

## Transfer Pricing Examinations

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### Organization and Responsibilities of Internal Revenue Service Field Office Personnel Dealing with Transfer Pricing Issues

#### *Organizational Structure*

The Assistant Commissioner (International) coordinates policy and technical positions concerning international issues, including transfer pricing issues, operating through an organization of regional commissioners and local district offices. The head of the local district offices is the District Director. The District Director pursues taxpayer examinations through the Chief of the Examination Division who in larger districts oversees a number of examination branches. Generally, in larger districts there is a large case examination branch,

which includes a number of large case examination groups. Larger districts may also include one or more groups of international examiners who specialize in the examination of international issues, including transfer pricing issues. International examiners in these groups may be assigned to examinations taking place in other districts throughout the region.

Taxpayers should be familiar with the organizational structure of the district with jurisdiction over their tax returns. Knowledge of the organizational structure and the lines of authority may be helpful in resolving substantive and procedural issues which cannot be resolved at the agent level.

#### *Coordinated Examination Program*

The coordinated examination program (“CEP”) is a special program created by the Service in the late 1960’s for the examination of large corporate taxpayers. *Internal Revenue Manual (“IRM”) 42(11)1.*

The objective of the CEP is to centralize responsibility for the control and management of the examination of taxpayers with divisions and/or subsidiaries located throughout the United States or in foreign countries. Under the CEP, the “primary” taxpayer and all entities over which the “primary” taxpayer exerts effective control are treated as one unit for purposes of planning and executing the examination. *IRM 42(11)2(1) and (2).* The “primary” taxpayer is identified as the taxpayer exerting control over

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all other entities in the CEP examination. *IRM 42(11)3(13)*.

The district where the “primary” taxpayer is located is designated the “primary” district with responsibility for managing and controlling the CEP examination, including entities over which the primary taxpayer exerts control. *IRM 42(11)3(12) and (13)*.

The primary district is supported in CEP examinations by support districts, which are districts other than the primary district, providing support for the examination of the CEP case. Typically, support districts include districts where subsidiaries or divisions of the primary taxpayer are located.

CEP examinations are managed by a “case manager” who is the Service employee responsible for organizing, controlling and directing the examination of a CEP case. *IRM 42(11)3*. The case manager is assisted by the “team coordinator,” who is a member of the examination team responsible for specific examination assignments, but who is also often designated by the case manager to perform coordinating duties. *IRM 42(11)3(16)*.

Generally, the case manager and the team coordinator manage a team of Service personnel in large case CEP examinations. This team often includes the following personnel:

- An international examiner, who is a revenue agent with special training in international areas of the tax law. Generally, the international examiner examines international issues, including transfer pricing issues, and prepares the information document requests for international issues.
- An economist who provides economic analysis in areas such as the valuation of intangibles, selection of comparable transactions and the determination of arm’s length transfer prices.
- An engineer who assists the examination team with valuation and technology issues, including performing functional analysis of controlled manufacturing or assembly processes as relevant in transfer pricing comparability analysis.

- A computer audit specialist who assists in developing computer software needed to analyze computer readable data received from the taxpayer, and to organize data to assist the international examiner and economist in analyzing transfer pricing issues.

#### *Opening Conference*

Most CEP examinations begin with an opening conference. The opening conference is the first formal meeting between the Service and the taxpayer. Taxpayers should ask questions during the conference concerning the anticipated scope of the examination. The Internal Revenue Manual includes the following language concerning the opening conference:

“The purpose of . . . the opening conference is to plan in a cooperative manner with the taxpayer to insure the best use of both parties’ resources. Every effort should be made to establish and maintain meaningful dialogue.” *IRM HB 42(11)8, § 710(3) (October 13, 1993)*.

Taxpayers may be able to use the opening conference to narrow the scope of the examination and to express concerns about anticipated overly broad information document requests (IDRs). It may be possible to reach an informal agreement with the case manager concerning procedures for requesting documents, including accommodations intended to avoid, to the extent possible, disruption of the taxpayer’s business. Such agreements are particularly important in transfer pricing cases.

Also, the opening conference may be an appropriate time to discuss (i) Accelerated Issue Resolution<sup>1</sup> when it is anticipated that Examinations will raise an issue, such as a transfer pricing issue, that is a carryover issue from an earlier cycle still under examination, (ii) Delegation Order 236<sup>2</sup> when it is anticipated that Examinations will raise an issue that Appeals has settled in an earlier cycle and which should be resolved on the same basis in the cycle under examination and (iii) Early Referral to Appeals,<sup>3</sup> when it is anticipated that Examinations will raise an issue that is similar to an issue that was favorably settled by Appeals in a prior cycle, but which does not meet all the requirements of Delegation Order 236—for example, an issue which was settled as part of a “tradeoff”

<sup>1</sup> Rev.Proc. 94-67, 1994-2 C.B. 800.

<sup>2</sup> Delegation Order 236, 1994-1 C.B. 326.

<sup>3</sup> Rev.Proc. 96-9, 1996-2 I.R.B. 1.

settlement. Each of these procedures is discussed beginning at page 10.

It is advisable to wait until the case manager or other team member states at the opening conference or at a later date that a particular issue (such as a carryover issue) will be raised before requesting consideration of one of the foregoing procedures as a means of expeditiously dealing with the issue.

#### *Maintaining Credibility with the Service*

Generally, the credibility that the taxpayer is able to achieve with the Service will have an impact on the conduct of the examination. When an agent perceives the taxpayer or his representative as cooperative and responsive, the agent is generally more likely to accept taxpayer contentions concerning the merits of the issues. Because CEP taxpayers can expect to be continually dealing with the Service, achieving a short term gain at the expense of the taxpayer's credibility may be outweighed by the long-term consequences. Moreover, in "inbound" cases, a taxpayer could conceivably be denied access to Competent Authority proceedings if the Service concludes that a transfer pricing issue is not properly factually developed because of lack of taxpayer cooperation.<sup>4</sup> Of course, there may be instances when the conduct of prior cycle examinations indicates that the optimal strategy as to certain issues is to place the taxpayer in the best posture to receive favorable Appeals consideration.

