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What Does *Textron* Mean for Preserving the Confidentiality of Tax Accrual Workpapers?

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In-house tax managers are perennially concerned that the Internal Revenue Service (IRS) will request their tax accrual workpapers during an audit, as a result of the Supreme Court decision that no general privilege applies to tax accrual workpapers. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). Nevertheless, the IRS has long recognized that the fear of disclosure of tax accrual workpapers could cause tax managers to be less forthcoming in their dealings with financial auditors and in Security Exchange Commission (SEC) filings. Therefore, the IRS has had a longstanding formal policy of restraint in requesting the workpapers. *See* Internal Revenue Manual (IRM) 4.10.20.3.1.

Two relatively recent developments have heightened tax managers' anxiety concerning the possible disclosure of tax accrual workpapers. The first involves the IRS's war on corporate tax shelters. In recent years, the IRS has leveraged its legal right to obtain tax accrual workpapers into a tax shelter deterrent. In an attempt to make corporate taxpayers pay a price for engaging in questionable tax practices, the IRS in 2002 formally adopted a policy that all tax accrual workpapers will be requested when the taxpayer has invested in more than one listed transaction or if the taxpayer has not disclosed its participation in a listed transaction. *See* Announcement 2002-63, 2002-2 C.B. 72 (June 17, 2002), incorporated in IRM 4.10.20.3.2. The second, more recent development, is the Financial Accounting Standards Board (FASB)'s adoption of FIN 48[1], which requires corporations to prepare and maintain detailed documentation of the legal and factual support for their provisions for uncertain tax positions. Disclosure of the FIN 48 compliance portion of tax accrual workpapers could provide IRS auditors with a road map for potential audit issues. The IRS has repeatedly stated that it has not changed its policy of restraint in requesting tax accrual workpapers to take advantage of the increased disclosure requirements of FIN 48. However, it also has repeatedly stated that it is reviewing its policy of restraint. Naturally, the continuing review and reconsideration unnerves practitioners and tax managers alike.

With this background, there has been increasing focus on the scope of the attorney-client privilege and the attorney work-product doctrine as applied to tax accrual workpapers. If one of these privileges applies, IRS auditors cannot obtain the workpapers, regardless of their internal policies regarding tax shelter situations and FIN 48. For this reason, practitioners and tax managers took notice when the court in *United States v. Textron Inc.*, 507 F.Supp.2d 138 (D. R.I. 2007), denied the enforcement of an IRS summons seeking a corporation's tax accrual workpapers on the basis that the attorney work-product doctrine applied.

The Chief Counsel of the IRS has stated that the government will continue to take the position it argued in *Textron* or attempt to limit the case to its unique facts. Moreover, the IRS has appealed the case to the First Circuit Court of Appeals (Doc. No. 07-2631, filed Oct. 31, 2007). The First Circuit's holding will be binding in the entire First Circuit, which covers four northeastern states and Puerto Rico, and will be more influential in other courts around the country than the district court's opinion.

[1] *See Role of Outside Tax Advisors in FIN 48 Compliance, 3 Taxing Times 30* (February, 2007).

Work-Product Doctrine

The attorney work-product doctrine generally applies to legal advice prepared for the primary purpose of aiding in anticipation of future litigation.[2] The privilege applies to: (1) materials or communications of a nature that qualifies for protection; (2) that were prepared in anticipation of litigation; and (3) were prepared by or for that party or that party's attorney or other qualifying representative. The attorney work-product doctrine is not the same as the attorney-client privilege. This article deals primarily with the application of the attorney work-product doctrine. In general, the attorney-client privilege applies to advice provided by an attorney to a client. The attorney work-product doctrine applies to advice and the information that is prepared in anticipation of litigation. Disclosure to a third party will waive the attorney-client privilege, but it may be possible to disclose a document to a financial auditor and yet maintain the attorney work-product privilege. The work-product doctrine potentially is broader than the attorney-client privilege, in that it is not limited to confidential attorney-client communications relating to legal services. It includes gathering of facts from discussions with third parties and the lawyer's mental impressions. It also may apply to information with respect to which the attorney-client privilege has been waived.[3] The IRS can overcome the privilege in a summons enforcement proceeding if it shows sufficient cause for the production of the documents and in good faith believes: (1) the work-product sought is necessary to the determination of the taxpayer's tax liability; and (2) the information could not be obtained from any other source.[4]

