Hot Topics in Tax Litigation (11:15—12:15 P.M.)

Panelists:

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The Assessment and Collection of Criminal Restitution

Overview

- How restitution arises in a criminal tax case and how it is enforced.
- Assessment of restitution under the Firearms Excise Tax Improvement Act of 2010 (FETI Act).
- Collection of assessed restitution under the FETI Act.

The Criminal Case

- Generally restitution is based on the actual loss caused by the defendant for the periods of criminal conduct
  - Restitution may be ordered for loss of taxes owed by the criminal defendant or a third party
- Set out in the Judgment and Commitment Order (JCO)

Source of Restitution Ordered

- Acknowledged by the defendant in a plea agreement.
  - 18 U.S.C. § 3663(a)(3)

- As determined by the court pursuant to a sentencing hearing:
  - As a condition of supervised release under 18 U.S.C. § 3583(d)
  - As a condition of probation under 18 U.S.C. § 3563(b)(2)

Enforcement of Criminal Restitution Order

- Enforced by Justice Department Financial Litigation Units (USAO-FLU) as if it were a civil judgment. 18 U.S.C. § 3613(a).

- Interest runs on restitution, but it may be waived by the court ("Title 18 interest"). 18 U.S.C. § 3612(f).

- Before the FETI Act, the IRS was generally not involved in collection of restitution.

Section 3 of the Firearms Excise Tax Improvement Act of 2010

- Amends sections 6201(a)(assessment), 6213(b) (deficiency procedures inapplicable) and 6501(c) (assessment limitations period inapplicable) of the Code.

- Directs that the amount of criminal restitution "for failure to pay any tax" be assessed and collected "as if such amount were such tax." Sec. 6201(a)(4).

Which restitution orders are affected?

- Restitution that is traceable to a tax:
  - Most Title 26 criminal offenses.
  - Some Title 18 criminal offenses.
- Restitution ordered after August 16, 2010.
- No period of limitations for assessment.

How is restitution assessed?

- Exactly the amount ordered as restitution by the court for the tax periods set forth in the order.
- Assessment only after the judgment is final and no longer appealable.
- Not subject to any administrative or judicial challenge. Sec.6201(a)(4)(C).
  - "Last bite at the apple" is the sentencing hearing.
- Later examination of a restitution tax period is allowed.
  - Assessment following a civil examination for the same tax period as the restitution-based assessment is treated as a mirror assessment. Double collection, however, is prohibited.

How is it assessed? (cont.)

- Title 26 interest applies to the assessed restitution.
  - Title 18 interest is **not** assessed.

- Automatic assessment of accuracy-related (section 6662) or the fraud penalty (section 6663) is **not** allowed. Deficiency procedures still apply here.

- Abatement only allowed if the restitution order is reduced by the court.

Statutes of Limitation

- Normal 10-year collection period under section 6502(a).

- But the Service may still receive restitution payments pursuant to the sentencing court's restitution order after the collection period expires.

Restitution Payment Plans

- Most courts will order that the restitution be paid either immediately or periodically.

- A court-ordered payment plan for restitution does not restrict the Service's ability to collect assessed restitution.

Liens, Levies, CDP and Collection Alternatives

- CDP rights exist, but have limited value.
  - No challenge to assessment
  - Collection alternatives limited.

- Offers in compromise are **not** allowed if they compromise the amount of restitution ordered.

- Installment agreements are allowed, but cannot effectively compromise the amount of restitution ordered. See section 7122(a).

- Any compromise of the restitution amount must be ordered by the federal court. 18 U.S.C. § 3664(k).

Questions?

- See CC Notice 2011-018, The Assessment and Collection of Criminal Restitution (Aug. 26, 2011)

Variance Doctrine

Source – Treas. Reg. § 301.6402-2(b)(1)

- A claim for refund "must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof."
- "These requirements ensure that the IRS is given adequate notice of each claim and its underlying facts, so that the IRS may conduct an administrative investigation and determination." *Quarty v. United States*, 170 F.3d 961, 972 (9th Cir. 1999).