#### *The Importance of Developing and Telling a Story*

As part of the transfer pricing planning process, taxpayers should develop a story. The story should be simple, should be consistent with the facts and should explain why the results of the transfer pricing are reasonable. The story should be developed from the principal operating officers of the taxpayer as such officers could be summoned by the Service. Further, such officers would no doubt be testifying should the planning ever reach litigation. Such officers will be the most knowledgeable witnesses available concerning the taxpayer's business and the business justification supporting the transfer pricing. Moreover, the Section 6662 documentation requirements provide an added incentive for developing a cogent narrative to be included as part of the required documentation.

### **Organization of International Personnel at the Office of Chief Counsel Dealing with Transfer Pricing Issues**

#### *Organization Structure*

In the Chief Counsel's National Office, the Associate Chief Counsel (International) is responsible for developing and coordinating technical and litigation positions concerning international issues. Under the Associate Chief Counsel is a Deputy Associate Chief Counsel and two Assistant Chief Counsels. One of the Assistant Chief Counsels has primary responsibility over technical matters, and the other has primary responsibility over litigation matters. The latter office works closely with field litigators. In addition, in the National Office there is a group of attorneys who are part of the International Support Team. These attorneys are assigned to each region and provide technical support to examination and counsel field offices.

In the field there are attorneys who specialize in the litigation of international issues. These attorneys are known as International Special Trial Attorneys ("ISTAs"). There are eleven such ISTAs in the country, with three in the Western Region.

The function of an ISTA is to develop and litigate large case international issues. The ISTAs also assist the district examination divisions in developing international issues, including assistance with information gathering techniques such as summonses, section 982 Formal Document Requests, section 6038A issues and designated summonses. An ISTA has region-wide jurisdiction.

The direct line supervisor of an ISTA is the Regional Counsel. That line authority is generally delegated to the Assistant Regional Counsel (Large Case).

#### *Litigation*

Service litigators of fact intensive, complex issues such as transfer pricing issues frequently face questions from the Tax Court concerning why such issues are being litigated. That is, why the parties are about to consume several weeks of the judge's time with a trial that is almost always an exceedingly tedious proceeding.

Because of this, Service litigators may be reluctant to litigate transfer pricing issues when the litigator cannot

<sup>4</sup> See, e.g., Rev.Proc. 96-13, 1996-3 I.R.B. 1, § 12.02(g).

point to facts clearly justifying the Service in bringing the issue to court. Such facts might include a grossly disproportionate profit split or controlled results that are significantly outside of the range of comparable uncontrolled results. The absence of such facts will generally lead to settlement opportunities for cases under the jurisdiction of the Chief Counsel's Office.

### Defenses to Document Production Requests

#### *Privileges*

##### *The Attorney/Client Privilege*

The attorney/client privilege protects confidential communications between an attorney and client made in order to secure legal advice. The purpose of the privilege is to enable a client and attorney to communicate without a fear of future disclosure. Without the privilege, an attorney's ability to render effective legal advice would be impaired. The privilege applies to communications both to and from an attorney and applies to legal entities as well as individuals. The privilege also applies to agents working under the direction and control of an attorney who have been retained by the attorney to assist the attorney in providing legal advice.<sup>5</sup>

Thus, in the transfer pricing context, communications to accountants and economists retained by an attorney as experts to assist the attorney in providing legal advice are subject to the privilege. In this regard, the privilege extends to work papers and other documents prepared by an accountant or an economist at the attorney's request to assist the attorney in providing legal advice to the client.

To preserve the privilege, experts should communicate their findings to the attorney for forwarding to the client, rather than directly to the client. Also, the engagement letter—which should be between the attorney and expert—should state that the expert is being engaged to assist the attorney in providing legal advice to the client.

Different rules apply to experts engaged by an attorney to testify. Any document relied upon by a testifying expert in forming an expert opinion is subject to discovery by the opposing party. Further, the attorney/client privilege may be waived as to documents used by an expert to prepare for his or her testimony.<sup>6</sup> Thus, care must be taken in providing information to testifying experts and in preparing such experts for testimony.

Care must also be taken to avoid producing privileged documents in response to discovery requests. Such production, even if inadvertent, may result in a waiver of the privilege not only as to the document disclosed, but also as to all documents relating to the same subject matter.<sup>7</sup>

In the transfer pricing context, the privilege may be of most significance as to any preliminary analysis and associated materials developed by an expert assisting counsel in rendering legal advice concerning areas of possible exposure and the advisability of adopting a particular transfer pricing methodology. Producing part of such a preliminary analysis as part of the contemporaneous documentation required by the temporary section 6662(e) regulations may waive the privilege as to all such materials. For example, including a report prepared by such an assisting economist as part of the contemporaneous documentation may waive the privilege as to all materials relied upon, or developed, by the economist in preparing the report. Thus, when warranted by the amounts at issue, it may be advisable to retain two economists—one to assist counsel in rendering legal advice and one to assist in the preparation of the contemporaneous documentation.

It should be noted, however, that existing documents used by an expert in preparing a report do not become privileged simply because such documents were used by an expert assisting counsel. Such existing documents,

<sup>5</sup> *United States v. Judson*, 322 F.2d 460, 462 (9th Cir. 1963); *United States v. Kovel*, 296 F.2d 918, 921 (2d Cir. 1961).

<sup>6</sup> See Fed.R.Evid. 612 and *Wheeling-Pittsburg Steel Corp. v. Underwriters Laboratories*, 81 F.R.D. 8, 9-11 (N.D. Ill. 1978).

