

TAX SECTION

New York State Bar Association

Report on Regulations Under Section 6662(e)

June 16, 1994

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June 16, 1994

Hon. Leslie B. Samuels  
Assistant Secretary (Tax Policy)  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

Hon. Margaret M. Richardson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, D.C. 20224

Re: Section 6662(e) Regulations

Dear Secretary Samuels and Commissioner  
Richardson:

Enclosed are copies of a Report by the  
New York State Bar Association Tax Section  
concerning the temporary and proposed  
regulations (IL-21-91) under section 6662(e) of  
the Internal Revenue Code, relating to the  
accuracy-related penalty applicable to certain  
section 482 adjustments.

The Report states that the regulations  
provide the guidance necessary for taxpayers and  
agents to apply section 6662(e), and in  
important respects encourage a common sense  
approach to audits. The Report goes on to make a  
number of suggestions for modifications in the  
regulations. In particular, the Report suggests  
that:

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(a) the three penalty standards in the regulations should be clarified;

(b) penalty exposure should not exist if circumstances change, without the knowledge of the taxpayer, after the transfer price is set in good faith but before the tax return is filed;

(c) the application of the documentation requirements should explicitly be made more flexible for small taxpayers; and

(d) the taxpayer should not risk a penalty merely because of the failure to provide background documents within 30 days.

Please let me know if the Tax Section can be of further help in the development of these regulations.

Sincerely,

Michael L. Schler  
Chair, Tax Section

NEW YORK STATE BAR ASSOCIATION TAX SECTION  
Report on Regulations Under Section 6662(e)

June 16, 1994

On January 27, 1994, the I.R.S. and Treasury Department issued Temporary Regulations (the "Regulations") under section 6662(e) to implement certain changes made to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of 1993 ("OBRA 93"). This report comments on the Regulations.<sup>1/</sup>

As recognized by the recent Joint I.R.S./Treasury Department Statement of Policy, the prevention of transfer pricing abuse must be an international tax enforcement priority.<sup>2/</sup> Moreover, as stated in the legislative history to OBRA 93, the accuracy-related penalty has not served as a deterrent to transfer pricing abuse, because I.R.S. agents have been reluctant to assert the penalty in the absence of well-defined rules.<sup>3/</sup>

We believe that generally the Regulations provide the guidance necessary for agents to apply, and taxpayers to avoid, the section 482 accuracy-related penalty. Further, in important

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<sup>1/</sup> The principal author of this report was Philip R. West. Helpful comments were provided by Richard G. Cohen, John A. Corry, Joseph A. Gruber, James A. Guadiana, Hope P. Krebs, Richard O. Loengard, Jr., Kevin M. Rowe and Michael L. Schler.

<sup>2/</sup> Leslie B. Samuels, Assistant Secretary for Tax Policy, Department of the Treasury and Margaret M. Richardson, Commissioner, Internal Revenue Service, Tax Compliance in a Global Economy: Statement of Policy and Action Plan (Dec. 17, 1993).

<sup>3/</sup> Staff of House Ways and Means Comm., Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Ways and Means, Print No. 103-11, 103d Cong., 1st Sess. 282 (May 18, 1993) ("House Report"); S. Rpt. No. 103-37, 103d Cong., 1st Sess. 197 (June 1993) ("Senate Report").

respects, the Regulations encourage a common sense approach to audits, an approach that is necessary in an area as fact-based and historically contentious as transfer pricing. We are disturbed, however, that several aspects of the Regulations appear to impose unreasonable burdens on taxpayers and do not further the objectives of deterrence and enforceability.<sup>4/</sup>

The Regulations provide that a penalty (the "net adjustment penalty") is imposed on any tax underpayment attributable to a "net section 482 transfer price adjustment." A "net section 482 adjustment"<sup>5/</sup> is defined as the sum of all increases in a taxpayer's taxable income for taxable year resulting from allocations under section 482, with certain adjustments.

