington, taxpayers who have kept adequate records and paid the required taxes may appeal to the Superior Court of Thurston County within the time limit for refund or, if an application for refund was timely made with the Department, within 30 days after rejection of the application, whichever time limitation is later. RCW 82.32.180.

  ✓ **Practice point—exhausting administrative remedies.** Before moving your appeal to court, you may need to fully exhaust your administrative remedies. For example, in Connecticut, the failure of two taxpayers to exhaust an administrative remedy before filing a suit in court that alleged a market improperly collected Connecticut sales tax on their purchase of certain food items resulted in the dismissal of their complaint for lack of subject matter jurisdiction. The court reasoned that an existing administrative remedy must be exhausted before the Superior Court will obtain jurisdiction. *Peruta v. Emcon Cheshire, Ltd.*, Connecticut Superior Court, No. HHBCV054004390S (June 8, 2006).

**C. Interest on overpayments**

- **Computation of interest.** In most states, interest begins to accrue from between 45–120 days after the claim is filed. The interest rate on overpayments may or may not be the same as the rate for underpayments.

- **Practice point—requesting a credit instead of refund.** If the state overpayment rate is less than the state underpayment rate, consider requesting a credit instead of a cash refund if you anticipate having other liabilities for the same period. By using the credit to offset the liability, you can avoid having to pay interest at the higher rate. Also, requesting a credit can be good option if interest doesn’t accrue until after the refund claim was filed even though the tax was paid much earlier. In some states, the overpayment credits will have an effective date based on when the tax was originally paid rather than when the claim was filed. Thus, they can be used to offset liabilities (and thus avoid interest on those liabilities) that relate to periods earlier than when interest on the overpayment would otherwise accrue.
• **Practice point—structure relief in earliest years.** In some instances, state officials may have more flexibility concerning the computation of interest than on compromising a particular legal issue. So if you’re negotiating a percentage settlement of an issue (and are requesting relief in the form of credits), see if the state will structure the settlement so that the relief is granted on the earliest transactions. This will result in credits with earlier effective payment dates, which will maximize your potential interest savings when you apply the credits to offset an older liability.

• **Problem state—Wyoming.** In Wyoming, there is no statutory provision at all authorizing interest on overpayments.

4. **Positioning yourself going forward**

   A. **Data and document retention—positioning yourself for future appeals**

   • **Accounts payable data.** If you include a tax field in your AP data, this will make the reverse audit process much easier by allowing you to track and identify potential overpayments. Although tax fields are increasingly common for expense purchases, tax fields are less common for capital purchases.

   • **Invoices.** Retaining copies of invoices is vital to a refund claim. If copies are scanned and retained electronically, it is vital to have a proper indexing system. Along with the invoices, it is helpful to save contemporaneous information about the purchase, including: copies of canceled checks; purchase orders; and contracts.

   B. **Do refund claims trigger audits?** In some states, filing a refund claim may increase your audit profile. So taxpayers will want to weigh potential exposures before filing their refund claim. Note that even if the statute of limitations has expired, many states will allow a refund to be offset by amounts determined to be due to the state.

   C. **Direct pay permits.** Most states allow certain companies to obtain direct pay permits (typically manufacturers or other types of companies that purchase goods and services that may qualify for exemption). Direct pay permits represent an alternative to periodic reverse audits. Instead of periodically reviewing sales and use tax overpayments, direct pay permit holders make a tax-liability determination as purchases are being made.

II. **State Tax Appeal Litigation**

1. **Discovery, Privilege and Discovery of Privileged Documents.**

   A. **Discovery**

   • The purpose of discovery is to ascertain facts which have a direct bearing on the issues before the court (i.e. avoid trial by surprise). Any matter not privileged and which is relevant “to the claim or defense of any party,” or, with good cause shown, to any matter relevant “to the subject matter of the action.” FRCP 26(b)(1). An inquiry is proper if it is “reasonably calculated to lead to the discovery of admissible evidence.” There is an implied and enforceable duty to preserve documents and information that may be relevant in a case.

   ✓ **Scope - Discovery is governed by the rules of the forum:**

   • Federal Rules of Civil Procedure (Rule 16, Rule 26, Rule 33, Rule 34, Rule 37)
Timing - Traditional notion: after suit is filed and the time to answer expires or the issues are joined

Tax Audits & Informal Appeals

(1) Discovery rules of the forum don't apply.

(2) Threat of assessment coerces disclosures, so the audit is ultimately broader than discovery rules might allow.

