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U.S. v. Deloitte: Expansion of Work Product Doctrine in Tax Controversies

Protecting Confidentiality of Internal Tax Documents From the IRS

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Jonathan M. Prokup, Shareholder, **Chamberlain Hrdlicka**, West Conshohocken, Pa.

Edward Froelich, Of Counsel, **Morrison & Foerster**, Washington, D.C.

Kevin Spencer, Partner, **McDermott Will & Emery**, Washington, D.C.

Tuesday, September 28, 2010

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Will & Emery

United States v. Deloitte: Expansion of Work Product Doctrine In Tax Controversies

Protecting Confidentiality of Internal Tax Documents From the IRS

Kevin Spencer
202-756-8203
kspencer@mwe.com

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www.mwe.com

Boston Brussels Chicago Düsseldorf Houston London Los Angeles Miami Milan Munich New York Orange County Rome San Diego Silicon Valley Washington, D.C.
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Work Product Doctrine

Brief Summary

- Established by U.S. Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1947), which held that attorney’s witness interview notes were protected from discovery.
- Court explained: “the general policy against invading the privacy of an attorney's course of preparation is so well recognized and so essential to an orderly working of our system of legal procedure that a burden rests on the one who would invade that privacy to establish adequate reasons to justify production through a subpoena or court order .”



Federal Rule of Civil Procedure 26(b)(3)

- Partially codified *Hickman v. Taylor*.
- “Ordinarily, a party may not discover documents or tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party’s attorney, consultant, surety, indemnitor, insurer, or agent).”
 - Exception: “[P]arty shows that it has a substantial need for the materials to prepare for its case and cannot, without undue hardship, obtain their substantial equivalent by other means.”
 - But there is almost absolute protection from disclosure of so-called “opinion work product”
 - Court “must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party’s attorney or other representative concerning the litigation.” Fed. R. Civ. P. 26(b)(3)(B).



Waiver of Work Product

- Clear case = intentional disclosure to adversary
- Disclosure to third party does not necessarily waive protection
- Waiver occurs when disclosure of protected materials to third parties who are not adversaries substantially increases the opportunity for potential adversaries to obtain information



The War For Tax Accrual Workpapers

- Twenty-six year battle
- *U.S. v. Arthur Young*, 465 U.S. 805 (1984)
 - Court affirmed IRS’s right to obtain auditor’s “tax accrual work papers”
 - Court explained role of accountant very different from the role of an attorney
 - Accountant is a “public watchdog” and is required to “maintain total independence from the client at all times and requires complete fidelity to the public trust”
 - No accountant work-product privilege



Government's Response to *Arthur Young*

- Announcement 84-46, 1984 I.R.B. 18 -- IRS and its “policy of restraint”
 - Only seek tax accrual workpapers in “unusual circumstances”
- Announcement 2002-63, 2002-2 C.B. 72 -- IRS amends policy
 - Routinely seeks if taxpayer engaged in “listed transaction”
 - *See* Internal Revenue Manual Sec. 4.10.20 (1-15-2005)
- Announcement 2010-9, 2010-7 I.R.B. 408; Announcement 2010-17, 2010-13 I.R.B. 515
 - “While the Service intends to require the reporting of uncertain tax positions, the Service is proposing to otherwise retain its existing policy of restraint”
 - Prop. Treas. Reg. § 1.6012-2(a)(4)
 - “A corporation required to make a return under this section shall attach Schedule UTP, Uncertain Tax Position Statement, or any successor form, to such return, in accordance with forms, instructions, or other appropriate guidance provided by the IRS.”



The War Continues

- *Textron, Textron, and more Textron*
 - *U.S. v. Textron*, 507 F.Supp.2d 138 (D.R.I. 2007) – workpapers are protected work product
 - *U.S. v. Textron*, 553 F.3d 87 (1st Cir. 2009) – affirms trial court
 - *U.S. v. Textron*, 577 F.3d 21 (1st Cir. 2009) (*en banc*) – reverses and holds no work product protection
 - Petition for *certiorari* denied (May 2010)
- *Textron* has implications beyond application of privilege to tax workpapers because work product potentially applies to all discovery



Deloitte v. United States

The Facts

- Dow Chemical filed refund suit challenging adjustments made to partnership returns filed by 2 partnerships in which Dow was partner
- During discovery, IRS issued a summons for Dow's tax accrual workpapers from its auditor Deloitte LLP
- Deloitte turned over all documents sought except for 3 documents claiming they are protected work product
- Government moved to compel



