

First Circuit Denies Work Product Protection For Tax Accrual Workpapers

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In a defeat for taxpayers, the U.S. Court of Appeals for the First Circuit has held that the work product doctrine does not protect tax accrual workpapers from discovery by the Internal Revenue Service.

According to the IRS, “[t]he term ‘tax accrual workpapers’ refers to those audit workpapers, whether prepared by the taxpayer, the taxpayer’s accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. These workpapers reflect an estimate of a company’s tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis.”¹

Publicly traded corporations are required to obtain certified financial statements from an independent accounting firm. In order to obtain a clean opinion letter that the financial statements fairly represent the financial condition of the company, a company must prepare tax accrual workpapers identifying and evaluating positions that might result in adjustments of tax liabilities by the government. It doesn’t take very long to realize who else would be interested in an itemized roadmap of the weaknesses in a corporation’s tax returns. Unfortunately, the IRS has broad authority to issue administrative summonses requiring production of documents to assist it in determining the correctness of any return,² and the Supreme Court has held that the scope of that power extends to tax accrual workpapers.³

A company can try to protect itself against an assertion of such power by the IRS by claiming privilege. However, the scope of the relevant privileges – attorney-client and work product – in the context of tax accrual workpapers is unclear. Therefore, the recent *en banc* First Circuit decision in *United States v. Textron Inc.*,⁴ addressing that very issue, was closely watched by the tax commu-



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nity.

Textron is a publicly traded conglomerate. Textron employs in-house tax attorneys and accountants who assist in preparing tax accrual workpapers. Textron’s returns were regularly audited by the IRS in the years prior to the years at issue in the case. In seven of Textron’s eight previous audit cycles, “unagreed” issues had been administratively contested, and three of those issues were litigated in federal court.

The IRS has announced that it will not seek tax accrual workpapers unless the taxpayer did not properly disclose a “listed” or similar transaction or engaged in multiple listed transactions, in which case the IRS may request all tax accrual workpapers for all years under examination.⁵

During its examination of Textron’s 1998-2001 tax years, the IRS discovered that a Textron subsidiary had engaged in nine sale-leaseback transactions that were substantially similar to the “sale in, lease out” or SILO transactions that it had categorized as listed transactions, and, in accordance with its audit policy, the IRS requested all of Textron’s tax accrual workpapers. Textron refused to produce the workpapers, so the IRS issued an administrative summons. Textron again refused, asserting claims of attorney-client and tax-practitioner privilege, and privilege under the work product doctrine. The government brought suit to enforce the summons.

Textron calculated reserves for contingent tax liabilities as necessary to have its financial statements certified by Ernst & Young (and in a manner similar to that now required under FIN 48). The calculation required estimates of the potential magnitude of liability should the IRS challenge uncertain positions Textron took in its tax returns. These estimates were supported by workpapers – spreadsheets and backup emails or notes, including a spreadsheet listing each debatable position taken on its tax returns, the additional taxes that could be assessed by the IRS, and percentage estimates of the IRS’s chances of success. Textron permitted Ernst & Young to examine the final tax accrual workpapers at issue in this case with the understanding that the information was to be treated as confidential. Such disclosure was necessary in order for Ernst & Young to determine the adequacy and reasonableness of the reserves on the financial statements.

A federal district court in Rhode Island held in favor of the IRS on the issues of attorney-client privilege and tax-practitioner privilege, reasoning that Textron had waived whatever such privilege it had by disclosing the content of

the workpapers to Ernst & Young.⁶ On the issue of the work product doctrine, however, the court held in favor of Textron.

On appeal, a divided panel of the Court of Appeals for the First Circuit affirmed the district court’s application of the work product doctrine but remanded the case to the district court for a determination of whether disclosure of the workpapers to Ernst & Young caused a waiver of the work product privilege.⁷ The First Circuit, however, then vacated the panel’s decision and agreed to rehear the case *en banc*. In a dramatic reversal, the First Circuit held by a vote of 3-2 that work product protection did not apply to Textron’s tax accrual workpapers, because they were prepared to support Textron’s audited financial statements rather than “for use in possible litigation.”⁸

The work product doctrine, codified in Rule 26 of the Federal Rules of Civil Procedure, provides that ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative. The doctrine has its roots in the 1947 case *Hickman v. Taylor*,⁹ in which the Supreme Court explained that work product merits protection because “[p]roper preparation of a client’s case demands that he 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.” In contrast, reports made in the ordinary course of business generally do not merit protection under federal law.

