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TAX LITIGATION ISSUES

Expert Analysis

The IRS Still Wants Your Company's Workpapers

In May 2007, the authors wrote about a dispute between the Internal Revenue Service and Textron Inc., an aerospace and defense contractor, regarding the discoverability of the corporation's tax accrual workpapers.[1] Textron objected to the IRS's policy of seeking tax accrual workpapers, which relate to a corporation's reserves for contingent tax liabilities, on the grounds that they were protected by the attorney-client privilege and the work product doctrine, and the case was taken to federal court.

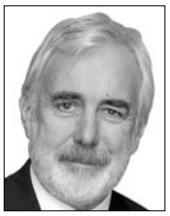
As the authors suggested in their earlier article, which outlines the factual issues presented in this case, the court's decision, recently reviewed by the U.S. Court of Appealf for the First Circuit, is significant to both corporate America and the IRS.

District Court

The IRS sought to enforce its summons against Textron in an action in the federal district dourt of Rhode Island. In defending the action, Textron argued that the documents sought by the government were protected by the attorney work product doctrine and by the attorney-client and §7525 tax practitioner privileges. Specifically, Textron argued that the documents included confidential legal advice that Textron received from its in-house attorneys regarding matters in controversy or potentially in controversy between Textron and the IRS.[2]

After an evidentiary hearing, the district court found in favor of Textron on its work product claim, but rejected its other defenses. Although the court opined that the subpoenaed documents were privileged attorney-client communications, it found that the privilege was waived when Textron disclosed the papers to its outside auditor, Ernst & Young.[3]

With respect to the work product claim, the



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court found credible Textron's testimony that the workpapers were prepared to ensure that the company was "adequately reserved 'with respect to any potential disputes or litigation that would happen in the future.'" Relying on the First Circuit's "because of" test for determining whether documents were prepared in anticipation of litigation, as required for work product protection, the court held that although

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the tax accrual workpapers also were prepared for the purpose of obtaining an opinion letter from Ernst & Young regarding Textron's reserves, "there would have been no need for such reserves 'if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding.'"[4]

Furthermore, the court opined that Textron's disclosure to the auditors did not constitute a waiver of the protections offered by the work product doctrine, noting that the standard for waiver of work product was different from that applied to the attorney-client privilege. In the district court's view, the disclosure to the auditors did not substantially increase the likelihood that Textron's adversary, the IRS in this case, would obtain the information contained in the documents, which would result in a waiver of the work product doctrine.[5]

First Circuit's Opinion

The IRS appealed. Specifically, the government appealed the court's determination that the work product doctrine protects tax accrual workpapers and its conclusion that Textron's disclosure to Ernst & Young did not result in a waiver of work product protection. A divided panel of the First Circuit ruled 2-1 to affirm in part and remand in part the district court's decision. It is worth noting that one member of the majority, Judge Schwarzer, was sitting by designation from the Northern District of California.[6]

As an initial matter, the circuit panel noted that the documents in question were workpapers which generally listed the "questionable positions" Textron took on its tax returns, estimated the likelihood that those positions would be challenged, and calculated how much tax liability might result. Stating that the question presented on appeal was whether the work-product doctrine protects these documents, the court noted that the work-product extends only to those documents prepared in anticipation of litigation. "In assessing whether a document was prepared in anticipation of litigation, this circuit uses the 'because of' test [under which] a document is protected 'if, in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation.'"[7]

The government argued the work-product doctrine did not apply in this case because the preparation of tax returns is not intended to be an adversarial process, but rather "a self-reporting regime that relies on the good faith of taxpayers." The court rejected this position, finding that while not all dealings with the IRS is the equivalent of "litigation," the resolution of disputes through adversary administrative processes, as Textron would be required to do if the dispute was not initially settled, meet the definition of litigation. Indeed, the court accepted Textron's representation that it routinely engages in administrative disputes, and sometimes federal

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court litigation, with the IRS.[8]

The IRS also argued that the work-product doctrine was inapplicable to Textron's situation because the tax accrual papers were not prepared "in anticipation" of litigation. First, the government took issue with the district court's application of the "because of" test, arguing that it misapplied the test when it found that the documents would not have been created "but for" the prospect of litigation.

Citing a Second Circuit case, *United States v. Adlman*,[9] the First Circuit panel noted that the "'because of' test 'really turns on whether it would have been prepared irrespective of the expected litigation with the IRS.'"

Finding that the function of Textron's tax accrual workpapers was to analyze litigation for the purpose of creating and auditing a reserve fund, the court opined that Textron's anticipation of the need to reserve money in anticipation of disputes with the IRS was the "driving force behind the preparation of the documents" and that they were, therefore, prepared in anticipation of litigation.[10]

The government also argued that the workpapers were prepared in the ordinary course of business rather than in anticipation of litigation. Specifically, the IRS claimed that Textron prepared the documents for a business reason—to obtain an opinion from its outside auditor—and to comply with its reporting obligations under the securities laws. The First Circuit agreed that the documents were created for a dual purpose, but rejected the notion that the mere presence of a business or regulatory purpose defeated any applicable work-product protection. "'Dual purpose' documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose."[11]

Finally, the IRS asserted that Textron had failed to adequately satisfy the "identification and explanation" requirements of the work-product doctrine. The court responded by noting that while it consistently had required parties asserting work-product protection to "identify the litigation for which the document was created…and explain why the work-product privilege applies to all portions of the document," these requirements were not to be given a "hypertechnical construction."