Deloitte v. United States

The Facts

- Documents withheld:
 - “Dow Memo” - 1993 draft memo prepared *by* Deloitte summarizing a meeting between Dow employees, Dow outside counsel, and Deloitte employees “about the possibility of litigation” and the need to account for possibility during audit; and
 - “Dow Documents” - 1998 legal and tax analysis and “flow chart” prepared by Dow’s in-house counsel and accountants and a 2005 tax opinion prepared by Dow’s outside counsel after the transaction was executed
- Dow Documents were disclosed to Deloitte to “review the adequacy of Dow’s contingency reserves” for the transactions under scrutiny



Deloitte v. United States

District Court

- 623 F.Supp. 2d 39 (D.D.C. 2009)
- No *in camera* inspection
- Documents protected because created in anticipation of future litigation
 - Fact that Deloitte Memo created by Deloitte not determinative:
“contents record the thoughts of Dow’s counsel regarding the prospect of litigation”
- No waiver because disclosure “was not inconsistent with maintenance of secrecy”
 - Deloitte not a potential adversary
 - No evidence showing it was unreasonable for Dow to expect Deloitte to maintain confidentiality



Deloitte v. United States

Appeal

- 623 F.Supp. 2d 39 (D.C. Cir. 2010)
- Government appealed and Dow intervened to assert work product protection for 3 documents
- Government argued:
 - (1) Deloitte Memo is not work product because Deloitte created it
 - Alternatively, Dow waived protection when it orally disclosed information to Deloitte
 - (2) Dow Documents are work product, but Dow waived protection by giving to Deloitte



Deloitte v. United States

Deloitte Memo Is Work Product

- Government incorrectly focused on who created the Deloitte Memo
- Correct inquiry focuses on document's content – the mental impressions and conclusions of Dow's attorneys
- Government mistakenly assumed Fed. R. Civ. P. 26(b)(3) “provides an exhaustive definition of what constitutes work product”
 - *Hickman* goes further than Fed. R. Civ. P. 26(b)(3)
 - Protects “intangible” things like the thoughts and opinions of counsel



Deloitte v. United States

Deloitte Memo Is Work Product

- Content determines whether document is work product not its function
 - Government argued the Deloitte Memo was not work product because it was created during annual audit, not in “anticipation of litigation”
- Circuits split on proper test to determine whether document was prepared in “anticipation of litigation”
 - Most circuits (including D.C. Circuit) have adopted “because of” test. *See In re Sealed Case*, 146 F.3d 881, 884 (D.C.Cir. 1998)
 - Fifth Circuit has adopted more stringent “primary motivating purpose” test. *See United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982)



Deloitte v. United States

Deloitte Memo Is Work Product

- Government relies on *El Paso* and *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009)(*en banc*) -*Textron* court found no evidence that workpapers were prepared for “potential use in litigation” or “serve any useful purpose” in litigation
- Reliance misplaced -- under the “because of” test, material generated in anticipation of litigation may also be used for ordinary business purposes without losing its protected status
 - *Textron* is distinguishable on its facts
 - Judge Torruella’s dissent says court applied different standard – whether the documents were “prepared for use in possible litigation”
- Remand because Deloitte Memo could contain non-work product information



Deloitte v. United States

No Waiver of Dow Documents

- D.C. Circuit first to address whether disclosure to independent auditor waives protection
 - Most district courts ruled no waiver
- Disclosure does not necessarily waive protection
 - Waiver occurs when voluntarily disclose to an adversary or a “conduit” to an adversary
- Court ruled Deloitte could never be Dow’s adversary because of its professional duties
- Correct inquiry is whether “Deloitte could be Dow’s adversary in the sort of litigation the Dow Documents address”



Deloitte v. United States

No Waiver of Dow Documents

- Dow contemplated litigation with the IRS, not Deloitte
- Deloitte was not a conduit to Dow's adversaries
 - Dow had a reasonable expectation of confidentiality
- Cannot rely on *Arthur Young*
 - Government attempts to discover the thoughts and opinions of attorney's not an independent auditor's interpretations of its client's financial statements



Deloitte versus Textron -- Comparison

- Did *Textron* fashion a new test?
- Content of putatively privileged documents
- You know it when you see it
- Is the IRS disadvantaged in combating tax shelters?



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Strafford Publications Webinar

Jonathan Prokup

Chamberlain Hrdlicka

610.772.2340

Jprokup@chamberlainlaw.com

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www.taxblawg.net

The D.C. Circuit's decision in *Deloitte* has given taxpayers new hope

- Rule 26(b)(3) partially codifies the work product doctrine
- Under *Hickman*, the doctrine protects “intangible” things
 - *Hickman v. Taylor*, 329 U.S. 495 (1947)
- The substance of a document, not the form, controls

Uncertainty remains about the scope and application of the doctrine

- What does it mean for a document to be prepared in “anticipation of litigation”?
 - Work product designation depends on substance
 - But substance may depend on context

When is work product prepared in “anticipation of litigation”?