The Regulations then provide that certain amounts may be excluded from the net section 482 adjustment. For transfer prices set using methods specified in the section 482 regulations ("specified methods"), the taxpayer must meet the "specified method requirement" and the "documentation requirement" to exclude adjustments to those prices from the net section 482 adjustment. For transfer prices set using methods not specified in the section 482 regulations ("unspecified methods"), the taxpayer must meet the "unspecified method requirement" and the documentation requirement to exclude adjustments to those prices from the net section 482 adjustment.

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<sup>4/</sup> Although generally outside the scope of this report, we are also disturbed by the overall thrust of the statute. It requires even taxpayers who set their transfer prices in a non-abusive manner to, in effect, set those prices as if they were anticipating a protracted tax controversy.

<sup>5/</sup> The Regulations refer to a "net section 482 transfer price adjustment" (Temp. Reg. § 1.6662-6T(a)(1)) and then define the term "net section 482 adjustment" (Temp. Reg. § 1.6662-6T(c)(1)). We presume that no difference is intended between the terms.

## 1. The Penalty Standard

### A. Summary of Regulations

Different penalty standards apply under (i) the specified method requirement, (ii) the unspecified method requirement where no specified method is potentially applicable and (iii) the unspecified method requirement where a specified method is potentially applicable. Each standard requires a reasonable conclusion on the part of the taxpayer as described below and, in each case, reasonableness is based on a number of facts and circumstances, some of which are set forth in the regulations.<sup>6/</sup>

The penalty standard under the specified method requirement is met if the taxpayer selects and applies a specified method in a reasonable manner. Reasonableness in this case requires, at a minimum, that "the taxpayer reasonably concludes that the method (and its application of that method) provides the most accurate measure of an arm's length result under the principles of the best method rule" of the section 482 regulations.<sup>7/</sup> The best method rule explicitly provides that "an arm's length result may be determined under any of the available methods without first disproving the applicability of any other method."<sup>8/</sup> Thus, it appears that a taxpayer's selected method may be the best method even though other methods also apply. Apparently, however, a taxpayer will not be shielded from penalties if it has selected a method without reviewing the other applicable methods and rejecting them because of the relative

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<sup>6/</sup> Temp. Reg. § 1.6662-6T(d)(2)(ii)(A)-(D).

<sup>7/</sup> Temp. Reg. § 1.6662-6T(d)(2)(ii).

<sup>8/</sup> Temp. Reg. § 1.482-1T(b)(2)(iii)(A).

superiority of the chosen method regarding (i) the completeness and accuracy of the data used to apply the method, (ii) the degree of comparability between the controlled and uncontrolled transactions, and (iii) the number, magnitude and accuracy of the adjustments required to apply the method.<sup>9/</sup>

The best method rule is also the benchmark for the application of the second standard, applicable when an unspecified method is used and no specified method is potentially applicable. It requires that the taxpayer select and apply an unspecified method in a reasonable manner and provides that "a taxpayer's selection and application [of a method] is reasonable if the taxpayer reasonably concludes that the method (and its application of that method) provided the most accurate measure of an arm's length result under the principles of the best method rule" of the section 482 regulations.<sup>10/</sup> Although the second standard appears to be substantively the same as the first standard, I.R.S. officials reportedly view the second standard as higher.<sup>11/</sup>

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<sup>9/</sup> Id. ("The arm's length result of a controlled transaction must be determined under the method that provides the most accurate measure of an arm's length result under the facts and circumstances of the transaction under review."); Temp. Reg. § 1.6662-6T(d)(2)(ii) ("[an] application of a specified measure provides the most accurate measure of an arm's length result if it provides a more accurate measure of an arm's length result than any alternative specified method and any alternative application of the method chosen").

<sup>10/</sup> Temp. Reg. § 6662-6T(d)(3)(ii)(C).

<sup>11/</sup> See Turro, IRS, Treasury Officials Spin Transfer Pricing Regs, Tax Analysts' Highlights and Documents 3193 (Feb. 16, 1994). The quotations in the cited article make it clear that it is the second standard that is referred to as a higher standard. This view is apparently based on the presence of the phrase "given the available data" in the first standard. Id. That concept is also incorporated in the second standard, however, by virtue of the incorporation of the enunciated facts and circumstances referred to above. See Temp. Reg. § 1.6662-6T(d)(2)(ii)(B) ("the extent to which accurate data was available"). In fact, the language of the Regulations could lead one to conclude that the second standard is actually lower. In particular, it appears that, in the case of the second standard, a reasonable conclusion that the best method rule has been met constitutes a safe harbor, not a minimum threshold, as is the case under the first standard. Compare Temp.

