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District Court Protects Tax Accrual Workpapers

May 23, 2008

Alert Number: 08-50

In a Memorandum Opinion released May 8, the U.S. District Court for the Northern District of Alabama granted a motion by Regions Financial Corporation ("Regions") to quash an IRS summons served on Regions' independent auditor, Ernst & Young ("E&Y"), seeking Region's tax accrual workpapers. The Court found that the documents were protected by the work product doctrine as they had been created in anticipation of litigation and that Regions had not waived its privilege when it disclosed the documents to E&Y.

Background

In 2000, Regions entered into a transaction with the European Bank for Reconstruction and Development ("EBRD"). During an IRS exam for the 2002 and 2003 tax years, the IRS determined that Regions had engaged in two listed transactions. Consistent with its modified policy of requesting tax accrual workpapers where the taxpayer engages in more than one listed transaction, the IRS served a summons on E&Y.

E&Y provided the summons to Regions. After reviewing the summons, Regions permitted E&Y to produce approximately 260,000 pages of documents but instructed E&Y to withhold 20 documents totaling 151 pages relating to the ERBD transaction. Thereafter, Regions filed a motion to quash the summons with the Court, claiming that the documents were privileged and therefore not subject to the IRS summons.

The withheld documents consisted of core documents -- including three documents created by the law firm of Alston & Bird, one document created by E&Y partners not associated with the audit -- and related derivative documents. The Court noted that the core documents were created at the behest of Regions' general counsel, who typically only became involved in analyzing Regions' tax liabilities if litigation was likely to result from a tax position. In their respective briefs, the parties argued that either all of the documents were subject to summons or none of the documents were.

Court Analysis

The Court noted that Regions did not contest that the IRS summons was proper on its face but claimed that the documents being withheld were subject to the work product doctrine or privilege. As a result, the Court determined the heart of the dispute was the scope of the work product privilege as applied to the documents and whether Regions had waived any privilege by the disclosure of the documents to E&Y.


The Court noted that courts in general have struggled with the articulation of a clear test to determine what constitutes "prepared in anticipation" in the context of an IRS summons. Acknowledging that the Supreme Court has not provided controlling guidance on this matter, the Court addressed the two prevailing standards: the "primary motivating purpose" standard first articulated in *U.S. v. El Paso Co.* and the "because of litigation" standard first articulated in *U.S. v. Aldman*. The Court noted that the "because of litigation" standard afforded broader protection.

As the parties disagreed over which standard should apply, the Court reviewed the relevant case law with respect to precedent and concluded that the "because of litigation" standard should be applied to the case at issue, but noted that the same result occurs under either standard. Citing *Textron*, the Court found Regions argument persuasive that Regions would not have the contingent liability that the documents address if it did not believe that it would engage in litigation with the IRS over the tax consequences of the transaction. Rejecting the government claim that no work product privilege exists if the document had any other use other than



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litigation, the Court noted that it had not found support for the proposition that the exclusive use of the document must be for litigation.

After review of the documents, the Court found the disputed documents contain the mental impressions of Regions' lawyers, which the Court noted is precisely the kind of legal analysis that the work product doctrine exists to protect. As a result, the Court concluded that Regions carried its burden of showing that the documents were created in anticipation of litigation.

Finally, the Court considered whether the work product privilege had been waived, noting that where privileged documents are made available either to an adversary or to a third party who could serve as a conduit to an adversary, the privilege is waived. In this regard, the government argued that the disclosure to E&Y constituted a waiver. The Court rejected this argument, stating that E&Y was not an adversary of Regions and, based on a confidentiality agreement wherein E&Y agreed to protect documents provided by Regions, E&Y was not a conduit to an adversary. Based on its analysis, the Court found that the disputed documents were privileged, that privilege had not been waived, and, as a result, quashed the summons.

PwC Observes: The court's opinion indicates that whether documents are subject to the work product doctrine is a facts and circumstances test and that in this particular situation, the taxpayer's facts supported a finding that the disputed documents were protected by such doctrine. Although this is the second loss for the government at the District Court level on access to tax accrual workpapers, the IRS already has publicly stated that it continues to believe that the work product doctrine is not an appropriate defense to a request for tax accrual workpapers.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional. Please visit us at: <http://www.pwc.com/us/insurance/tax>

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