



TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

Tax Accrual Workpapers May Be Discoverable

Tax accrual workpapers are documents created by a corporation that relate to its reserves for contingent tax liabilities. Commonly, such documents reflect a detailed analysis of tax-beneficial transactions that could be challenged by the Internal Revenue Service (IRS) and that portion of the expected savings that should be set aside in the event deductions are disallowed.

In recent years, the IRS has adopted a policy of seeking tax accrual workpapers related to “listed transactions,” which are transactions defined by the IRS as tax avoidance schemes. While many companies have complied with such requests, recently Textron Inc., an aerospace and defense contractor, has objected and the federal government has taken it to court over the issue.¹ The briefs in the case address the significant policy questions that arise whenever the government seeks to obtain information regarding a company’s internal litigation assessments.

Textron’s Workpapers

In April 2003, the IRS initiated an audit of Textron’s tax liabilities for the years 1998 through 2001. During the 2001 tax year, Textron engaged in multiple “Sale-In, Lease-Out” (SILO) transactions, which were identified as “listed transactions” in a notice issued by the IRS on Feb. 11, 2005. Shortly thereafter, in the context of its ongoing audit, the IRS issued a summons for tax accrual workpapers created by Textron contemporaneous with the SILO transactions. After Textron refused to produce the requested documents, the government filed a petition in the U.S. District Court for the District of Rhode Island to enforce its summons.

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Standard for Enforcement of IRS Summons

The U.S. Supreme Court has stated that the government must establish four elements in order to obtain enforcement of an IRS summons: (1) it was issued for a legitimate purpose; (2) it seeks relevant information; (3) the information sought is not already within the IRS’s possession; and (4) the administrative steps required by the Internal Revenue Code (IRC) have been followed.² Once these elements have been proved, a heavy burden of proof shifts to the taxpayer opposing the summons. The taxpayer must “disprove the actual existence of a valid civil tax determination or collection purpose by the [IRS].”³ Where taxpayers allege bad faith on the part of the government, they are required to produce “reasonably particularized evidence in support of those allegations.”⁴

In objecting to the government’s petition, Textron argued that the government had no legitimate purpose in seeking the tax accrual workpapers. Claiming that the IRS did not need the workpapers to complete its audit, Textron asserted that the government’s petition was merely a “pretext disguising [its] real objective.” According to Textron, the government’s real objectives included seeking confidential information about Textron’s evaluation of the transactions, the hazards of litigation percentages and the resulting reserve for each transaction. Citing case law, Textron claimed that the IRS improperly wanted “a forced revelation of [Textron’s] evaluation of [its] case... to take advantage of [Textron’s] assessment of [its] prospects for victory and an acceptable settlement figure.”⁵

Noting that the IRS had offered to withdraw its request for the workpapers if it settled, Textron further argued that the IRS was using the summons enforcement action to pressure it to capitulate with respect to the SILO transactions. Finally, Textron argued that the IRS was improperly requesting tax accrual workpapers to discourage taxpayers from investing in SILO transactions. According to Textron, the IRS’s actions have the effect of “changing the ‘cost-benefit analysis’ [for potential investors], irrespective of whether the transaction is perfectly legal.”⁶

In rebuttal, the government disputed Textron’s claim that the government did not need the documents, noting that in *United States v. Arthur Young & Co.*,⁷ the Supreme Court had held that tax accrual workpapers prepared by a corporation’s outside auditor were relevant to the IRS’s investigation of the corporation’s tax liability and properly could be obtained by the IRS via summons. Furthermore, in responding to Textron’s argument that it was improperly attempting to discourage similar transactions, the government asserted that “it is a result, not a purpose, of the IRS seeking tax accrual workpapers more frequently due to its policy change, that corporate directors and officers will factor into their decision-making the greater probability that their aggressive tax transactions will come to light.” Thus, the government argued that its purpose in seeking the documents was legitimate and proper, and that it had satisfied the prerequisites for its petition.⁸

Claim of Work Product, Privilege Protection

Textron also argued that the documents sought by the government are protected by the attorney work product doctrine and by the attorney-client and §7525 tax practitioner privileges regardless of their relevance to the government’s audit.⁹ Claiming that the requested documents include confidential legal advice that Textron received from its in-house tax attorneys regarding matters in controversy or potentially in controversy between Textron and the IRS, Textron observed that “[i]n