<sup>7</sup> 8 Wigmore, *Evidence* § 2328, at 638 (McNaughton rev. 1991); *Lee National Corporation v. Deramus*, 313 F. Supp. 224 (D. Del. 1970) (all communications relating to corporate bylaws and charter amendments waived after one such communication was disclosed). More recent decisions have tended to more narrowly construe the waiver doctrine. See, e.g., *Weil v. Investment Indicators*, 647 F.2d 18, 25 (9th Cir. 1981) (waiver limited to attorney's advice concerning registration under state "Blue Sky" laws after one such communication was disclosed).

including records documenting third-party transactions, are not privileged unless the documents independently meet the requirements of the attorney/client privilege.<sup>8</sup> For example, a legal memorandum prepared by counsel at the request of the client, discussing whether a particular uncontrolled transaction qualifies as a comparable transaction under the regulations, would be privileged, while invoices documenting the uncontrolled transaction would not.

For purposes of the attorney-client privilege, communications with in-house counsel are generally treated the same as communications with outside attorneys.<sup>9</sup> Accordingly, communications with in-house counsel will be privileged if the other requirements for the privilege are established.<sup>10</sup>

In-house counsel may provide both legal advice and business advice. Legal advice is protected by the privilege, while business advice is not.<sup>11</sup> Tax advice is generally considered legal advice. Thus, communications between corporate officers and in-house counsel relating to tax planning opportunities should fall within the privilege.

An issue that sometimes arises in the in-house counsel context is who is the “client.” The Supreme Court addressed this issue in *Upjohn Company v. United States*.<sup>12</sup> The Court in *Upjohn* rejected the “control group” (generally senior management) test, replacing it with a facts-and-circumstances analysis including the following factors:<sup>13</sup>

- Was the communication from the corporate employee required to supply a basis for legal advice?

- Did the communication concern matters within the scope of the corporate employee’s duties?
- Did the corporate employee know that the attorney needed the information to provide legal advice?
- Were the communications considered confidential when made and were the communications kept confidential by the corporation and its employees?

Under *Upjohn*, communications with lower level employees may be subject to the attorney/client privilege under the above facts-and-circumstances analysis.

Another issue that sometimes arises in the corporate context is whether the attorney/client privilege applies to former corporate employees. This issue arises in transfer pricing litigation when counsel for the Service seeks to interview former employees of the taxpayer. The Tax Court recently held that neither the attorney/client privilege nor American Bar Association Model Rule 4.2 (prohibiting *ex parte* contact with a party represented by counsel) precludes interviews of former employees.<sup>14</sup> Thus, taxpayers should not overlook former employees in assessing hazards of litigation. Such employees, who are knowledgeable concerning disputed facts, should be contacted during the early stages of issue development.

#### *Work Product Doctrine*

The work product doctrine was described by the Supreme Court in *Hickman v. Taylor*<sup>15</sup> as applying to materials prepared by an attorney in anticipation of litigation. The purpose of the work product doctrine is to protect the mental impressions, conclusions, opinions

<sup>8</sup> However, see the discussion in the text below of *United States v. Bell*, 95-1 U.S.T.C. (CCH) ¶ 50,006 (N.D. Cal. 1994) where an IRS summons requesting information furnished to an expert assisting counsel was not enforced as improperly requesting attorney work product. As discussed in the text below, the requested documents were work product because of the manner in which the documents were described in the summons.

<sup>9</sup> *Natta v. Hogan*, 392 F.2d 686, 692 (10<sup>th</sup> Cir. 1968).

<sup>10</sup> See Gendelman, *The Attorney-Client Privilege in the Corporate Tax Setting*, Presentation at the Tax Executive Institute, 20<sup>th</sup> Annual Regional IX Tax Conference (May 23, 1994).

<sup>11</sup> *United States v. Huberts*, 637 F.2d 640 (9<sup>th</sup> Cir. 1980).

<sup>12</sup> *Upjohn Company v. United States*, 449 U.S. 383 (1981).

<sup>13</sup> *Id.* at 394-95.

<sup>14</sup> *Fu Inv. Co. v. Commissioner*, 104 T.C. No. 20 (Apr. 3, 1995).

<sup>15</sup> 329 U.S. 495 (1947).

and legal theories of an attorney from an opposing attorney. The doctrine serves to safeguard the adversary system of litigation by encouraging careful and thorough preparation by attorneys. The Federal Rules of Civil Procedure have extended the doctrine to apply to materials prepared by a party's consultant or agent.<sup>16</sup> Thus, the work product doctrine may apply to materials prepared by accountants or economists to assist the attorney in preparing for trial. Moreover, the work product doctrine may apply to materials prepared by accountants or economists assisting the taxpayer in anticipation of litigation even though an attorney is not involved.<sup>17</sup>

Unlike the attorney/client privilege, the work product doctrine is qualified in that it can be overcome by a showing of sufficient need. For example, documents prepared by an attorney in anticipation of litigation may be obtained upon a showing of substantial need and an inability to obtain equivalent materials without undue hardship.<sup>18</sup> Where "opinion" work product is involved, *i.e.*, mental impressions, conclusions and legal theories, greater protection is afforded, requiring a showing of a "compelling" need.<sup>19</sup> The Federal Rules of Civil Procedure also provide greater protection for facts known to, or opinions of, non testifying experts. Discovery from such non testifying experts is permitted only upon a showing of "exceptional circumstances," under which it is impracticable to obtain the information by other means.<sup>20</sup>

The Tax Court affords somewhat greater protection to work product as the Tax Court's rules do not include a substantial need qualification. The Tax Court has indicated, however, that the work product doctrine is not absolute and thus work product may be subject to discovery under appropriate circumstances.<sup>21</sup>

As with the attorney-client privilege, care must be taken to avoid waiving the work product doctrine through inadvertent production or through disclosure to a testifying expert. It may be advisable, when warranted by the amount at issue, to retain both testifying and non-testifying experts to avoid potential waiver issues. The non-testifying expert can generally be given greater access to background information and other materials as needed to assist the attorney in preparing for trial.

