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TAX LITIGATION ISSUES

Expert Analysis

The Next Chapter in 'Textron' Over Protection for Work Papers

By **Jeremy H. Temkin**

In connection with the preparation of financial statements, corporations prepare tax accrual work papers, which reflect an assessment of the merits of tax positions the Internal Revenue Service might challenge in an audit. Such work papers are generally prepared by the company's accounting staff, frequently with the assistance of internal and outside counsel. Over the past two years, this column has tracked the IRS's attempts to compel one corporate taxpayer, Textron Inc., to disclose its tax accrual work papers in connection with an audit.[1]

After both the district court and a panel of the U.S. Court of Appeals for the First Circuit upheld Textron's claim that the work papers were privileged under the attorney work product doctrine, an en banc panel of the First Circuit reversed course, dealing a blow to the ability of taxpayers to maintain the confidentiality of candid assessments of their chances of success in litigation with the IRS. As a strong dissenting opinion points out, the First Circuit's en banc decision in *Textron* is at odds with the Second Circuit's decision in *United States v. Adlman*,[2] and has far-reaching implications.

Background

Textron Inc. is a publicly traded aerospace and defense contractor. In 2001, one of its subsidiaries engaged in a series of sale-in, leaseout (SILO) transactions. In 2003, in the course of auditing Textron's tax returns for the years 1998-2001, the IRS identified the SILO transactions. Because such transactions are "listed" by the IRS as potential tax shelters subject to abuse by taxpayers, consistent with its policy with respect to listed transactions, the IRS sought Textron's tax accrual work papers, which included spreadsheets that list debatable tax positions, the dollar amount subject to possible dispute and a percentage estimate of the IRS's chances of success.

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In Textron's case, the work papers were generated within its tax department with the assistance of the company's tax lawyers. In addition, Textron relied on the advice of outside counsel regarding tax reserve requirements. Significantly, Textron initially prepared the work papers to establish and support the tax reserve figure on its annual financial statements, and it shared the work papers with its independent auditors in connection with the audit of those financial statements.[3]

Textron refused to produce the work papers claiming, in part, that they were prepared in anticipation of potential litigation with the IRS over debatable tax positions, and thus were protected by the attorney work product doctrine. The IRS brought an action to enforce its summons in the U.S. District Court for the District of Rhode Island.

The district court quashed the summons, holding that while the work papers helped determine the correct amount to be reserved on its financial statements and were "useful in obtaining a 'clean' opinion letter" from its auditors, "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.'" In addition, the district court rejected the government's argument that Textron had waived the work product protection by disclosing the information to its outside auditors.[4]

The IRS appealed, and a divided three-judge panel affirmed the district court's decision. Specifically, the majority of the panel agreed with the trial court's conclusion that the applicable test was whether the work papers had been prepared "because of" the possibility of litigation.[5] The en banc court then granted the government's petition for rehearing, vacated the panel's decision and, by a 3-2 split, reversed the panel's decision, concluding that the work product doctrine did not apply to tax accrual work papers.[6]

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The En Banc Majority Opinion

The majority opinion starts with a review of the U.S. Supreme Court's decision in *Hickman v. Taylor*, [7] from which the work product doctrine derived. In *Hickman*, the Court noted that "[p]roper preparation of a client's case demands that [an attorney] assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference…. This work is reflected, of course, in interviews, statements, memoranda, correspondence, briefs and mental impressions, personal beliefs, and countless other tangible and intangible ways—aptly though roughly termed…as the 'work product of the lawyer.' "[8] Such work product warranted protection. Hence, the work product privilege, as codified in Federal Rule of Civil Procedure 26(b)(3), which extends to documents and other tangible things that "are prepared in anticipation of litigation or for trial."

With respect to the work papers at issue in *Textron*, the majority stressed the apparently undisputed fact that Textron's purpose in creating the papers was "to establish and support the tax reserve figures for [its] audited financial statements." Based on the testimony of the IRS's expert, the former chief auditor of the Public Company Accounting Oversight Board, the majority concluded: "[t]hat the purpose of the work papers was to make book entries, prepare financial statements and obtain a clean opinion cannot be disputed."