- What is “litigation”?
- When can it reasonably be “anticipated”?

What is “litigation”?

- Broader than just judicial proceedings
- Touchstone: must be “**adversarial**”
 - *United States v. Textron*, 553 F.3d 87 (1st Cir. 2009) (withdrawn).
 - Wright and Miller, 8 Fed. Prac. & Proc. § 2024 (3d ed. 2010) (“include[s] proceedings before administrative tribunals if they are adversarial in nature”)
 - *In re Grand Jury Subpoena*, 220 F.R.D. 130, 147 (D. Mass. 2004).
 - *Southern Union Co. v. Southwest Gas Corp.*, 205 F.R.D. 542 (D. Ariz. 2002)

What makes a proceeding sufficiently “adversarial” to be treated as litigation?

- Right to cross-examine witnesses
- Right to dispute evidence and legal arguments before a neutral arbiter
 - Dennis J. Ventry, Jr., Protecting Abusive Tax Avoidance, *Tax Notes*, 2008 TNT 171-26 (Sept. 3, 2008).
 - Peter A. Lowy and Juan F. Vasquez Jr., "When Is the Work of a Tax Professional Done in Anticipation of Litigation and Thus 'Work Product'?" *J. Tax'n* 155, 156 (Mar. 2003).

Does a federal tax examination qualify as “litigation” for these purposes?

- “Antechamber” to litigation
- Verification of tax liability
 - United States v. Frederick, 182 F.3d 496 (7th Cir. 1999)

Does a protest before IRS Appeals qualify as “litigation”?

- Must be “adversarial”
- Cross-examination of witnesses?
- Right to dispute evidence and legal arguments before a neutral arbiter?

The exam team has the opportunity to examine the taxpayer's witnesses

- Summons power
- Statements given under threat of penalty
- Increasing use of court reporters

The exam team has the opportunity to conduct discovery of facts

- Summons power
 - FRCP 30: depositions
- Information Document Requests
 - FRCP 33: interrogatories
 - FRCP 34: requests for production

Taxpayer can dispute deficiencies before IRS Appeals

- Appeals intended to be an independent arbiter
- Protest and rebuttal
- Appeals conference
 - Exam team presents arguments
 - Taxpayer given opportunity to respond

Assertion of a deficiency creates a live dispute to be resolved

- Partnership analogy
- Possible outcomes
 - Settlement
 - Appeals
 - Litigation

Conclusion: IRS appeals process should be treated as litigation

- Anticipation of an adjustment that is likely to be disputed at Appeals should be considered “anticipation of litigation”
 - *United States v. Roxworthy*, 457 F.3d 590, 600 (6th Cir. 2006)

When is it reasonable to anticipate an adjustment and appeal?

- More than a “remote possibility”
- Specific claim
- Genuine fear / strong prospect / substantial possibility

Is anticipation of “litigation” reasonable only after an adjustment is asserted?

- Issues generally identified by the IRS
 - Listed transactions
 - LMSB Tier I/II/III Issues
- Reliance on prior experience

Are tax accrual workpapers prepared in anticipation of litigation?

- Distinction among workpaper components
 - Legal analysis and conclusions
 - Reserve computations
- Risk-management protocols and practices
 - Maintain distinctions

Following the *Deloitte* decision, what materials qualify for protection?

- Remains a factual determination
 - “Under *Hickman* ... the question ... whether the document contains work product—the thoughts and opinions of counsel developed in anticipation of litigation.”

Is an independent policy of analyzing potential tax disputes self-serving?

- Just to obtain protection as work-product?
- Role of the judicial system
 - Ascertain intent and reasonableness
- Still have to satisfy the “because of” or “primary purpose” test, depending on jurisdiction
 - *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982).

The same standards for other areas of litigation should apply to tax litigation

- No mutual exclusivity between business and litigation
 - United States v. Adlman, 134 F. 3d 1194, 1202 (2d Cir. 1998)
- Forced waiver of attorney-client privilege
 - Federal tax penalties
 - Relationship with auditors

Tax “exceptionalism” does not justify excluding workpapers from the doctrine

- Exceptionalism
 - Protecting the “lifeblood” of the government
 - Acting in the broader public interest
- Justifies investigative powers
- Still subject to limitations

Protecting tax advice is consistent with the policy of *Hickman v. Taylor*

- Protection depends on substance, not form
 - Transmission of work product does not necessarily cause waiver
- Requirement of disclosure encourages counsel to refrain from giving written advice