According to the First Circuit in its *en banc* decision, “[f]rom the outset, the focus of work product protection has been on materials prepared for use in litigation, whether the litigation was underway or merely anticipated.” Thus, it is not enough to trigger work product protection that the subject matter of a document relates to a subject that might conceivably be litigated, or that the materials were prepared by lawyers or represent legal thinking. Unlike work product with the “touch and feel of materials prepared for a current or possible (*i.e.*, ‘in anticipation of’) law suit . . . [n]o one with experience of law suits would talk about tax accrual workpapers in those terms.” The court found no evidence that Textron’s workpapers “were prepared for such a use or would in fact serve any useful purpose for Textron in conducting litigation if it arose.”

In summary, the court stated that “the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron’s workpapers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though

not protected; and IRS access serves the legitimate, and important, function of detecting and disallowing abusive tax shelters.”

One of the judges wrote a vigorous dissent, declaring that the majority, in order “[t]o assist the IRS in its quest to compel taxpayers to reveal their own assessments of their tax returns,” had abandoned the circuit’s “‘because of’ test, which asks whether ‘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.’”¹⁰ Instead, the majority imposed “a ‘prepared for’ test, asking if the documents were ‘prepared for use in possible litigation.’” The dissent expressed great concern that, “under the majority’s rule, there is no protection for . . . ‘documents analyzing anticipated litigation, but prepared to assist in a business decision rather than to assist in the conduct of the litigation.’ . . . Nearly every major business decision by a public company has a legal dimension that will require such analysis. Corporate attorneys preparing such analyses should now be aware that their work product is not protected in this circuit.”

It remains to be seen whether other circuits will follow in the footsteps of the First Circuit. The Fifth Circuit, under a more restrictive “primary purpose” test, had already held tax accrual workpapers unprotected.¹¹ The dissent in *Textron* opined that the issue is now ripe for clarification from the Supreme Court. However, if Textron files a petition for a writ of certiorari with the U.S. Supreme Court, it is far from certain that the Supreme Court will grant review.

The IRS’s policy of restraint is of little comfort to companies. Even those companies that can be sure they are not engaging in any listed transactions cannot count on the IRS to maintain its policy indefinitely in the face of the First Circuit’s blessing of extensive summons authority. The IRS has made clear that it regards FIN 48 workpapers to be tax accrual workpapers, subject to its policy of restraint, but also subject to its summons authority.¹² Because of the stakes involved, we are likely to see more cases in the near future involving the application of the work product doctrine to tax accrual workpapers.

¹ I.R.M. 4.10.20.2 (7/12/2004).

² Internal Revenue Code of 1986, as amended, § 7602.

³ U.S. v. Arthur Young & Co., 465 U.S. 805 (1984), rev’g 677 F.2d 211 (2nd Cir. 1982), rev’g 496 F. Supp. 1152 (D.C. N.Y. 1980).

⁴ No. 07-2631 (1st Cir. Aug. 13, 2009) (*en banc*).

⁵ Announcement 2002-63, 2002-2 C.B. 72.

⁶ United States v. Textron Inc., 507 F. Supp. 2d 138 (D. R.I. 2007).

⁷ 553 United States v. Textron Inc., F.3d 87 (1st Cir. 2009).

⁸ United States v. Textron Inc., No. 07-2631 (1st Cir. Aug. 13, 2009) (*en banc*) (*emphasis in original*).

⁹ 329 U.S. 495 (1947).

¹⁰ (*Emphasis in original*).

¹¹ United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982).

¹² See FIN 48 and Tax Accrual Workpaper (TAW) Policy Update LMSB Commissioner Memorandum, LMSB-04-0507-044 (May 10, 2007).

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