(3) Unbeknownst to Taxpayer, State's counsel may already be involved and crafting audit inquiries and document requests.

The fallacy of the informal forum:

(1) "It's ok; we're not building a record."

(2) We can't do any harm; the next level is de novo."

(3) Taxpayer may make inadvertent waivers of privileged information.

(4) Taxpayer may disclose non-privileged information that cannot be compelled in audit and that could help the State's case, compared to formal discovery to which objections could be made to challenge disclosure.

Vulnerable Sources of Information

- Public Domain Information
- Annual Reports
- SEC Filings
- Press releases, articles, interviews
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- Internet Web-pages
- Blogs
- State Questionnaires
- Audit Interviews

✓ Non-privileged Document-related Data
- Meta-data
- Drafts and revisions
- Transmittal documents (e.g. e-mail, fax, letter)
- Messages: e-mail / voice-mail / text

Internal Documents
- Board & Committee Minutes
- Policy and procedure manuals and other guidelines
- Other internal communications (memoranda, e-mail / voice-mail / text)

✓ External documents and communications
- Example:
  ✓ Consultant's:
    (1) voice-mails / e-mails / Outlook meeting requests
    (2) initial presentation materials
    (3) engagement letter
    (4) implementation work plan
    (5) project management reports / spreadsheets
    (6) issue memoranda
  ✓ Accountants:
    (1) Tax Work papers
    (2) Fin 48 Work papers
    (3) Bank records:
    (4) account signature cards
(5) statements of account

- Expense Reimbursement Records
- Payroll and Personnel Records
- Property management records
- Transaction Closing Binders
- Travel Logs

Times and places to manage vulnerability:

- Reviewing Court. Too late.
- Trial Court. Maybe (protective orders; in limine orders; sealing orders)
- Administrative Hearing. Maybe (possibly a closed forum, but may still need in limine orders to protect the record.)
- Audit. Yes, but only as negotiated.
- After creation. Document retention policies.
- At creation. Just right!

B. Privilege – There are various types of privilege to protect documents from discovery including Attorney-client privilege, Work product doctrine, Accountant-client privilege and Federal tax practitioner privilege. These privilege can affect tax planning, tax litigation and financial statements.

- **Attorney-Client Privilege** - General privilege applicable to communication between attorney and client, made in confidence, for the purpose of obtaining legal advice. As applied to tax transactions, it is not applicable if the opinion or other communication is used to provide protection against penalties or to help the client in filing a return. Privilege is waived if the communication is shared with any person outside the attorney-client relationship.

- Disclosure to an accountant, whose assistance is deemed necessary to the lawyer’s representation, may not waive the privilege. This is the “Kovel” relationship.
  - Is the accountant assisting the lawyer, or merely providing accounting services to the client?

C. Accountant – Client Privilege

- Arthur Young (U.S. 1984)
  - Is it still good law?
    - **Was there an accountant-client privilege**
Now, IRC sec. 7525

Footnote 17 – IRS Manual provided that access to accountants tax accrual workpapers would only be in “unusual circumstances” and only as a “collateral source for factual data”

IRS Policy After Arthur Young

- “Restraint” IRM 4.10.20; Announcement 2002-63
- IRS is considering whether it should change its policy of restraint
- Korb: Transparency is not a two-way street. Taxpayers should not have access to information IRS acquired in developing its case. 1998 IRS RRA led to the damage of tax shelters.

Federal Tax Practitioner Privilege - General privilege applicable to communication between individual authorized to practice before the IRS and client, made in confidence, for the purpose of obtaining tax advice. Applies only to civil tax matters before the IRS or in a civil tax proceeding in Federal court.

- Does not apply to tax shelters (IRC §7525)
- Privilege is waived if the communication is shared with any person outside the practitioner-client relationship.

Federal Work Product Doctrine - Under FRCP 26(b)(3), a document is privileged work product if three requirements are met:

- Documents and tangible things;
- Prepared “in anticipation of” litigation or for trial; and
- By or for another party or by or for that other party’s representative.

Two Standards for Determining “in Anticipation of” Litigation

- “Because of” Standard:
  - Document is privileged if prepared because of potential or anticipated litigation.
  - Document can serve a dual purpose and therefore be shared with a third party without loss of privilege.
  - “Because of” standard adopted in 1st, 2nd, 3rd, 4th, 6th, 7th, 8th, and 9th Circuits.

Two Standards for Determining “in Anticipation of” Litigation

- “Primarily or Exclusively” Standard:
• Primary motivation for preparing the document must be with regard to litigation.