Judicial Evolution

- "Courts have long interpreted § 7422(a) and Treasury Reg. § 6402-2(b)(1) as stating a '*substantial* variance' rule which bars a taxpayer from presenting claims in a tax refund suit that '*substantially* vary' the legal theories and factual bases set forth in the tax refund claim presented to the IRS." *Lockheed Martin Corp. v. US*, 210 F.3d 1366, 1371 (Fed. Cir. 2000) (emphasis added).

Legal vs. Factual Variance

- Legal variance
  - "Here, however, plaintiff wishes to raise the issue of the gross income from mining for the testing sand, which is *not at all related to the issue* of the rate of depletion that had been properly raised." *Ottawa Silica Co. v. US*, 699 F.2d 1124, 1139 (Fed. Cir. 1983) (emphasis added).
- Factual variance
  - "We agree with the government that the introduction of additional [qualified research] expenses would constitute a substantial variance of the factual basis of Lockheed Martin's claims." *Lockheed Martin*, 210 F.3d at 1371.

Parameters

- Does not prevent a taxpayer from presenting probative *evidence* in support of claim. *See Rogan v. Ferry*, 154 F.2d 974, 977 (9th Cir. 1946).
- Germaneness doctrine – If a taxpayer files a timely claim, it may raise a new theory while the IRS has jurisdiction if the theory relates to facts that the IRS examined or should have examined. *Parker Hannifin Corp. v. US*, 71 Fed. Cl. 231 (2006).
- Since it emanates from a regulation, the variance defense may be waived by the IRS's administrative consideration or by the government's delay in asserting it as a defense in litigation. *See Goulding v. US*, 929 F.2d 329, 332-33 (7th Cir. 1991).

Recent Developments

- Remains a standard weapon in the government's arsenal of defenses to tax refund suits.
  - *Bush v. US*, 106 Fed. Cl. 563 (2012) (holding that variance barred taxpayers from asserting they should have received notice of deficiency)
  - *Heger v. US*, 103 Fed. Cl. 261 (2012) (same)

Recent Developments

- *Bayer Corp. and Subs. v. US*, 2012 WL 4339554 (W.D. Pa. Sept. 20, 2012)
  - Tax refund suit involving Bayer's claims for § 41 research credits for multiple tax years
  - Earlier (Feb. 2012) ruling required Bayer to prove its research activities by "business component" – product, process, technique, etc.
  - Bayer's refund claims had organized its research activities "cost center" – *i.e.*, accounting categories
  - Government argued that proof of "business components" in litigation constituted variance similar to that in *Lockheed*

Recent Developments

- *Bayer Corp. and Subs. v. US*, 2012 WL 4339554 (W.D. Pa. Sept. 20, 2012)
  - District court did not accept the government's argument.
  - *Lockheed* is distinguishable because Bayer not seeking to introduce new QREs.
  - The IRS did not demand a list of business components during audit.
  - Bayer's refund claims advised the IRS of the factual bases for its claims; the proof of business components was merely probative evidence.

Recent Developments in Work Product Doctrine

Overview

- Work Product Doctrine
  - Background
  - Tax Audits as Litigation
  - Tax Court Rule 70 (2012 Revisions) and Substantial Need Exception
  - Federal Rule of Civil Procedure 26 (2010 Revisions) and Protection for Expert Materials

Work Product Doctrine

- Established by the U.S. Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1947), in which the Court held an attorney's interview notes were protected from discovery.
  - Protection directed toward materials that would give one side an unfair advantage in an adversarial proceeding, such as trial preparation materials revealing one party's legal theories, strategy, factual analysis, evaluations of witnesses, and anticipated arguments by the other side.
- Partially codified by Fed. R. Civ. Proc. 26(b)(3): A party may *not* obtain discovery of documents and tangible things:
  - Prepared ***in anticipation of litigation or for trial***;
  - By or for a party or by or for that party's representative;
  - Except upon a showing of a ***substantial need and undue hardship***.
- Heightened level of protection for "core" or "opinion" work product.
- A waiver of work product occurs when a party discloses material "in a way inconsistent with keeping it from the adversary." *Evergreen Trading, LLC v. United States*, 80 Fed. Cl. 122 (2007).