In the third case, in which an unspecified method is used and a specified method is potentially applicable, the taxpayer may avoid penalties if it reasonably concludes that, given the available data, none of the specified methods was likely to provide an arm's length result and the application of the selected method was likely to provide an arm's length result. Thus, in such a case, a taxpayer cannot merely be content with what it reasonably believes to be the best among a number of alternatives, none of which "is likely" to produce an accurate measure of an arm's length result. Faced with such a choice, the taxpayer must use the best specified method, even if it is not as likely to produce an accurate measure of an arm's length result as another, unspecified, method.<sup>12/</sup>

#### B. Recommendations

We recommend that the final regulations clarify the three penalty standards. They should make explicit that they incorporate the principle of the best method rule that an arm's length result may be determined under any of the available methods without first disproving the applicability of any other method. They should clarify the extent, if any, to which methods other than the selected method must be considered.

We also recommend that, if the second standard discussed above is intended to be stricter than the first standard, the

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Reg. § 1.6662-6T(d)(3)(ii)(C) ("selection and application is reasonable if . . .") with Temp. Reg. § 1.6662-6T(d)(2)(ii) ("selection and application of a specified method is reasonable only if . . .") (emphasis added).

<sup>12/</sup> This result is compelled by the statute. See Code § 6662(e)(3)(B)(ii)(I).

Regulations should more clearly so state.<sup>13/</sup> Finally, we believe that the Regulations should include, among the explicit facts and circumstances that will indicate reasonableness, the existence for a prior year of an Advance Pricing Agreement and the the conclusion of a section 482 audit sanctioning the application of the selected method. This is consistent with the legislative history to the OBRA 93 changes to the accuracy-related penalty.<sup>14/</sup>

## 2. Current Data Requirement

### A. Summary of Regulations

For purposes of both the specified method requirement and the unspecified method requirement, a taxpayer must determine its transfer prices using the most current reliable data that is available before the return is filed.<sup>15/</sup>

### B. Recommendation

We believe that this requirement is unreasonable because it creates penalty exposure if circumstances change after a taxpayer sets its transfer prices in good faith, even if the taxpayer is not aware of the changed circumstances.

The section 482 regulations prescribe methods for determining whether a transfer price is an arm's length price. Although in theory a taxpayer need not use the methods set forth in these regulations, the I.R.S. is required to apply them on

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<sup>13/</sup> Moreover, it is not clear to us whether the first standard was intended to be a minimum standard and the second standard was intended to be a safe harbor. If this was not intended, the language should be clarified. If it was, its rationale should be stated in the preamble.

<sup>14/</sup> See House Report at 285, Senate Report at 200.

<sup>15/</sup> Temp. Reg. § 1.6662-6T(d)(2)(ii)(B).

audit.<sup>16/</sup> If the taxpayer's results fall outside the range of results established under the "best" method as determined under the section 482 regulations, the I.R.S. will adjust the taxpayer's transfer prices.<sup>17/</sup>

Therefore, as a practical matter, taxpayers are required, prior to consummation of their intercompany transactions, to determine the best method for setting transfer prices and to determine what their results should be under that method. Moreover, reimbursements or supplemental payments among related taxpayers after the taxable year to bring non-arm's length transfer prices within an arm's length range are apparently impermissible unless the taxpayer has in effect a written agreement providing for such reimbursements or payments.<sup>18/</sup> This appears to be the case even if newly-discovered facts indicate that the transfer price, as originally determined, was not an arm's length price.

The legislative history to the OBRA 93 changes to the accuracy-related penalty similarly indicates a preference for early attention to the determination of transfer prices.<sup>19/</sup> It states that application of a transfer pricing method would not be considered unreasonable by virtue of factual developments after the time the price is set and before the time the return is

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<sup>16/</sup> Temp. Reg. § 1.482-1T(b)(2).