#### *Accountant/Client Privilege*

Federal courts do not recognize an accountant/client privilege. *Couch v. United States*.<sup>22</sup> However, examining agents generally do not routinely request items such as tax accrual work papers because of the many levels of internal administrative review required for approval of such requests.<sup>23</sup> Whenever a request for such materials is made, taxpayers should confirm that the requesting agent has complied with the internal review procedures.

#### *Recent Court Opinions: Bell and Adlman*

In *United States v. Bell*,<sup>24</sup> the United States District Court for the Northern District of California held that reports prepared by an accounting firm for the taxpayer's attorney were subject to both the attorney/client privilege and the work product doctrine.<sup>25</sup> The court also held that preexisting documents provided to the accounting firm for use in preparing the reports were privileged.

In *Bell* the Service issued a summons to the taxpayer, Conner Peripherals, Inc. ("Conner"), and to Conner's Chief Financial Officer, Bell. The summons requested, among other documents (i) all reports prepared by third parties concerning transfer pricing, including all such

<sup>16</sup> See Fed.R.Civ.P. 26(b)(3) and *United States v. Nobles*, 422 U.S. 225, 238-39 (1975).

<sup>17</sup> See *Eoppolo v. National R.R. Passenger Corp.*, 108 F.R.D. 292, 295 (E.D. Pa. 1985) and *Carver v. Allstate Ins. Co.*, 94 F.R.D. 131, 133 (S.D. Ga. 1982).

<sup>18</sup> Fed.R.Civ.P. 26(b)(3).

<sup>19</sup> *Holmgren v. State Farm Mutual Auto Insurance Co.*, 976 F.2d 573, 577 (9th Cir. 1992).

<sup>20</sup> Fed.R.Civ.P. 26(b)(4)(B).

<sup>21</sup> *Hartz Mountain Industries v. Commissioner*, 93 T.C. 521, 529 (1989).

<sup>22</sup> 409 U.S. 322, 335 (1973).

<sup>23</sup> See I.R.M. Part IV, § 4024.4.

<sup>24</sup> 95-1 U.S.T.C. (CCH) ¶ 50,006 (N.D. Cal. 1994).

<sup>25</sup> See the December 13, 1994 Order of the Court appearing in 3 Tax Management, *Transfer Pricing Report* 651 (Jan. 4, 1995).

reports prepared at the direction of outside counsel and (ii) “all information . . . furnished by Conner . . . in connection with the preparation [of the] . . . report[s] [requested above].”

Conner refused to produce the two reports and the underlying materials furnished to the accounting firm, contending that the reports were subject to the attorney/client privilege and the work product doctrine. Conner contended that the reports were prepared by “non-testifying experts” and thus were entitled to greater protection. The Service contended that the attorney/client privilege and work product doctrine did not apply because the reports were prepared by persons other than attorneys, were not prepared in anticipation of litigation and the underlying materials did not come into existence pursuant to an attorney/client relationship.

The court identified the following as relevant factors in deciding whether the attorney/client privilege or the work product doctrine applied:

- Whether the accounting firm had been retained to act as a “non-testifying expert” for purposes of preparing counsel for anticipated litigation. The court’s discussion indicates that had the reports been prepared in connection with the preparation of a tax return or for another business purpose, the attorney/client privilege and work product doctrine would not have applied.
- Whether the accounting firm’s engagement letter indicated that the firm was engaged primarily to prepare Conner and its counsel for an anticipated dispute with the Service. This points to the importance of careful preparation of engagement letters when the intention is to retain the expert to advise counsel, rather than to assist in the preparation of the return or to testify.
- The probability of litigation with the Service. Conner’s contended that a dispute with the Service was “more than a remote possibility” because the Service had intensified enforcement of transfer pricing provisions “within the industry” and because other members of the industry “were already involved in disputes with the IRS.”<sup>26</sup> The Court’s reference to these facts is significant as many taxpayers subject to transfer pricing examinations could make similar contentions.

<sup>26</sup> *Bell*, 95-1 U.S.T.C. (CCH) at 87,028.

<sup>27</sup> 68 F.3d 1495 (2d Cir. 1995).

In another significant holding, the Court concluded that the underlying materials (including existing documents) supplied to the accounting firm in connection with the preparation of the reports would be subject to the work product doctrine if the reports were subject to the work product doctrine. The court agreed with Conner’s contention that supplying the underlying materials (including a list of those materials) would provide the Service with a “road map” of its adversary’s thought processes. Note, however, that nothing would prevent the Service from requesting the same materials identified generically rather than identified as having been furnished to the expert retained by counsel. The difference is that such a generic request would not be limited to the documents chosen by the taxpayer’s counsel as relevant to the analysis of the expert.

The Court in *Bell* also concluded that the materials underlying the reports were “opinion work product,” entitled to a heightened level of protection under the Federal Rules of Civil Procedure, and that the Service could not establish the required compelling need.

*Bell* is significant as it confirms that materials prepared by an expert assisting counsel in a transfer pricing context can be protected from disclosure if appropriate procedures are followed. The procedures include careful drafting of the engagement agreement and taking care that the materials are not inadvertently disclosed or used in connection with the preparation of the return. The other significant point in *Bell* is that the work product doctrine may apply to documents prepared before the return is filed, a point in time years before any litigation could occur.

Another recent opinion of some significance is *United States v. Aldman*.<sup>27</sup> Although not involving a transfer pricing issue, *Aldman* contains language that taxpayers can point to as supporting work product protection for transfer pricing documents prepared at the planning stage—often years before any litigation could occur. In *Aldman*, the Vice President for Taxes of the taxpayer (Sequa Corporation), who was an attorney, requested that Arthur Andersen & Co. (“AA”) prepare a draft memorandum discussing the probable tax consequences of a proposed restructuring transaction. AA prepared the draft memorandum and presented it to Aldman in August of 1989. After making changes to address questions raised by Aldman, AA sent the memorandum in final form to Aldman in September of 1989.