• Only if primary motivation test is satisfied may a document be shared with a third party.

• “Primarily” standard adopted in the 5th and 11th Circuits.

✓ Shift of Burden to the IRS - If the work product doctrine applies, the IRS can obtain the information only if the IRS shows:

• A substantial need for the privileged information in the preparation of the IRS’ case; and

• An inability to obtain substantially equivalent information by other means without undue hardship.

✓ Shift of Burden to the IRS - The IRS manual takes the view that the privilege applies only if the document is prepared by or under the supervision of the party’s attorney.

• FRCP and non-tax cases indicate that privilege applies without involvement of an attorney.

✓ State Work Product Doctrine - State work product doctrine is supplemental to the federal work product doctrine. State civil procedure rules that protect against compelled disclosure of work product documentation vary by state. Some state work product doctrines are more protective than the federal work product doctrine -- New York, California

✓ Other state work product doctrines rely on the federal work product doctrine -- District of Columbia

For Example:

✓ New York State Civil Practice Law & Rules

• § 3101(c) “Attorney’s work product. The work product of an attorney shall not be attainable.”

• § 3101(d)(2) “. . . Materials otherwise discoverable under subdivision(a) . . . Prepared in anticipation of litigation or for trial by or for another party, or by or for that party’s representative . . .”

✓ California Code of Civil Procedure

• § 2018(a) “A writing that reflects an attorney’s impressions, conclusions, opinions, or legal research or theories is not discoverable under any circumstances.”

• § 2018.030(b) “The work product of an attorney [other than in (a)] is not discoverable . . .”
IRS issued a summons to obtain two KPMG memoranda that analyzed the tax consequences of transactions involving the creation of a captive insurance company and related stock transfers. Identified through header as attorney-client privilege but not work product. Memoranda concluded it was “more likely than not” that the tax treatment would apply and that this tax treatment was supported by substantial authority under Treas. Reg. Section 1.6662-4(d). Memoranda were prepared after close of the transactions.

District Court ruled no privilege because the memoranda were created to assist the taxpayer in preparation of its taxes and yearly audit and, therefore, were not prepared in anticipation of litigation.

Sixth Circuit reversed and held that the work product doctrine applied to protect the memoranda from disclosure to the IRS.

If documents are prepared in anticipation of litigation, as well as to be used in business decision making, such documents can still be protected.

Comcast - Massachusetts Superior Court held, in two unpublished decisions, that certain documents prepared by the Arthur Andersen firm were protected under both the attorney-client privilege and the work-product doctrine. The issue arose during the course of an audit in which the Massachusetts DOR claimed that a transaction was designed to avoid Massachusetts tax. The DOR had issued an administrative summons requesting documents relating to the transaction and the formation of certain entities.

In planning for the liquidation, the company had relied on its in-house tax counsel for advice.

In-house tax counsel in turn relied on advice from two law firms as well as the accounting firm Arthur Andersen.

In response to the Commissioner’s administrative summons, Comcast claimed that 19 documents, including documents prepared by Arthur Andersen, were protected by the attorney-client privilege and/or the work-product doctrine.

Superior Court held that the Arthur Andersen documents were protected by the attorney-client privilege because:

- the memos contained a detailed analysis of Massachusetts tax law; and
- the memos provided in-house counsel with information critical to his ability to effectively represent his client.
One Arthur Andersen memo was also protected under the work-product doctrine because the memo outlined the feasibility of the potential restructuring in light of applicable Massachusetts law and the potential for DOR litigation.

- Does Disclosure to Auditors Waive Privilege?

- Cases finding that work product privilege is not waived:

- Cases finding that work product privilege is waived:

- Work Product: Textron - Several Leveraged Lease Transactions. IRS requested all tax accrual workpapers

- Government’s arguments:
  - Disclosure to outside accountants destroys privilege
  - Documents were created for ordinary business purposes, not in anticipation of litigation
  - IRC 7525 was not intended to apply to communications with an auditor for the purpose of evaluating financial statement reserves

- Taxpayer’s counter-arguments:
  - Improper purpose for requesting tax accrual workpapers
    - Obtain legal analysis
    - “Bargaining chip” to force concessions in litigation
    - Leverage to discourage investments by changing “cost-benefit” analysis
✓ Work Product – Prepared in anticipation of litigation

- Documents created in anticipation of litigation, as well as creating contingency are protected work product

- Rhode Island District Court (Aug. 2007), rejects attorney-client privilege and IRC 7525 federal tax practitioner privilege arguments

✓ Rejects notion that independent auditor was providing tax advice when it reviewed tax contingency reserve and workpapers

✓ Disclosure of privileged documents to any party, including financial auditor, waives these privileges

- Court upholds taxpayer’s assertion of work product doctrine

- Applying the First Circuit’s “because of” test, Court found that Textron prepared workpapers “in anticipation of litigation”

✓ Tax contingency reserve evidences hazards of litigation, which therefore must be deemed to be anticipated by the taxpayer

✓ Textron had, in fact, taken 7 of its last 8 IRS audits to Appeals and had litigated 3 assessments.