<sup>17/</sup> Temp. Reg. § 1.482-1T(d).

<sup>18/</sup> Temp. Reg. § 1.482-1T(e)(2)(i)(A). Even such an agreement will not be effective unless the actual payments are made before the filing of the tax return for the year of the transaction. *Id.* We note that the temporary section 482 regulations do not state clearly that reimbursements and supplemental payments without a written agreement are taken into account in determining whether a price is arm's length if such reimbursements or payments are made in the same taxable year as the original transaction payment. The final section 482 regulations should so state.

<sup>19/</sup> See House Report at 282, Senate Report at 196-97, H.R. Rep. No. 103-213, 103d Cong., 1st Sess., at 648-50 (Aug. 4, 1993) ("Conference Report").

filed, unless the taxpayer becomes aware prior to filing its tax return that application of the method more likely than not does not lead to an arm's length result.<sup>20/</sup>

The requirement of the Regulations that taxpayers use the most current data available at the time they file their returns is in conflict with the practical realities of transfer pricing compliance and with the section 482 regulations requiring advance determinations, and goes beyond the OBRA 93 changes to the accuracy-related penalty. We submit that a better rule would allow taxpayers to rely on the most current data available at the time they set their transfer prices, as long as they (i) set or re-confirm their transfer prices no earlier than 6 months before the beginning of the tax year in which the transactions occur, (ii) do not subsequently become aware of information that would affect the determination of whether their transfer prices are arm's length prices (or, if they do become aware of such information, take it into account), and (iii) act in good faith.

### 3. The Documentation Requirement

#### A. Summary of Regulations

To exclude a section 482 adjustment from the penalty base, taxpayers must compile certain documentation and supply it to the I.R.S. within 30 days of a request. That documentation is divided into two categories: principal and background documents.

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<sup>20/</sup> See House Report at 285, Senate Report at 200, Conference Report at 649-50. We are aware that the legislative history also states that reliance on data from years prior to the transaction year is acceptable "unless more current reliable data becomes available prior to filing the tax return". House Report at 285, Senate Report at 200. We do not, however, believe that this language compels the rule stated in the Regulations.

The distinction is relevant because the District Director may excuse a failure to produce principal documents only if (i) the failure is minor or inadvertent, (ii) the taxpayer has made a good faith effort to comply, and (iii) the taxpayer promptly remedies the failure when it becomes known. The District Director may extend (or not extend) the period for producing background documentation in his discretion.

The Regulations identify principal documents with reasonable specificity by setting forth nine categories of principal documents and describing them. The Regulations describe background documents, however, only by stating:

The assumptions, conclusions, and positions contained in principal documents ordinarily will be based on, and supported by, additional background documents. Documents that support the principal documentation may include the documents listed in § 1.6038A-3(c) that are not otherwise [principal documents]. . . . [Other] documents not listed in those regulations may be necessary to establish that the taxpayer's method was selected and applied in the way that provided the most accurate measure of an arm's length result . . . .<sup>21/</sup>

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<sup>21/</sup> Temp. Reg. § 1.6662-6T(d)(2)(iii)(C).

B. Recommendations Regarding Principal Documents

Although the list of principal documents is reasonably explicit, we believe the requirement to produce such documents is too burdensome for small taxpayers.

The Regulations state that "the expense of collecting data relative to the dollar amount of the transactions in question is a factor that may be taken into account in determining the scope of a reasonably thorough search for data."<sup>22/</sup> This statement, however, is found in that portion of the Regulations describing the specified method requirement. It is not cross referenced in the portion of the Regulations dealing with the documentation requirement.

We believe that some reference should be made in the Regulations to a reasonable and flexible application of the documentation requirement in the case of taxpayers that do not have a sufficiently large number of intercompany transactions to warrant compilation of all the listed documents. This is consistent with the excerpt from the Regulations quoted in the preceding paragraph, as well as with the spirit animating the Regulations and the section 482 regulations.<sup>23/</sup>

Moreover, we believe that at least one of the current requirements is impractical for large, as well as small, taxpayers. Specifically, we believe that, if a taxpayer prepares

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<sup>22/</sup> Temp. Reg. § 1.6662-6T(d)(2)(ii)(B).