On appeal in *Textron*, the IRS is arguing among other things that an affirmance of the district court will create a conflict among the circuits. However, there already appears to be some disagreement among the courts in their interpretation of the requirement that work-product materials be prepared "in anticipation of litigation." Some courts apply a primary purpose test. For example, the Fifth Circuit has held that work-product material is prepared in anticipation of litigation "as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation."[5] *United States v. El Paso,* 682 F.2d 530, 542 (5th Cir. 1982). Other courts apply a less strict "because of" test. Under this test, the material is prepared in anticipation of litigation if it was prepared or obtained "because of" the prospect of litigation. *United States v. Adlman,* 134 F.3d 1194 (2d Cir. 1998). *In United States v. Roxworthy,* 457 F.3d 590 (6th Cir. 2006), the Sixth Circuit applied the "because of" test. The court held that the work-product doctrine applied because the taxpayer had a subjective anticipation of litigation that was objectively reasonable. The taxpayer's anticipation of litigation was objectively reasonable because the taxpayer's return was significant enough to ensure a yearly IRS audit, the transaction at issue involved a $112 million discrepancy between tax loss and book loss, the taxpayer had been advised that the area of law was unsettled and that IRS had recently targeted the type of transaction at issue. Not surprisingly, the IRS recently indicated in AOD 2007-004 (Oct. 1, 2007) that it will not follow *Roxworthy* because it believes that the possibility of an audit is insufficient and the possibility of litigation is too remote if the document is prepared in advance of an audit.

The work-product doctrine can be waived only if the otherwise protected information is divulged to a third party who has no interest in maintaining the confidentiality of a significant part of the work-product. In order to result in a waiver, the disclosure must be wholly inconsistent with the purpose of the privilege to safeguard the attorney's work-product and trial preparation. This means that where attorney work-product is given to an outside auditor who maintains confidentiality, it may be protected from disclosure to the IRS even though the same disclosure may result in a waiver of the attorney-client privilege. For example, in *Laguna Beach County Water Dist. v. Superior Court,* 124 Cal. App.4th 1453 (2004), the court held that there was no waiver of the attorney work-product doctrine when the attorney responded to inquiries by the auditor for the water district relating to the financial effect of pending or threatened litigation. The court held that the disclosure did not result in a waiver because it was consistent with the privilege and the parties did not intend to waive protection (the parties marked each letter with the notation "Attorney-Client and Attorney Work-Product Communication.")

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[2] *Hickman v. Taylor,* 329 U.S. 495 (1947); Fed. R. Civ. P. 26(b)(3); *United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998).*

[3] *Long-Term Capital Holdings v. United States,* 2003-1 U.S.T.C. 50304.

[4] *Upjohn Co. v. United States,* 449 U.S. 383. *See also* Fed. R. Civ. P. 26(b)(3).

[5] *See also United States v. Rockwell Int'l,* 897 F.2d 1255 (3rd Cir. 1990) and *United States v. Davis,* 636 F.2d 1029 (5th Cir. 1981), applying the more restrictive "primary purpose" test.

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Textron Decision

On Aug. 28, 2007, the District Court held that the attorney work-product doctrine protected Textron's tax accrual workpapers and that the IRS had not met the showing of substantial need necessary to obtain an opponent's attorney work-product. Textron engaged in various "listed transactions," including so-called "sale-in, lease out" (SILO) transactions during the 1998-2001 years in dispute. During its audit, the IRS issued a summons for all of Textron's tax accrual workpapers for tax year 2001, on the basis of its policy of requesting all tax accrual workpapers if a taxpayer invests in more than one tax shelter. In Announcement 2002-63, the IRS indicated its position that tax accrual workpapers are not generated in connection with seeking legal or tax advice, but are developed to evaluate a taxpayer's deferred or contingent tax liabilities in connection with a taxpayer's disclosure to third parties of the taxpayer's financial condition, and, therefore, the tax accrual workpapers are not privileged communications. *See also United States v. Telephone Data Systems, Inc.*, 90 A.F.T.R.2d 2002-5828 (where it was insufficient for a taxpayer to argue that, because it was audited regularly by the IRS, it anticipated the audit would lead to federal income tax proceedings, including litigation).