The majority then rejected Textron's assertion that "without the possibility of litigation, no tax reserves or audit papers would have been necessary," relying on the conclusion of the IRS's expert that, "even if litigation were 'remote' the company would still have to prepare work papers to support" the judgments reflected on its financial statements. Finally, the majority found that even if such litigation did occur, "it is doubtful that tax accrual work papers, which typically just identify and quantify vulnerable return positions, would be useful in the litigation anticipated with respect to those positions."[9]

The majority then distinguished between "case preparation documents" and "tax documents," placing the work papers in dispute in the latter category. Whether the work product doctrine should apply to such papers was a legal question to be decided in light of the language of Rule 26(b)(3), relevant Supreme Court's decisions, direct precedent, and policy judgments. Turning first to the language and history of the rule and the Supreme Court's decision in *Hickman*, the majority opined that documents are not entitled to protection because their subject matter relates to a topic that might conceivably be litigated. Nor does work product protection apply merely because the documents were prepared by lawyers or represent legal thinking. Rather, the majority concluded that the materials must have been prepared for "current or possible" litigation or trial.

The majority in 'Textron' noted that the privilege was aimed at protecting the 'litigation process, specifically, work done by counsel to help him or her in litigating a case,' rather than helping lawyers prepare corporate documents in the ordinary course of business dealings.

Leaving itself open to the dis-sent's complaint that it was providing no guidance with a "knows work product when it sees it" approach,[10] the majority noted that "[e]very lawyer who tries cases knows the touch and feel of materials prepared for a current or possible law suit. No one with experience of law suits would talk about tax accrual work papers in those terms." The purpose of these papers, in the Court's opinion, was "to support a financial statement and the independent audit of it."[11]

The majority also found that circuit precedent, specifically the First Circuit's decision in *Maine v. United States Dept. of Interior*, [12] supported its conclusion that Textron's work papers were not subject to work product protection. According to the majority, the court in *Maine* had found that work product protection "does not extend to 'documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of any litigation.'" The majority also relied on the Fifth Circuit's decision in *United States v. El Paso*, which applied a "primary purpose" test in concluding that work papers were not protected by the work product privilege because the company had generated the documents in order to "bring its financial books into conformity with generally accepted auditing principles."[13] Thus, under *Maine* and *El Paso*, Textron's work papers were not entitled to work product protection because their only purpose was to prepare financial statements.[14]

The majority then looked to underlying policy considerations to support its finding that Textron's papers are not subject to the privilege. The majority noted that the privilege was aimed at protecting the "litigation process, specifically, work done by counsel to help him or her in litigating a case," rather than helping lawyers prepare corporate documents in the ordinary course of business dealings. The majority then found that, given the requirement that public companies prepare tax accrual work papers in connection with mandatory audits, declining to extend the privilege to such papers would not discourage "sound preparation for a law suit" or any other dangers expressed by the Supreme Court in *Hickman*.

Finally, the majority responded to Textron's argument that it was unfair for the IRS to have access to its spreadsheets by stating that "tax collection is not a game." Thus, the majority concluded that the public's interest in revenue collection trumped any resulting unfairness. In reaching this conclusion, the majority appears to have been sympathetic to the difficulties faced by the IRS in deciphering complex corporate returns. Without going so far as claiming that these difficulties warrant breaching applicable privileges, the majority noted that "[i]f a blueprint to Textron's possible improper deductions can be found in Textron's files, it is properly available to the government unless privileged."[15]

The Dissenting Opinion

In a vitriolic dissent, Judge Juan R. Torruella, joined by Judge Kermit V. Lipez,

rejected the majority's position and analysis, accusing the majority of abandoning the "because of" test, which looks at whether the document in question was prepared or obtained because of the prospect of litigation. According to the dissent, the majority instead applied a test of whether the documents were "prepared for use in possible litigation." The dissent describes the majority's test as narrower than the "primary motivating purpose" test, which it viewed as having been specifically repudiated in *Maine*.[16]

The dissent accuses the majority of misreading *Maine* by unduly focusing on that decision's assertion that the "because of" test does not protect documents that are prepared in the ordinary course of a business that would have been prepared regardless of any litigation. Rather, tracing the background of *Maine* and especially its reliance on the Second Circuit's decision in *United States v. Adlman*, the dissent rejected the notion that documents were only protected if they were prepared for litigation.