However, two days after sending the final memorandum to Aldman, AA also sent a letter to Sequa's Vice president for Finance. The letter stated that it summarized AA's "recommendations and conclusions" as to the proposed restructuring plan. The letter also contained AA's recommendations as to the form of the transaction and as to the supporting documentation that should be developed. Finally, the letter contained an offer to "discuss related matters with a view toward . . . implementation [of the restructuring plan]."

More than four years after AA sent the final memorandum, the Service served a summons requesting the AA memoranda, which had been acknowledged as existing by Sequa. Sequa defended on both attorney/client privilege and work product grounds. The District Court rejected both defenses and ordered enforcement of the summons.

The Second Circuit rejected the attorney/client privilege defense, holding that the District Court did not abuse its discretion in concluding that Sequa consulted with AA for tax advice. That is, that AA was not acting as Aldman's agent, assisting with the rendering of legal advice. The Second Circuit noted that there was virtually no contemporaneous documentation supporting the view that AA was working under a separate engagement as to the memoranda in issue. AA regularly provided auditing, accounting and advisory services to Sequa. This contrasts with the separate engagement letter that was prepared in *Bell*, as discussed above. Further, all of AA's billings were lumped together as one amount. The Second Circuit concluded that these facts supported the District Court's holding that AA was not an agent assisting Aldman in providing legal advice under the rationale of cases such as *United States v. Kovel*.<sup>28</sup>

As to the work product defense, the Second Circuit reversed the District Court which held that the AA memoranda had not been prepared in anticipation of litigation because when the memoranda were prepared neither the reorganization transaction nor the Service audit had occurred. The Second Circuit held that work product protection may apply to documents prepared before the event giving rise to the litigation occurs. Thus, the fact that the reorganization had not occurred was not enough by itself to preclude work product protection.

Instead, the Second Circuit alluded to the need for a "causal relationship" between the anticipated litigation and the creation of the document.

The Second Circuit remanded the case to the District Court to determine whether Sequa's contentions were sufficient to satisfy the "anticipation of litigation" standard. Sequa had contended that it was audited every year, that the reorganization issue would require Joint Committee review and that there was no case "directly on point." In so remanding, the Second Circuit stated that the "mental impressions, conclusions or legal theories" should be protected if the District Court determined that the work product protection applies, but that the government satisfied the "substantial need" requirement of Fed.R.Civ.Proc. 26(b)(3).

*Preserving the Privilege Protecting Attorney/Client and Work Product Material*

The following procedures should help in maintaining the protection afforded to documents subject to the attorney/client privilege and the work product doctrine.

- All documents subject to the attorney/client privilege or work product doctrine should be marked:

**CONFIDENTIAL  
ATTORNEY/CLIENT PRIVILEGE  
ATTORNEY WORK PRODUCT**

- All documents prepared by experts retained by counsel should state the following:

**CONFIDENTIAL. PREPARED AT THE INSTRUCTION  
OF COUNSEL. ATTORNEY/CLIENT PRIVILEGE AND  
ATTORNEY WORK PRODUCT.**

- Material subject to the attorney/client privilege or work product doctrine should not be disclosed to third parties or to corporate employees who are not involved in, or who lack management authority over, the matters discussed in the privileged documents. See the above discussion of *Upjohn Co. v. United States*<sup>29</sup> as to the scope of the attorney/client privilege in the corporate counsel context. Improper disclosure could result in a waiver of the privilege.

<sup>28</sup> 296 F.2d 918, 921 (2d Cir. 1961).

<sup>29</sup> 449 U.S. 383 (1981).

- If possible, privileged documents should be separated from nonprivileged documents to avoid inadvertent disclosure in responding to Service document requests. If separation is not possible, then special tabs, color coding or some other method should be used so that privileged documents can be easily culled from nonprivileged documents.
- The number of persons responding to document requests should be limited. The persons responding should be familiar with the scope of the attorney/client privilege and the work product doctrine. If possible, in-house or outside counsel should examine documents that have been selected for production.
- Taxpayers should be careful to avoid referencing legal advice in any work paper prepared in connection with a tax return. Stating in a work paper that a particular methodology is based upon, or supported by, advice from counsel may result in a waiver of the privilege and thereby require production of the legal advice. Where an opinion of counsel is to be included as part of the section 6662(e) temporary regulation contemporaneous documentation, care must be exercised to ensure that the privilege is not inadvertently waived as to related advice from counsel.

*Scope of Service Document Requests: Overly Broad and Burdensome*

Section 7603 of the Internal Revenue Code requires that books and records requested in a summons be described with “reasonable certainty.” The application of this standard is illustrated by the following document request examples:

- All orders, directives, instructions, commands and regulations issued to ForeignCo by USCo. (*overly broad*)
- All orders, directives, instructions, commands and regulations issued to ForeignCo by USCo for each of the fiscal years 1990, 1991 and 1992. (*still overly broad*)
- All orders, directives, instructions, commands and regulations issued to ForeignCo by USCo for each of the fiscal years 1990, 1991 and 1992 relating to matters which affect pricing. (*vague*)
- All orders, directives, instructions, commands and regulations issued to ForeignCo by USCo for each of the fiscal years 1990, 1991 and 1992 relating to transfer pricing of products X, Y and Z. (*probably ok*)

*Relevance*

The generally accepted test for relevancy in a summons context is whether the summoned documents might “throw some light upon the correctness of the taxpayer’s return.” *United States v. Arthur Young*, 465 U.S. 805, 813 n. 11 and *United States v. Ryan*, 455 F.2d 728, 733 (9th Cir. 1962). Note, this is a relatively broad standard. In most instances, it is unlikely that an attack upon a summons based on relevance grounds will succeed.