Work Product: Tax Audit as Litigation

- Three tests used to determine whether material prepared "in anticipation of litigation":
  - Majority of Circuits use the "because of" test: Whether the document was prepared because of the prospect of litigation
    - *E.g., United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998): whether substantially same document would have been prepared irrespective of the expected litigation
  - 5th Circuit uses the "primary purpose" test
  - 1st Circuit purports to use "because of" test, but recently articulated the standard as whether a document was "prepared for use in possible litigation" *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009) (*en banc*).

Work Product: Tax Audit as Litigation

- Not all administrative proceedings constitute "litigation;" whether an administrative proceeding qualifies depends on the circumstances
  - *United States v. Baggot*, 463 U.S. 476 (1983);
  - *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006);
  - *Deseret Management Corp. v. United States*, 76 Fed. Cl. 88 (2007);
  - *Consolidated Edison Co. of N.Y., Inc. v. United States*, 90 Fed. Cl. 228 (2009);

Work Product: Tax Audit as Litigation

- *Fidelity International Currency Advisor A Fund LLC v. United States*, 2008 WL 4809032 (D. Mass. 2008);
- *In re Rail Freight Fuel Surcharge Antitrust Litigation*, 268 F.R.D. 114, 117 (D.D.C. 2010);
- *United States v. Eaton Corp.*, 2012 WL 3486910 (N.D. Ohio).

Tax Accrual Workpapers and Anticipation of Litigation

- The IRS defines tax accrual work papers (TAWs) broadly as:
  - "those audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserves for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and…footnotes disclosing those tax reserves on audited financial statements." I.R.M. 4.10.20.2(2).
  - Federal courts are divided on whether TAWs are prepared "in preparation for litigation" and are protected as work product.

Tax Accrual Workpapers and the Work Product Doctrine

- *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009)
  - TAWs were not work product, since they would have been prepared even in the absence of any imminent threat of litigation.

- *Regions Fin. Corp. v. United States*, 2008 WL 2139008 (N.D. Ala. 2008)
  - TAWs were work product, and taxpayer correctly withheld (or redacted) documents in response to an IRS subpoena.

  - "Were it not for anticipated litigation, [taxpayer] would not have to worry about contingent liabilities and would have no need to elicit opinions regarding the likely results of litigation."

- *United States v. Deloitte,* 610 F.3d 129 (D.C. Cir. 2010).
  - Documents that were prepared in connection with financial audits contained content that was protected work product

Conforming Amendments to Tax Court Rules

- On July 6, 2012, the U.S. Tax Court amended rule 70 to adopt the "substantial need and undue hardship exception" to work product protection

- Prior Tax Court Jurisprudence
  - Tax Court traditionally did not recognize exception to work product protection for "substantial need and undue hardship"
    - *See Dvorak v. Commissioner*, 64 T.C. 846, 850-51 (1975), refusing to "incorporate into this Court's discovery procedure the requirements of 26(b)(3) of the [FRCP], under which 'work product' materials are discoverable if 'the substantial equivalent of the materials' is unavailable."
  - Over time, Tax Court began to recognize limited exception
    - *See Ratke v. Commissioner*, 129 T.C. 45, 52 (2007): "The privilege resulting from the work product doctrine is qualified; it may be overcome by an appropriate showing."

Conforming Amendments to Tax Court Rules

- Recent Cases on "Substantial Need and Undue Hardship"
  - *In re Echo Star Communications Corp*., 448 F.3d 1294, 1302 (Fed. Cir. 2006);
  - *Vicor v. Vigilant Ins. Co*., 674 F.3d 1 (1st Cir. 2012);
  - *United States v. ISS Marine Services, Inc.*, 2012 WL 5873682, *14 (D.D.C. Nov. 21, 2012);
  - *Securities & Exchange Commission v. Sells*, No. 11-cv-04941 (N.D. Cal. Feb. 4, 2013).

Rule 26: 2010 Amendments Regarding Experts

- Changes to FRCP 26 and Tax Court Rule 70.

- Rule 26: Experts that are "retained or specially employed to provide expert testimony in the case" or those "whose duties as the party's employee regularly involve giving expert testimony" are **required to provide a written report** along with the party's initial disclosures, which include, *inter alia*, opinions, qualifications, and compensation.

- **Previous Rule 26(a)(2)(B):** The written report must include a statement of "**data or other information considered by**" the expert in forming his/her opinion for the case.

