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What To Give IRS In An Audit

Provide receipts and other supporting information if the IRS asks, but what if you have memos and letters from tax advisers about whether you qualify for a deduction, audit risk or potential tax litigation? You don't want to hand them a roadmap of arguments to make against you. "Work-product" protection means a taxpayer need not turn over documents created in anticipation of litigation. This protection has wide application, not just to tax litigation.

What should you do if the IRS asks for all your documents about a particular deduction, income item, or tax year? As part of vetting a particular tax position, you and your tax advisers may discuss what tax arguments the IRS could make. You might talk about audit risk and tax authorities pro and con. Traditionally, documents to be used in tax litigation and relating to the strength or weakness of a tax position are covered by work-product privilege so the IRS generally cannot get them. If the IRS issues an Information Document Request or subpoena, you may be able to legitimately refuse.

Work-product protection is different from attorney-client privilege. Attorney-client privilege protects communications between clients and their *lawyers*, whether or not those communications deal with anticipated litigation. Discussions with tax lawyers are privileged, but discussions with accountants are not, unless the accountants are

subcontractors of the tax lawyers. Having lawyers hire accountants can bootstrap attorney-client privilege to accountant communications, which makes sense where tax litigation is imminent or might involve an IRS criminal matter.

Unfortunately, in *U.S. v. Textron, Inc.*, the First Circuit Court of Appeals gave the IRS access to all documents not protected by attorney-client privilege, radically curtailing work-product protection. Textron memos and calculations dealt with the extent to which its tax reporting would pass muster in an IRS audit. The court found the documents were not prepared *specifically* for use in litigation so were fair game. Although this decision is binding only in federal courts within the First Circuit, there are signs the IRS may apply it nationally.

Companies and individuals alike should plan ahead for which tax issues on their returns are solid and which are not, and these may help:

- Legend Everything. It may help if your notes and documents are legended at the time they are created with “work-product” protections. It may help if you can show they are for the specific use of anticipated litigation.
- Hire a Lawyer. If you solely deal with your tax *lawyer* and *not* your accountant, this should not apply. Having your tax lawyer act as the liaison for all communications can import attorney-client privilege.
- Separate Tax Dispute Files. Keep legal opinions and memos on tax matters in a separate file. Don’t just have a “tax” file. If you have a big tax issue (say a lawsuit recovery, a casualty loss or conservation easement), keep *that* file separate.
- Bifurcate Files. Segregate tax issues. Keep a file on each and don’t commingle them. That way if you turn over a file you’ve limited the disclosure to the pertinent topic.
- Words vs. Numbers. If you maintain tax accrual work papers, limit them to numerical analyses. Keep tax memos in a legal file, preferably with your lawyer. Think of tax documents as

tax returns and spreadsheets only, numbers rather than words. Keep legal issues associated with taxes (discussion of case law, IRS rulings, etc.) in a legal file.

- **Corporate Counsel.** In a company, keep legal opinions and tax memos with the general counsel's office. Keep legal opinions and tax memoranda in a file separate from accounting and financial statements.
- **Timing.** Work-product protection is more clear-cut *after* your return is filed. If you know you have a dispute, you have a much better argument you are preparing documents for the *specific* purpose of litigation.

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