*The Powell Requirements*

The following requirements for enforcement of a summons were set forth by the Supreme Court in *United States v. Powell*, 379 U.S. 48, 57-58 (1964):

- The investigation must be conducted for a legitimate purpose (*e.g.*, not to harass the taxpayer or to secure a settlement).
- The summoned materials must be relevant to the investigation.
- The information sought must not already be within the Commissioner’s possession.
- The administrative steps required by the Internal Revenue Code, *e.g.*, the reopening procedures for second examinations, must have been followed.

Generally, once the *Powell* requirements have been established through an affidavit of the issuing agent, the burden shifts to the taxpayer to affirmatively establish bad faith on the part of the Service. *Liberty Financial Services v. United States*, 778 F.2d 1390, 1392 (9th Cir. 1985) and *United States v. Samuels, Kramer & Co.*, 712 F.2d 1342, 1345 (9th Cir. 1983).

*Service Requests for Information and Documents from Third Parties*

The Service has historically contended that third-party comparable information may be compelled through administrative summonses and trial subpoenas.<sup>30</sup> Courts, in deciding whether to enforce third-party summonses or subpoenas, generally consider (i) the

<sup>30</sup> See the discussion of this issue in 2 Tax Management, *Transfer Pricing Report* 783 (Apr. 13, 1994).

relevance of the information sought,<sup>31</sup> (ii) whether trade secrets might be disclosed, (iii) the potential competitive disadvantage that could result from disclosure and (iv) the nexus, if any, between the third party and the taxpayer.<sup>32</sup>

Court enforcement is more likely when dated information is requested as the probability of competitive harm presumably diminishes as time passes.<sup>33</sup> Court enforcement is also more likely as to a third party who previously supplied information to one of the parties, for example at trial.<sup>34</sup>

Conversely, courts are more likely to deny enforcement where a real probability of competitive harm exists. The courts will generally balance the Service's need for the information against the potential damage to the third party from disclosure.

### IRS Issue Resolution Developments

#### *Accelerated Issue Resolution—Multicycle Settlements of Factual Issues*

On October 13, 1994, the Service issued Revenue Procedure 94-67, 1994-2 C.B. 800, describing the Accelerated Issue Resolution (“AIR”) process. AIR is a procedure by which a settlement for years under audit can be applied to years for which returns have been filed, but which are not under audit. The purpose of the AIR Procedure is to accelerate the process by which issues currently under examination, and also present in later tax periods, can be resolved for all years up until the last year for which a return has been filed. The AIR procedure was previewed by John Monaco, Assistant Commissioner for Examinations, in a speech on October 24, 1993.

According to Monaco, AIR does not involve case managers resolving issues based upon hazards of litigation. Instead, case managers would be guided by the Internal Revenue Manual, which provides for the following settlement authority:

“In attempting to reach agreement, examination personnel have the authority and responsibility to reach a definite conclusion based on a balanced and impartial evaluation of all evidence. While this authority does not extend to consideration of the hazards of litigation, technical personnel should fully exercise their professional judgment in considering factual issues.” *IRM 424(12).1(6)*.

This language allows Examination agents to use professional judgment in evaluating and, if appropriate, accepting a taxpayer's position on a factual issue.

The Revenue Procedure defines an AIR agreement as a closing agreement between the Service and a CEP taxpayer relating to one or more issues for taxable periods ending before the date of the agreement. *Rev.Proc. 94-67, § 2*. The Revenue Procedure provides that an AIR agreement will not include issues outside the jurisdiction of the District Director and will not include the following issues:

- Issues subject to an Advanced Pricing Agreement,
- Issues under the jurisdiction of the Assistant Commissioner (Employee Plans & Exempt Organizations),
- Any partnership item as defined in section 6231,

<sup>31</sup> The Tax Court recently granted motions filed by two third parties to quash subpoenas served in a transfer pricing case by both the Service and the taxpayer. The court stated that the potential harm to the third parties outweighed the usefulness of the evidence, which was not “central to the factual issues in the case.” *Medieval Attractions N.V. v. Commissioner, et al.*, Docket No. 20532-91, *et al.*, as reported in, 3 Tax Management, *Transfer Pricing Report* 874 (Apr.12, 1995).

<sup>32</sup> In *Nissei Sangyo v. United States*, 95-2 U.S.T.C. (CCH) ¶ 50,327 (E.D. Ill. 1995), the District Court stated that a summons issued to a United States subsidiary, acting as an agent under section 6038A for its Japanese parent, is in reality a summons issued to “a third party shareholder.” The Court on that basis stated that the summons may be quashed if “unduly burdensome” in relation to the “nexus” between the Japanese parent and the United States subsidiary. The Court did not discuss the fact that a controlled relationship implies a certain “nexus” that is not present when unrelated parties are involved.

<sup>33</sup> See, e.g., *Donruss Company v. Commissioner*, 386 F.2d 431 (2d Cir. 1967) (subpoena for eight- or nine-year-old third-party financial information enforced because likelihood of prejudice deemed “slight and remote”).

<sup>34</sup> For example, in *National Semiconductor Corporation v. Commissioner*, T.C. Memo. 1994-95, the Service served trial subpoenas on third-party semiconductor manufacturers which had previously provided evidence used at trial by the taxpayer. The third-party manufacturers responded to the Service trial subpoenas.