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Strafford Publications Webinar

Edward L. Froelich
Washington, D.C.
Morrison & Foerster LLP
(202) 778-1646
efroelich@mofo.com

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Overview

- Stepping Back -- pre-*Textron*, pre-UTP
- Changing landscape – what has brought us to this point?
- IRS summons authority
- Schedule UTP

Stepping Back – The UTP In Context

- Putting aside the UTP and the IRS's current view of the application of privileges to workpapers, consider the following scenario:
 - IDR Nos. 1 and 2 are the standard requests for general information; e.g., corporate organizational chart, prior-year returns, list of officers, listed transactions.
 - IDR No. 3 requests you to list all positions on the return which the IRS could reasonably reject, and the basis on which the IRS could reject that position.
- What would your response have been to IDR 3?

An Altered Landscape

- General trend in tax administration to rely on increased disclosure
- Reconsideration of policy of restraint in light of perceived abusive transactions
- FIN 48
- *Textron*
- UTP Proposal
 - Chief Counsel Wilkins' March 5, 2010 Remarks at FBA Tax Law Conference: "Why would the IRS choose to spend time finding these issues or risk not finding them when the issues are there for the asking and not protected by any privilege?"
- Corporate Governance Project

IRS Summons Authority

- **Code Section 7602(a) – General Authority**
 - Provides authority to compel taxpayers or third parties to provide IRS
 - Books, records or other data in the course of an examination
 - Testimony under oath
 - Can be used as an aid to investigate possible tax crimes prior to referral to the Department of Justice
 - Code Section 7604 – allows for enforcement of summons in federal district court
 - Distinguishable from power of Government as litigator to obtain information through discovery where Federal Rule of Civil Procedure 26 governs scope of discovery
- **Special Summons Authority**
 - “John Doe” – Code Section 7609(f)
 - Designated Summons – Code Section 6503(j)
 - Supplemental Formal Document Request – Code Section 982

Limitations on IRS Summons Authority

- *Powell* criteria. The Supreme court in *United States v. Powell*, 379 U.S. 48 (1964) established that IRS must satisfy four criteria to validate summons:
 - Legitimate purpose
 - Relevant -- lesser standard than Rule 26 relevancy standard in discovery
 - Not already in IRS possession
 - Followed all applicable administrative requirements, e.g., in the case of third-party summons, IRS must provide requisite notice to taxpayer and parties named in the summons
 - Related criteria of burden, vagueness and overbreadth
- Privileges. Satisfying the *Powell* criteria is not the end of the inquiry: has the taxpayer interposed legitimate objections based on privilege or work product? *United States v. Euge*, 444 U.S. 707 (1980).
- A note on relevance. The Supreme Court held that an outside auditor's financial audit workpapers are relevant to the IRS's examination of the return of the audited company. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

Making Objections to a Summons

- Objections based on relevancy, burden, overbreadth or vagueness – raise the problems orally with the agent and see if the summons scope can be narrowed or particularized informally
- For objections based on other grounds such as any of the four *Powell* criteria, privilege or work product best practice is to provide written support for each objection prior to the return date on the summons
 - Can some portions of the requested information be provided?
 - If the IRS follows up with a summons enforcement action, adequate showing will be required.
 - Privilege log
- An alternative is to appear at the requested date of the summons and make objections in person to the agent, but this is not a generally recommended approach
- Motion to quash third party summons under Code Section 7609(b)(2)
- Right of intervention in limited circumstances

Deloitte and Summons Authority

- *Deloitte* establishes the proposition that work product, *wherever found*, can be protected from disclosure
 - Assuming no waiver
 - Work product in internal files
 - Work product in outside auditor files
 - Thus, whether a summons is issued directly to a company or to its outside auditor for tax analyses, work product can be asserted
 - *Arthur Young* is distinguishable
- *Deloitte* is reasonably read to reach a contrary conclusion to *Textron* and supporting consideration of assertion of work product with respect to internal tax accrual workpapers
 - *Textron* footnote regarding testimony of VP of Tax
 - *Roxworthy* discussion of dual purpose and “prepared in the substantially the same manner

Uncertain Tax Position Proposal

- Proposed effective date of Schedule UTP is for tax years beginning after December 15, 2009 and ending after the date of publication of final regulations. See Prop. Reg. § 1.6012-2(a)(5).
- IRS initially indicated it may seek legislation for penalties should a taxpayer fail to file the schedule or fail to adequately disclose required information though later comments from officials suggest they will not. IRS has indicated also that it will wait to see how taxpayers comply and revisit the question of penalties. See Announcement 2010-75.
- Numerous comments received on proposed draft UTP resulting in release of significantly changed final Schedule UTP and instructions on September 24. See Announcement 2010-75.
- IRS issued proposed regulations on September 8, 2010 requiring filing of Schedule UTP. See 75 FR 54802 (Sept. 9, 2010). In accordance with a formal rulemaking, IRS invited comments on the new proposed regulations and will hold a public hearing on October 15.