(1) Court furthermore held that Textron had not waived the work product privilege by disclosing workpapers to its independent auditor

(2) TEST: Was disclosure made to an adversarial party, or did it substantially increase the opportunity for potential adversaries to obtain the information?

(3) NO: Textron secured a nondisclosure commitment from the auditors, and AICPA professional conduct rules ensure confidentiality of information

(4) Court did not find that IRS had met exception to the work product privilege, (based on demonstrating a compelling need for the documents in question)

(5) IRS appealed to the 1st Circuit

(A) Note that Textron’s facts (i.e., robust audit and litigation history, negotiated nondisclosure agreement with independent auditors) were important aspects of the Court’s analysis

- First Circuit Court of Appeals - United States v. Textron Inc., docket no. 07-2631 (1st Cir., 8/13/09) (en banc)).
Reversed District Court

A three-judge panel of the First Circuit affirmed the district court. The court then granted an IRS petition to hear the case *en banc*. The full court reversed the District Court.

Held - The work-product privilege did not apply to Textron’s tax accrual workpapers because the documents sought were not prepared “in anticipation of litigation.”

The workpapers were statutorily required for the purpose of financial reporting and thus were prepared in the ordinary course of the taxpayer’s business.

Summary

Positive constitutional protection

government may not obtain private advisory documents

Non-tax cases indicate that privileged work product may be shared with third parties if they are not adverse with regard to the anticipated litigation.

Information may be disclosed without loss of work product protection under certain circumstances

- If auditor is not “adverse party”

Impact of FIN 48

Effect on Work Product Protection - FIN 48 requires that work product be prepared on a routine basis to support financial reporting. This may reinforces IRS arguments against work product protection for tax-accrual work papers. The impact will vary by federal and state venues

Increased Waiver Risks

FIN 48 Work Product Requirements

- Each tax position must be analyzed for recognition and measurement

  - recognized only if more likely than not to be sustained upon examination

  - measured based on the largest amount of tax benefit that is greater than 50% likely of being realized

- It must be presumed that each tax position will be examined by a taxing authority with full knowledge of all relevant information
• Each conclusion is based on technical merits and widely understood administrative practice, without consideration of offset or aggregation

• Government Arguments Reinforced
  ✓ Reinforces arguments the government already makes in opposing work product claims
  ✓ Documents are prepared in ordinary course of business irrespective of the prospect of litigation
  ✓ Documents are prepared pursuant to public regulatory requirements

• Explicit recognition and measurement analysis will tend to replicate work product that otherwise would be created in anticipation of litigation

• More difficult to demonstrate that materials have been prepared in anticipation of actual rather than hypothetical litigation

✓ Importance of Forum

✓ The FIN 48 impact will be particularly pronounced in the minority “primary purpose” federal jurisdictions (5th and 11th Cir.)

• more stringent factual showing required

• dual purpose work product not protected

✓ Impact may be diminished at the state level in jurisdictions where greater protection is afforded

• For example, California does not generally impose the “anticipation of litigation” requirement

✓ Increased Waiver Risks

• Alters the quantity and quality of potentially discoverable material

• Increases the level of disclosure sought by outside auditors

• Elevates importance of the Textron non-waiver analysis

• Raises concern over the potential breadth of waiver

✓ Examples of Increased Disclosure Sought by Attest Firms

✓ Support for recognition and valuation of initial return position

• More likely than not opinion

• Litigation evaluation
✔ Evaluation of litigation in progress
  • Subsequent changes based on new information or change in judgment
  • Settlement strategy in addition to probable litigation result
  • Position will be resolved or significantly increase or decrease within a twelve month window—“reasonably possible” determination

✔ Disclosures sought from outside counsel

✔ Preparation of documents
  • distinguish “routine” matters from significant or controversial positions as to which litigation is foreseeable
  • identify and document objective factors that would lead to litigation
  • consider timely engagement of outside counsel where appropriate

✔ Control of documents
  • privileged materials consistently labeled and segregated
  • under proper forms of engagement and close supervision of third party consultants