- Any issue, if the resolution sought is contrary to a private letter ruling, a technical advice memorandum, a closing agreement with the same taxpayer or a position proposed by the Service in response to a private letter ruling request that is withdrawn following notification that the Service would take a position adverse to that sought by the taxpayer and
- An issue designated for litigation by the Office of Chief Counsel. *Rev.Proc. 94-67, § 3.02.*

The Revenue Procedure states that the District Director must request consent from the involved Service office before an AIR may be executed for the following issues:

- Issues coordinated under the Industry Specialization Program,
- Appeals coordinated issues,
- Issues currently under Competent Authority consideration,
- Issues where the taxpayer has obtained Competent Authority assistance in prior years,
- Issues within the jurisdiction of the Department of Justice,
- Issues controlled by the Regional Commissioner and
- Issues in multi-district cases. *Rev.Proc. 94-67, § 3.03.*

An AIR agreement should be submitted to the case manager in the district with jurisdiction over the taxpayer's returns. *Rev.Proc. 94-67, § 4.01.* The AIR must state the issues for which the AIR agreement is sought, the taxable years involved and the material facts and law applying to the issues. *Rev.Proc. 94-67, § 4.02.*

Significantly, an AIR request must state whether the CEP taxpayer has applied for Competent Authority assistance for the AIR agreement issues and whether the taxpayer intends to seek relief from double taxation for the AIR agreement issues. *Rev.Proc. 94-67, § 4.03.* Copies of all contracts, agreements and other documents pertinent to the request must be supplied with the request, and the taxpayer must submit certified English translations of all applicable foreign laws. *Rev.Proc. 94-67, § 4.04.*

The AIR request must be signed by the taxpayer or by the taxpayer's authorized representative. Further, the

AIR request must include a declaration under penalty of perjury, signed by a person authorized to sign the return, stating that the facts in the AIR request are true, correct and complete. *Rev.Proc. 94-67, § 4.06.*

The District Director may grant a request for an AIR agreement where:

- There appears to be an advantage in having the issues permanently and conclusively closed or the CEP taxpayer shows good and sufficient reason for desiring the closing agreement and it is determined that the United States will not sustain a disadvantage through consummation of the agreement and
- The law is properly applied to the facts without taking into account the hazards of litigation, or the provisions in Delegation Order 236 are applicable and are satisfied. *Rev.Proc. 94-67, § 5.06.*

The AIR request is a closing agreement under section 7121 and thus should comply with the form and content requirements of Revenue Procedure 68-16, 1968-1 C.B. 770. However, an AIR agreement in the form of a closing agreement should not be entered into for issues subject to double taxation. *Rev.Proc. 94-67, § 9.02.* Instead, such issues should first be taken to Competent Authority. Consideration by Competent Authority may ultimately result in a closing agreement reflecting the terms of the double taxation relief granted under the Competent Authority procedure.

Examinations for a number of years has informally applied AIR procedures to resolve transfer pricing issues present over several audit cycles. Typically when the procedure is used, the taxpayer and the Service agree that the initial cycle will be developed thoroughly, so that an agreed formula can be developed to be applied to later years. For example, the taxpayer and the Service might agree that a cost plus 20 percent formula is to be applied to costs of a foreign subsidiary performing assembly of a product designed and marketed by the U.S. parent. The initial cycle would be thoroughly developed, allowing both parties to be satisfied that the cost plus 20 percent formula is arm's length. The later cycle would then be developed principally to determine the cost base to which the 20 percent markup would be applied.

AIR is not limited to transfer pricing disputes. The AIR procedure has also been used to resolve (i) a uniform capitalization issue under section 263A present over

several cycles and (ii) a research credit issue present over several cycles.<sup>35</sup>

Because of the emphasis placed upon the AIR procedure by the Commissioner, Examination Division Case Managers and International Examiner Group Managers will generally be receptive to the use of AIR to resolve transfer pricing and other issues occurring over several cycles. Perhaps an unstated motivation is the general examination preference to resolve issues with taxpayers rather than have the issues resolved by Appeals.

#### *Delegation Order 236—Limited Settlement Authority over Legal Issues Delegated to Examinations*

Unlike the AIR procedure discussed in the preceding section, Delegation Order 236, 1994-1 C.B. 326, gives Examinations limited settlement authority over legal, as opposed to factual, issues. Under Delegation Order 236, Examination Division Case Managers are given limited settlement authority for “rollover” and “recurring” legal issues. Such issues may be settled over several cycles using a closing agreement similar to that used under the AIR procedure.

Under Delegation Order 236, a “rollover” issue is defined as an adjustment arising from the same legal issue and the same transaction or taxable event that was involved in an earlier or later year settlement on the merits by Appeals. Examples given in the Delegation Order include the rate of amortization or depreciation of an asset, bad debt losses and basis and inventory adjustments. Thus, the Delegation Order permits Examinations to “rollover” to the current cycle the same depreciation rate or basis adjustment from a prior-cycle settlement by Appeals.

Delegation Order 236 defines a “recurring” issue as an issue involving an adjustment arising from the same legal issue in a separate transaction or a repeated taxable event in which the taxpayer advances the same legal position that was advanced as to the transaction or repeated taxable event in an earlier cycle. Examples given in the Delegation Order include methods of depreciation, use of accounting methods, computation of depletion, tax credits and similar items. “Recurring issues” may involve a transaction “similar” to the transaction giving rise to the Appeals settlement and thus may be more than simply a “rollover” of a prior Appeals settlement.

The Delegation Order is limited to situations where the facts are “substantially the same” as the facts of the prior cycle, the issue was settled on its merits independent of other issues, *i.e.*, was not part of a tradeoff settlement, the legal authority has not changed and the issue was settled by Appeals with the same taxpayer.

Delegation Order 236 presumably may be used to settle transfer pricing issues similar, but not identical, to transfer pricing issues in different years previously settled by Appeals.

Because Delegation Order 236 is a type of AIR procedure, Examinations considers Delegation Order 236 as within the Commissioner’s policy directive to achieve, to the extent possible, currency as to years under examination. Thus, where a taxpayer is aware of a favorable Appeals settlement in a prior year, the taxpayer should bring the settlement to the case manager’s attention and request that Delegation Order 236 be applied. However, the Delegation Order gives final authority to the case manager in deciding whether or not to implement the procedure.