Rather, the court opined that Textron had met these requirements in identifying the possibility of litigation with the IRS over its disputed tax positions. Further, the court stated that "[i]f we were only to afford work product protection over documents of this sort by requiring a showing, as the IRS suggests, that there was some specific quantum of expectation that the position at issue would mature into full-fledged litigation, we would essentially be offering protection only to the cantankerous and combative taxpayer who intends to thoroughly litigate every position."[12]

The Minority Opinion

Circuit Judge Boudin wrote an opinion concurring in part and dissenting in part with the majority's opinion. Judge Boudin focused primarily on the "because of" test and its application by the majority. Expressing concern that the majority's application of the work-product privilege was too broad, he opined that the qualified privilege was not intended to apply to "any and all work by an attorney that happens to refer to litigation; it means work connected to preparing for or managing litigation."[13]

Relying on language from the First Circuit's opinion in *Maine v. U.S. Dep't. of the Interior,*[14] which quoted the Second Circuit's opinion in *Adlman*, the minority opinion stated that circuit precedent dictated that work-product protection does not extend to documents prepared "in the ordinary course of business or that would have been created in essentially the same form irrespective of the litigation. This caveat applies 'even though litigation is already in prospect.'"[15]

Arguing that the majority opinion incorrectly applied this precedent, Judge Boudin stated that the court's focus in *Maine* was not on the subject matter discussed in the materials at issue, but whether the documents were created in the ordinary course of business or were otherwise independently required. The minority opinion found that the tax accrual workpapers at issue in this case fell into both of these categories—created in the ordinary course of business and independently required.

"The government offered compelling evidence that the sole reason for the creation of Textron's estimates of risk with respect to individual tax positions was to prepare the reserve figures for the company books and statements and to satisfy the auditors that the reserves were adequate. No contrary evidence was offered by Textron. The district court made no contrary findings and any such finding would have been clearly erroneous."

Accordingly, the minority opinion concluded, circuit precedent required the majority to adhere to the long-standing rules regulating the application of the work-product doctrine. "An en banc court could change the rule; a panel majority cannot."[16]

Work-Product Protection

Concluding that Textron's tax accrual workpapers were protected by the work-product doctrine, the majority then turned to the question of whether Textron's disclosure of the workpapers to its outside auditor, Ernst & Young, amounted to a waiver of the privilege. The court noted that a waiver of the work-product doctrine occurs where disclosure is made to a real or potential adversary or a conduit to a potential adversary.

Stating that a number of district courts had concluded that disclosure to independent auditors did not waive work-product protection, the court found that Textron was in a cooperative rather than adversarial relationship with Ernst & Young.

The government countered that the auditor may have served as a conduit to a potential adversary because it was subject to a valid subpoena from the IRS. However, the court found that the auditor did not physically retain a copy of Textron's workpapers. While this fact might indicate that Ernst & Young would not have to disclose those papers, the court noted the possibility that the auditors' own papers, prepared in partial reliance on Textron's workpapers, might be subject to discovery.

"Thus, disclosure of E&Y's workpapers might reveal Textron's own analysis." Because the district court did not address the question of whether the government could obtain discovery of the auditor's workpapers, "it made no factual findings regarding the actual contents of E&Y's workpapers or the extent to which disclosure of such workpapers would effectively constitute disclosure of Textron's own assessment." Accordingly, the court remanded the case to the district court for further development of this issue.[17]

Conclusion

The First Circuit's decision is important as it broadens the scope of what may be protected as work product. It remains an open issue whether disclosure of work product to independent auditors constitutes a waiver, an issue which likely will continue to be litigated given the circuit court's remand. For this reason, and the possibility that either side may request a rehearing or appeal, this case will continue to draw attention from tax practitioners.

1. John J. Tigue, Jr. and Jeremy H. Temkin, "Tax Accrual Workpapers May Be Discoverable," New York Law Journal (May 17, 2007).
2. Memorandum of Respondent, Textron Inc., in Opposition to Petitioner United States of America's Petition to Enforce Summons ("Textron Memorandum") at 1.
3. *United States v. Textron Inc.*, 507 F. Supp.2d 138, 151-52 (D.R.I. 2007).
4. Id. at 150.
5. Id. at 152-53.
6. 553 F.3d 87 (1st Cir. 2009).
7. Id. at 93 (internal citations omitted).
8. Id. at 94-95.
9. 134 F.3d 1194 (2d Cir. 1998).
10. 553 F.3d at 95 (citations omitted).
11. Id. at 96 (citing 8 Charles Alan Wright, Arthur R. Miller & Richard L. Marcus, Federal Practice and Procedure, §2024 (2008)).
12. Id. at 101.
13. Id. at 106 (minority opinion).
14. 298 F.3d 60 (1st Cir. 2002).
15. Id. at 107 (citing *Maine v. U.S. Dep't. of the Interior*, 298 F.3d at 70).
16. Id. at 108-109.
17. Id. at 103-104.