Schedule UTP

- Schedule UTP released September 24, 2010. See Announcement 2010-75.
 - Filing required for 1120, 1120 L, 1120 PC and 1120 F filers that meet the \$100M asset minimum. Applies to these filers if related parties issued audited financial statements. Consolidated return filers file one UTP.
 - The Service previously announced that it will not require a Schedule UTP from Form 1120 series filers other than those identified above (such as real estate investment trusts or regulated investment companies), pass-through entities, or tax-exempt organizations. See Announcement 2010-30. After receiving some comments, it then stated that it will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers for 2011 or later years. Announcement 2010-75.

Schedule UTP

- What tax positions must be reported?
 - A tax position for which a reserve was recorded
 - A tax position for which no reserve was recorded based on an expectation to litigate
- How is the tax position measured?
 - A tax position is based on the unit of account in the audited financial statements in which the reserve is recorded. A tax position taken in a tax return means a tax position that would result in an adjustment to a line item on that tax return if the position is not sustained. A line item on a tax return may be affected by multiple units of account, in which case each unit of account must be reported separately on Schedule UTP.
 - How does the unit of account rule apply to research credit positions?
See Example 5 of the Instructions.

Schedule UTP Requirements

- What's supposed to be reported in the new schedule?
 - UTP number
 - Primary Code sections relating to the position
 - Whether the position is a "Major Tax Position"
 - Ranking of the tax position
 - The taxable year to which the position relates
 - Whether the position involves a permanent inclusion or exclusion of any item and/or the timing of that item
 - Pass-through entity EIN
 - Concise description

Schedule UTP

- What is a Major Tax Position (draft Schedule required a disclosure of a Maximum Tax Adjustment)?
 - Relative size of the position is greater than or equal to 10%
 - Expectation to litigate positions are disregarded
- What is a Ranking of Tax Position?
 - Essentially a ranking by size of the position

Schedule UTP

- What is a concise description?
 - “Provide a concise description of the tax position, including a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identify of the tax position and the nature of the issue.”
 - Instructions specifically state that description is not to include an assessment of litigation hazards or other risk analysis.
 - This is a major change from the draft Schedule which requested a statement of the rationale and the reasons for determining the position is uncertain.

Schedule UTP – Example 10

- The corporation investigated and negotiated several potential business acquisitions during the tax year. One of the transactions was completed during the tax year, but all other negotiations failed and the other potential transactions were abandoned during the tax year. The corporation deducted costs of investigating and partially negotiating potential business acquisitions that were not completed, and capitalized costs allocable to one business acquisition that was completed. The corporation established a reserve for financial accounting purposes in recognition of the possibility that the amount of costs allocated to the uncompleted acquisition attempts was excessive.
- Sample description: The corporation incurred costs of completing one business acquisition and also incurred costs investigating and partially negotiating potential business acquisitions that were not completed. The costs were allocated between the completed and uncompleted acquisitions. The issue is the whether the allocation of costs between uncompleted acquisitions and the completed acquisition is appropriate.

Privilege And The UTP

- Final Schedule UTP does not contain the requirement to provide a rationale regarding the nature of the uncertainty of the reported position. This removes one significant area of concern regarding possible waiver of privilege that was in the draft Schedule UTP.
 - Announcement 2010-75
- Announcement 2010-76 states that the IRS will not assert a waiver of privilege or work product during an examination for documents that are disclosed to an outside auditor in the course of a financial audit.
 - Applies only to documents that are otherwise protected or privileged and for which such protection has not already been waived through some other disclosure.
 - What about assertion of waiver in subsequent litigation?
 - What about the expectation to litigate UTP prong? Does it relate to anticipation of litigation requirement for work product?
 - What about merely identifying a position as an uncertain tax position?
 - What about construing the UTP itself as a waiver?

Recommendations for UTP Preparation

- Segregate internal tax analyses/opinions from UTP preparation files.
- As much as possible, UTP workpapers should not include or substantially refer to tax accrual workpapers. Note, IRS has stated that if there is a request for tax reconciliation workpapers, taxpayers can redact any protected information.
- UTP concise statement should be prepared from the outset to be provided to the IRS and so avoid any waiver concerns.
- Consider enhanced review of FIN 48 determinations.