✔ Disclosure of documents
  • avoid disclosure of privileged materials where possible
  • nondisclosure agreement should be secured where necessary

✔ Planning For Tax Litigation Lessons from the front (pages):
  • Mead Corp. v. Illinois DOR
    ✔ Mead did not file amended non-unitary returns for years prior to sale of Lexis (not doing so was not inconsistent with business liquidation argument for nonbusiness)
    ✔ IDOR did not file a motion in limine to block testimony regarding non-unitary relationship in years prior to sale of Lexis

✔ Wal-Mart Stores East, Inc. v. North Carolina
  • WSJ:
    • “But [Accounting Firm’s] contributions to Wal-Mart’s state-tax minimization project are outlined in a raft of documents filed in
recent months in North Carolina state court, where the state’s attorney general is challenging a Wal-Mart tax-cutting structure involving real estate investment trusts.”

- “Senior tax experts at the big accounting firm swapped ideas via e-mail in a series of meetings.”
- “[T]he material includes company e-mails and memos”

Planning For Tax Litigation Lessons from the front (pages):

WSJ:

- “An [Accounting Firm] tax executive urged his team to be discreet, according to a staff memo included in the North Carolina court records.”

- [O]ne high ranking tax partner sent an e-mail to a colleague addressing a concern often faced by companies . . . “You asked if we have a document that details how the tax savings will work, how much they will save . . . We really don’t have anything like that except for the sales document, partly because we have avoided calling this a ‘tax’ project, to show that we did not have a tax savings motivation, rather it is a ‘domestic restructuring project.’”

2. Other Matters to Consider in State Tax Litigation

A. Selection of Counsel:

- Who to choose? Consider factors such as
  - knowledge of the local landscape
  - competence/experience with income tax issues
  - balance of litigation/negotiation skills
  - understanding client objective(s)
  - time/resources to devote to your case
  - ability and proven capacity for good communications with client
  - reputation with revenue authority
  - ability to staff appropriately
  - appropriate contacts/relationships with opposing party/counsel
  - cost

- When to Involve Counsel in an Audit that May Involve Litigation:
  - considerations in using counsel during audit
protest/administrative appeals
✓ consistency with company positions in other tax and non-tax litigation

B. Pre-audit Planning:
   • review of prior audit
   • review of status of statutes of limitation
   • information/investigation of likely issues
   • pre-audit conference
   • communication with management

C. Conduct of Audit:
   • commencement
   • logistics
   • responding to requests for records
   • requests for interviews

D. Conclusion of Audit:
   • exit conference
   • preliminary assessment and negotiation
   • assessment

E. Compliance with Statute of Limitations:
   • Was the assessment timely issued?
   • Was the refund timely claimed?
   • Refunds vs. deficiencies
   • Using refund issue as offsets where claim statute has expired

F. Exhaustion of Administrative Remedies:
   • how much is required
   • “free shot” vs. time & expense to exhaust

G. Pay to Play Requirement, Uncontested and Contested Amounts - “perfecting” a refund claim by payment of assessments and interest considerations (pay under protest, demand refund, accrual of interest on refund if successful)
H. Venue Considerations:
   • State court
   • independent administrative judge
   • tribunal
   • appellate district

I. Publicity:
   • General
   • tax press
   • involvement of company PR personnel

J. Stipulations:
   • benefits
   • process
   • advisability of presenting “cold case” vs. live witnesses

K. Discovery:
   • marshaling documents and facts
   • privileged materials, trade secrets and public records/confidentiality laws
   • dealing with burdensome discovery requests
   • discovery from the tax administrator
   • level of company management involvement
   • identifying and preparing corporate representatives for deposition

L. Use of Expert Witnesses in Tax Cases:
   • credibility issues where affiliation with company too close
   • avoiding temptation to “over-expert” an issue
   • Summary Judgment vs. Trial:
   • summary judgment available only when no disputed facts
   • advantages of summary judgment include speed, lower cost
   • advantages of trial include ability to engage judge, provide context
M. Settlement Issues:
   - when to make the offer
   - dealing with post audit period exposure

N. Briefing (Pre and Post Trial):
   - company review of drafts
   - verifying factual statements

O. Conduct of Trial:
   - considerations in choosing company witnesses
   - attendance by other company personnel
   - minimizing “armada” impression
   - recovering attorneys’ fees and costs

P. Resorting to the State Legislature:
   - before, during or after suit?
   - effect of pending litigation
   - maximizing possibility of success