In Announcement 2002-63, the IRS indicated its position that tax accrual workpapers are not generated in connection with seeking legal or tax advice. …

Textron's workpapers consisted of a spreadsheet identifying issues on its tax return that counsel deemed uncertain. Textron used the spreadsheet on a yearly basis to summarize tax reserve items for financial accounting purposes. The spreadsheet indicated in percentage terms the estimates by counsel of the likelihood of prevailing in litigation and corresponding dollar amounts for reserves on each issue. There were additional back-up workpapers containing spreadsheet drafts, the prior year spreadsheet and notes and memoranda of in-house tax attorneys regarding which issues should be included on the spreadsheets. Textron's accountants, in-house counsel and outside counsel prepared the spreadsheets in close cooperation with one another, and the documents reflected the opinions and judgments of the attorneys. Textron provided the final spreadsheet on a confidential basis to Ernst & Young—its independent auditor—during the course of the financial audit.

In the First Circuit, a document is prepared "in anticipation of litigation" if it is prepared "because of litigation." The court in *Textron* held that the tax accrual workpapers satisfied this "because of litigation" test. Specifically, the court stated:

> However, it is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared at all "but for" the fact that Textron anticipated the possibility of litigation with the IRS. If Textron had not anticipated a dispute with the IRS, there would have been no reason for it to establish any reserve or to prepare the workpapers used to calculate the reserve. Thus, while it may be accurate to say that the workpapers helped Textron determine what amount should be reserved to cover any potential tax liabilities and that the workpapers were useful in obtaining a "clean" opinion from E&Y regarding the adequacy of the reserve amount, there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding.

507 F.Supp.2d at 150. Thus, even though there were other reasons for preparation of the documents (financial reporting), they were protected from disclosure.

The court held that the attorney-client privilege and the tax practitioner privilege under I.R.C. § 7525 (which generally tracks the attorney-client privilege) applied to the documents, but that Textron waived those privileges when it provided the final spreadsheet to its independent auditors. The attorney-client privilege and the tax practitioner privilege are designed to encourage full and frank discussions with attorneys and tax advisors by keeping the communications confidential. Any action inconsistent with strict confidentiality generally waives the privileges, and many courts have held that providing documents to independent auditors is a waiver. However, the court found that the work-product doctrine—also applicable to the tax accrual workpapers—serves a different purpose and thus has a

different waiver standard. The work-product doctrine is designed in part to prevent an adversary in litigation from gaining an unfair advantage by piggy-backing on an opponent's attorney work-product. The privilege is designed to allow an attorney a zone of privacy, free from interference from an adversary.

Accordingly, a waiver of the privilege generally occurs only when the party does something inconsistent with keeping the information from the adversary. Textron provided the spreadsheet to its auditors with the understanding that the auditors would maintain confidentiality and the auditors had a professional obligation to comply. Therefore, the court held that, by providing the spreadsheet to its auditors, Textron did not act inconsistently with the underlying purpose of keeping the documents from its potential adversary (the IRS) and thus did not waive the work-product privilege.