<sup>23/</sup> See Temp. Reg. § 1.482-1T(f)(1) (relating to the small taxpayer safe harbor).

"an overview" of its business before conducting at least preliminary discussions with an examining agent, the overview will be of little use. The inquiries of an agent will vary with the level of his experience in the subject industry as well as the taxpayer's business. This experience could be considerable or totally lacking. Accordingly, information of this type is best prepared following at least preliminary discussions with an agent and not at the time a return is prepared.

C. Recommendation Regarding Background Documents

Although the cross-reference to the regulations under section 6038A is helpful as a starting point, the District Director has the discretion to require production within 30 days of documents that are not described in the Regulations. We believe that this is unreasonable, and puts taxpayers at an unfair risk of arbitrary assertion of penalties. We submit that the final regulations should make clear that the District Director's broad investigative powers under sections 7601, et seq. are fully applicable in the context of a transfer pricing examination, but that failure to supply background documents will not put taxpayers at risk of penalties under section 6662(e). Alternatively, the final regulations should itemize background documents with the same degree of specificity as principal documents.

#### 4. The Attorney Client Privilege

Some have expressed concern that the Regulations implicitly condition penalty relief on a waiver of the attorney client privilege. Although the scope of the privilege has not been articulated consistently by the courts, a review of the pertinent case law reveals at least a potential conflict between the privilege and the documentation requirement.

The first principal document listed in the Regulations includes an analysis of the legal factors that affect the pricing of property or services. The fifth principal document is "[a] description of the unspecified methods that were considered and an explanation of why they were not considered."<sup>24/</sup> The seventh principal document includes a description of how comparability of other transactions was evaluated.

Each of these documents, as well as others required by the Regulations, may contain communications made in confidence by a client in the course of seeking legal advice from a lawyer. As such, the taxpayer generally could resist disclosure of the documents.<sup>25/</sup>

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<sup>24/</sup> We understand that the quoted language was intended to refer to "other methods," not "unspecified methods."

<sup>25/</sup> See, e.g., Colton v. U.S., 306 F.2d 633 (2d Cir. 1962). This conclusion is not changed by the fact that the documents may relate to an item disclosed on a tax return, even though the item itself would not be privileged, nor would certain "underlying details". See, e.g., In re Sealed Case, 877 F.2d 976, 979 (D.C. Cir. 1989).

The Regulations implement the statutory rule that, to exclude section 482 adjustments from the computation relating to whether the penalty threshold has been met, the taxpayer must compile documentation setting forth the determination of a transfer price and establishing that use of such method was reasonable. It is difficult to imagine a regulation implementing this statute that would not either call for documents potentially subject to the attorney-client privilege or specifically exclude all such documents.

We do not believe that taxpayers should be able to exclude their section 482 adjustments from the penalty threshold computation merely by asserting the privilege. Taxpayers would have such authority, however, if the Regulations contained a blanket exception from the documentation requirement for all documents that are alleged to be protected by the attorney-client privilege. Moreover, such an exception would improperly leave in taxpayers' hands the final decision as to the legitimacy of an assertion of the privilege.

On the other hand, we do not believe that taxpayers should be forced to waive the privilege in order to avoid the penalty. We do not believe the existing regulations will generally force taxpayers to do so. Under the regulations, taxpayers have no obligation to disclose privileged documents. Rather, they are free to withhold such documents as long as they produce other documents providing the specific information called for by the Regulations.

To be sure, injustices may be worked in certain cases by the regulations, because taxpayers may have only a single set of documents providing the required information, and those documents might be exempt from mandatory disclosure by virtue of the privilege. In this situation, taxpayers may be forced to choose between paying the penalty, providing privileged information to the IRS, or going to the expense of creating additional non-privileged documents providing the required information.

We believe this conflict is unavoidable, and arises any time a taxpayer is required to provide information to defend a tax position taken on its return (or to show a good faith basis for a position to avoid a penalty). We see no alternative to the position in the present regulations requiring specified types of information to be provided to the IRS to defend a pricing decision, even if the existing documents containing that information might contain privileged information.