- **Revised Rule 26(a)(2)(B)**: The written report need only disclose "**the facts or data considered by**" the expert witness.

Rule 26 Amendments: Rule 26(a)(2)(B)

- The Advisory Committee Notes to Revised Rule 26(a)(2)(B):
  - "The refocus on 'facts or data' is meant to limit disclosure to material of a factual nature by excluding theories or mental impressions of counsel."
  - "[T]he intention is that 'facts or data' be interpreted broadly to require disclosure of any material considered by the expert, from whatever source, that contains factual ingredients."
- "The [2010] amendments are meant to alleviate the perceived uncertainty and rising costs associated with attorneys' limited interactions with their retained experts as a result of court opinions allowing discovery of an expert's draft reports and of all communications with counsel." *Republic of Bjorkman*, 2012 WL 12755 (D. Colo.).

Rule 26 Amendments: Rules 26(b)(4)(B)-(C)

- Amendments also added current Rules 26(b)(4)(B) and (C).

- Rule 26(b)(4)(B):
  - Protects drafts of an expert's written report as work product.
  - Protects drafts of an expert's "summary of … facts and opinions" (if expert is not required to provide a written report).
- Rule 26(b)(4)(C):
  - Protects communications between the attorney and the expert as work product.
  - Three Exceptions:
    - Communications relating to the expert's compensation,
    - Identification of facts or data provided by the attorney that the expert considered in forming his/her opinion, and
    - Identification of assumptions provided by the attorney that the expert relied on in forming his/her opinion.

Rule 26 Amendments: Recent Developments

- *In re the Application of the Republic of Ecuador*, 280 F.R.D. 506 (N.D.Cal. 2012).
  - A "draft report" for purposes of Rule 26(b)(4)(B):
    - Must be authored (or co-authored) by the expert or his/her assistants; *and*
    - A draft of a report ultimately submitted in the underlying litigation.
  - Draft worksheets created by the expert or his/her assistants for use in the expert report were protected as "drafts."
  - Various notes, letters, memoranda and outlines created by expert and his/her assistants were not "drafts" for purposes of Rule 26(b)(4)(B) protection.
  - Copying an attorney on a communication among employees of the party and the expert does not automatically protect the communication as work product. The communication must "include the theories or mental impressions of counsel."

Rule 26 Amendments: Recent Developments

- *In re Application of Republic of Ecuador*:

- Discoverable "facts/data considered, reviewed or relied upon for the development, foundation, or basis" of the expert testimony include:

    - Testing of material involved in litigation,

    - Notes of any such testing,

    - Communications with anyone other than the party's counsel about the opinions expressed, or

    - Alternative analyses, testing methods, or approaches to the issues proffered, whether or not considered in forming the opinions expressed.

Rule 26 Amendments: Recent Developments

- Rule 26(b)(4)(C), by its terms, only protects communications between an attorney and an expert providing a written report.

  - Courts have held that Rule 26(b)(4)(C) does not apply to communications with non-reporting experts. *In re the Application of the Republic of Ecuador*, 280 F.R.D. 506 (N.D. Cal. 2012) ("Nor does protection exist for communications between an expert witness and a consulting expert"); *See also Republic of Ecuador v. Bjorkman*, 2012 WL 12755 (D. Colo. 2012).

  - One court has applied Rule 26(b)(4)(C) to protect communications between an attorney and a non-reporting expert. *PACT XPP Technologies, AG v. Xilinx, Inc.*, 2012 WL 1205855 (E.D. Tex.).

Rule 26 Amendments: Recent Developments

- *Fialkowski v. Perry*, 2012 WL 2527020 (E.D. Pa.)
  - A party's business records and explanations thereof provided to her accountant expert witness for the purpose of assisting her attorney in litigation constituted "facts and data" considered and "assumptions" relied on by the expert and were not protected by work product.
  - Providing work product protection would not serve the amendment's purpose of protecting counsel's mental impressions, rather than those of the party or the witness.
- *In re Abestos Products Liability Litigation (No. VI)*, 2011 WL 6181334 (E.D. Pa.)
  - Information provided by attorneys to the diagnosing doctors of plaintiffs in asbestos litigation regarding the plaintiffs' "exposure, medical, and smoking histories" constituted "facts or data" considered by the witnesses and was not protected by work product.