Observations and Recommendations

There should be a note of caution in evaluating the effect of *Textron*—the *Textron* court dealt with a pre-FIN-48 tax year. The court specifically recognized that workpapers created in the ordinary course of business are not covered by the work-product doctrine, even under the "because of litigation" standard noted above. In applying this standard, the court stated that Textron would have had no reason to establish a reserve, or to prepare workpapers, had it not anticipated a dispute with the IRS. IRS Chief Counsel Donald Korb has repeatedly stated that the *Textron* case has no application under FIN 48 tax years because of the requirement to document uncertain positions. Korb asks: How can the document be prepared in anticipation of litigation if it is required to be prepared under FIN 48? The standard for FIN 48 disclosure, however, turns on what would happen on examination of the issue, including litigation. Thus, it could be argued that all FIN 48 workpapers are attorney work-product because anticipation of litigation is an integral part of the recognition process. Nevertheless, it remains to be seen how the "anticipation of litigation" standard will be applied under the more robust financial accounting disclosure and reserve requirements of FIN 48.

There are a few key take-away observations from the *Textron* litigation. Textron's tax accrual workpapers reflected opinions and judgments of in-house and outside counsel regarding potential litigation with the IRS. The workpapers were prepared by or in conjunction with in-house and outside counsel. Also, Textron provided the documents to its auditors with an understanding that the workpapers would be kept confidential. These points were highlighted by the court in its discussion of the application of the work-product doctrine and whether it was waived.

In general, in order to strengthen an argument that the work-product doctrine applies, any documents that are prepared by or for an attorney should be labeled as confidential and either subject to the attorney-client privilege and/or the attorney work-product doctrine (as appropriate). However, in order to make sure that the privilege identification has meaning, avoid identifying a document as protected by the attorney-client privilege if it is known at the time the document is prepared that it will be disclosed to auditors (in which case the attorney-client privilege will be waived). In addition—if the document will not qualify for either privilege—a label of "confidential" is still appropriate because of the IRS' continuing policy of restraint, but the label should not include one of the privileges if it is inappropriate. There are instances when courts have required disclosure of documents that would have been otherwise privileged because of abuse in overuse of a claim for privilege.

Where it is important that documents prepared by lawyers remain confidential, the documents probably should not be included in the tax accrual workpapers or be relied upon when financial auditors examine the company's tax provision. It is possible to describe the support for a particular position, where that support is also contained in a tax opinion, for example, without

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resulting in a waiver of the opinion itself. If, instead of providing the actual tax opinion, the company prepares a memo that describes the support for its position without disclosing that it has relied upon the opinion for its tax position, this is arguably not a waiver of the attorney-client privilege with respect to the opinion. Whether or not the workpapers are provided to outside auditors, also will depend on what is considered within the scope of "workpapers." The first factor is whether, on balance, there is any reason to withhold the workpapers from the auditors. There may be some instances (*e.g.*, a write-up on a well-known issue) that can be shared with auditors because there is no sensitive information in the write-up. The second factor is whether the auditors insist upon obtaining the information. For example, because the workpapers will almost certainly contain a list of all of the issues for which reserves are held and the amount of such reserves, the financial auditors may insist on obtaining this information for their audit. In such a case, there seems little choice—from a financial perspective—but to provide the workpapers to the auditors.

The question of whether documents will be protected under the work-product doctrine will come down to whether the workpapers were created as a result of the anticipation of litigation. First, the fact that the issues were identified by either the accounting or law firm as those likely to be challenged by the IRS and potentially audited should provide contemporaneous support that they are issues likely to be raised on audit and potentially leading to litigation. However, because this may not be sufficient, it may be advisable to prepare a separate memo—either by in-house or outside counsel—which describes the potential litigation risk on the various issues. This memo should not be provided to the auditors and, therefore, should remain confidential subject to the attorney-client privilege. This memorandum should be prepared contemporaneously with the workpapers (or prior thereto) to provide support for the application of the work-product privilege. Even though affidavits to this effect were successful in *Roxworthy*, contemporaneous documentation provides better support.

Finally, it is important to note that these arguments may not be sufficient to protect the document if the IRS can show sufficient cause for the production of the documents and in good faith believes: (1) the work-product sought is necessary to the determination of the taxpayer's tax liability; and (2) the information could not be obtained from any other source.[6] The IRS did not meet this burden in *Textron*.

[6] *United States v. Brown, 478 F.2d 1038 (7th Cir. 1973). See also Fed. R. Civ. P. 26(b)(3).*