#### *Early Referral to Appeals—Simultaneous Examination and Appeals Consideration of Issues*

Revenue Procedure 96-9, 1996-2 I.R.B. 1, describes the early referral to Appeals procedure. The procedure allows taxpayers to request transfer of developed, unagreed issues to Appeals, while other issues continue to be developed by Examinations. The early referral must be approved by both Appeals and Examinations. The procedure saves time as it allows Appeals and Examinations to work simultaneously.

Appropriate issues for early referral include issues that if resolved would lead to a quicker resolution of the entire case. The procedure does not apply to issues designated for litigation, but may include Industry Specialization Program issues and issues in Joint Committee cases. The procedure is presently limited to CEP cases.

The taxpayer must request early referral in writing from the CEP case manager. The request must identify the taxpayer, the years and the issues and state the taxpayer’s position on the issues.

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<sup>35</sup> See Ryan & Rogers, *Utilizing Linkage Agreements To Resolve Tax Issues With the Examination Branch of the Internal Revenue Service*, 92 TNT 210-127 (October 19, 1992).

Both Appeals and the District Director must approve the request for early referral. If both Appeals and the District Director approve, the request will be returned to the case manager who will inform the taxpayer and transmit the early referral issue file to Appeals. If the request is denied by the District Director or Appeals, the request will be returned to the case manager who will inform the taxpayer.

No formal appeal procedure is provided, but the taxpayer may request a conference to discuss the denial of the early referral request. The taxpayer should be advised of the decision within 45 days.

If the early referral request is approved, the case manager will send a Form 5701, Notice of Proposed Adjustment, to the taxpayer. The Form 5701 is not treated as a letter of proposed deficiency for purposes of the computation of increased interest under section 6621(c).

The taxpayer must respond to the Form 5701 within 30 days. The response could probably be done before the request is made for early referral—although the revenue procedure describes the response as occurring after the referral is approved. If accepted, Appeals will have jurisdiction over the early referral issues; the other issues will remain with Examinations.

Early referral issues will be resolved by Appeals using the usual procedures, including conferences. Settlement may be achieved using a Closing Agreement (Form 906). If the other issues are not settled by Examinations, the entire case may be referred to Appeals.

If the early referral issue is not settled, the issue is returned to the case manager with the Appeals' closing memorandum; if the case later comes back to Appeals, the section 6621(c) increased interest provision will apply.

The early referral procedure presumably will be used primarily for legal issues. Examinations may be reluctant to accede jurisdiction to Appeals as a routine matter as Examinations may perceive this procedure as enabling taxpayers to bypass Examinations.

#### *Mediation At Appeals—Another Chance for an Administrative Resolution*

Announcement 95-86, 1995-44 I.R.B. 1 (October 13, 1995), contains a procedure for mediation of certain nondocketed issues pending with Appeals. The procedure will allow taxpayers whose cases are under the jurisdiction

of Appeals to request mediation as a dispute resolution technique. Under the procedure, the taxpayer and Appeals will attempt to negotiate a settlement, assisted by an objective and neutral third party who has no authority to impose a decision.

The mediation procedure will be appropriate for factual issues, such as valuation issues, reasonable compensation issues and transfer pricing issues. However, mediation will be limited to CEP cases assigned to Appeals Team Chiefs. Mediation will not be available for an issue that is:

- designated for litigation,
- docketed in any court,
- an industry specialization program issue,
- an appeals coordinated issue or
- a Competent Authority issue involving appeals as described in Announcement 93-14, 1993-39 I.R.B. 12.

Mediation may be requested by the taxpayer or by Appeals when settlement discussions are unsuccessful. Mediation must be agreed to by both parties and must be approved by the appropriate Assistant Regional Director of Appeals—Large Case. Under the procedure, mediation will be nonbinding on the parties and settlement authority will remain with Appeals.

If approved, the parties will enter into a written agreement setting forth the procedures for mediation, including a procedure for selecting a mediator if the parties cannot agree on a mediator. The parties may select a representative of Appeals as the mediator, in which case the Appeals National Office will pay the expenses of the Appeals mediator. If a non-Internal Revenue Service employee is selected as the mediator, the parties will share the expenses equally.

The Announcement provides that Internal Revenue Service Employees participating in the mediation will be subject to the section 6103 disclosure provision, which should help to maintain the confidentiality of the mediation proceeding.

The new Appeals Mediation Procedure should assist taxpayers attempting to settle issues at Appeals. The procedure will enable an informed and disinterested party to provide a candid assessment of the merits, which may lead to settlement and thus avoid costly litigation.

*Designation of Issues for Litigation*

Issues may be designated for litigation under two procedures.

First, Revenue Procedure 87-24, 1987-1 C.B. 720, section 2.08, provides that the Director of the Tax Litigation Division (now Field Services) or the Deputy Associate Chief Counsel (International), after consulting with the Director of Appeals and the appropriate Regional Counsel, may determine that an issue or case should not be considered by Appeals. If such a determination is made, Appeals will forego settlement authority over the case.

In addition, section 2.04 of Revenue Procedure 87-24 provides that upon request from counsel, a case will be returned to Counsel to allow for adequate trial preparation. Thus, a Chief Counsel trial attorney may request that a case be returned from Appeals to Counsel for trial preparation irrespective of whether the case has

been formally designated under section 2.08 of Revenue Procedure 87-24 or under the Industry Specialization Procedure discussed below.

A case may also be designated for litigation under the Industry Specialization Program ("ISP"). These procedures are described at CCDM (35)(3)(14)(1). The CCDM specifies procedures for designating issues in nondocketed cases under the jurisdiction of the District Director, nondocketed cases under the jurisdiction of Appeals and docketed cases under the jurisdiction of Appeals or Counsel. The CCDM procedures provide that only in "unusual cases" will designation be considered for docketed cases under the jurisdiction of Appeals after settlement activity has begun.

Both the Revenue Procedure 87-24 and the ISP procedures provide for notification to the taxpayer when an issue is designated for litigation.