Further, the dissent notes that the "prepared for" test is contrary to the text of Rule 26, which extends its protection to documents "prepared in anticipation of litigation" as well as those prepared "for trial." "Nowhere does Rule 26(b)(3) state that a document must have been prepared to aid in the conduct of litigation in order to constitute work product, much less primarily or exclusively to aid in litigation. Preparing a document 'in anticipation of litigation' is suf-ficient."[17] Thus, the dissent rejects the majority's implication that only documents prepared for use at trial qualify as having been created "in anticipation of litigation."

Under *Adlman*, documents containing analysis of potential litigation are entitled to protection even if they were prepared primarily to assist others in making a business decision. Indeed, as an example of a protected document, the Court in *Adlman* described a memorandum prepared by a company's attorneys estimating the likelihood of success in litigation for purposes of justifying the litigation loss reserves on the company's financial statements. Because the First Circuit had specifically adopted *Adlman's* reasoning in *Maine*, the dissent opined that the majority's analysis was "blatantly contrary" to circuit precedent.

Recognizing that the court, sitting en banc, was authorized to create a new rule for the circuit, the dissent argued that the majority decision announced a bad rule. First, it is inconsistent with the plain language of Rule 26, which provided protection for documents prepared "in anticipation of litigation or trial." Second, it misses a fundamental aim of *Hickman*: protecting an attorney's privacy. "Without such privacy, litigants would seek unfair advantage by free-riding off another's work, thus reducing lawyers' ability to write down their thoughts."[18]

Quoting *Adlman*, the dissent further notes that "there is no basis for adopting a test under which an attorney's assessment of the likely outcome of litigation is freely available to his litigation adversary merely because the document was created for a business purpose rather than for litigation assistance." Indeed, some courts have observed that the discovery of tax accrual work papers would give the IRS an unfair advantage—a factor that would weigh in favor of recognizing the documents as privileged.[19]

Moreover, the dissent noted that the majority's opinion had significant and widespread ramifications impacting the work product doctrine in general. "As the IRS explicitly conceded at oral argument, under the majority's rule one party in a litigation will be able to discover an opposing party's analysis of the business risks of the instant litigation, the amount of money set aside in a litigation reserve fund…. Though this consequence was a major concern of the argument in this case, the majority does not even consider this 'sharp practice,' which its new rule will surely permit."[20] Indeed, the dissent raises the alarm that all corporate attorneys preparing analyses for any major business decision with legal dimensions should be aware that their work product may not be protected, at least in the First Circuit.

Next Stop: Supreme Court?

News reports indicate that Tex-tron's attorneys are "studying the opinion and 'exploring [the com-pany's] options.'"[21] As the dissent notes, the majority's opinion in *Textron* is both inconsistent with the law in other circuits and has potentially far-reaching consequences outside of the IRS audit context. Thus, the issue appears to be ripe for consideration by the Supreme Court, which can write the final chapter in the *Textron* saga.

1. John J. Tigue, Jr. and Jeremy H. Temkin, "The IRS Still Wants Your Company's Workpapers," New York Law Journal (March 12, 2009); John J. Tigue, Jr. and Jeremy H. Temkin, "Tax Accrual Workpapers May Be Discoverable," NYLJ (May 17, 2007).
2. 134 F.3d 1194 (2d Cir. 1998).
3. *United States v. Textron Inc.*, 2009 WL 2476475, **1-2 (1st Cir. Aug. 13, 2009).
4. *United States v. Textron Inc.*, 507 F.Supp.2d 138, 150, 152-53 (D.R.I. 2007).
5. *United States v. Textron Inc.*, 553 F.3d 87 (1st Cir. 2009).
6. 2009 WL 2476475 at *4.
7. 329 U.S. 495 (1947).
8. Id. at 511.
9. 2009 WL 2476475 at **6-7 (internal quotations and citations omitted).
10. Id. at *12.
11. Id. at *8.
12. 298 F.3d 60 (1st Cir. 2002).
13. 682 F.2d 530, 543-44 (5th Cir. 1982).
14. 2009 WL 2476475 at *8.
15. Id. at *9.
16. Id. at *10.
17. Id. at *10 (quoting *Adlman*, 134 F.3d at 1198-99).
18. 2009 WL 2476475 at *13.
19. See *Adlman*, 134 F.3d at 1199; *United States v. Roxworthy*, 457 F.3d 590, 595 (6th Cir. 2006).
20. 2009 WL 2476475 at *15.
21. Laura Saunders and Jennifer Levitz,"IRS Wins a Victory as Court Allows Access to Textron Tax Papers," The Wall Street Journal (Aug. 14, 2009).

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