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TAX CONTROVERSY UPDATE

District Court Denies IRS Request for Textron's Tax Accrual Workpapers

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For months now, corporate taxpayers and their advisors have been watching the federal district court in Rhode Island, eagerly waiting for the court to resolve a summons enforcement action in which the IRS sought to compel production of certain tax accrual workpapers of Textron, Inc.

The wait is over. On August 29, 2007, the court issued a memorandum and order denying the government's petition to enforce its summons on the grounds that the requested workpapers were protected under the work product doctrine. *United States v. Textron, Inc.*, No. 06-198T (D.R.I. Aug. 29, 2007). The decision offers much promise to corporate taxpayers concerned about the protection of confidential materials, but the contours of the opinion should be carefully evaluated.

Background

In connection with the federal tax audit of Textron's returns for 1998-2001, the IRS issued an administrative summons seeking Textron's "tax accrual workpapers." When Textron refused to comply, the government initiated a summons enforcement action in district court.

The specific documents at issue in *Textron* consisted of the company's tax reserve summary spreadsheet (which identified uncertain issues by name, ascribed percentage judgments on the chances of prevailing on each issue, and assigned dollar values), drafts and prior versions of the spreadsheet, and supporting notes and memoranda written by in-house attorneys detailing which items should appear on the spreadsheet and the hazards of litigation percentages ascribed to them. These tax accrual workpapers had been provided to Textron's independent auditor in the context of its financial statement audit.

Before the court, Textron argued that the documents were protected from disclosure under any of a number of theories, including (1) the attorney-client privilege, (2) the federal tax practitioner privilege of I.R.C. § 7525, and (3) the work product doctrine.

The Attorney-Client and I.R.C. § 7525 Privileges

The court found, initially, that the company's tax accrual workpapers were subject to the attorney-client privilege because the workpapers reflected communications from attorneys rendering legal advice in the form of assessments regarding which return items were subject to uncertainty and the relative chances of prevailing in litigation. The court also held that the workpapers were potentially subject to the similar but more limited section 7525 "federally authorized tax practitioner" privilege, rejecting the IRS's argument that the section 7525(b) tax shelter limitation applied.

The court held, however, that these privileges had been waived, noting that voluntary disclosure to any third party – *even an independent auditor* – operates as a waiver of the protections of both of these privileges. Textron had argued that the disclosure to its independent auditor should not give rise to a waiver of the attorney-client and tax practitioner

privilege because the auditor's evaluation of the tax contingency reserve and its workpapers actually constituted tax advice rendered to Textron, which itself was independently protected under section 7525. Characterizing that argument as "creative," the court nevertheless rejected it, suggesting that the auditor's review of the tax contingency was not done with an eye toward advising its audit client, but rather toward reporting to the investing public that the company's financials were fairly stated.

Work Product

Having found the attorney-client and section 7525 privileges inapplicable, the court turned to the work product doctrine and reached a different result. The work product doctrine protects documents to the extent they reflect counsel's mental impressions, legal theories, and strategies compiled "in anticipation of litigation." Following binding precedent of the First Circuit, the court held that a document would be considered to have been prepared "in anticipation of litigation" if it were prepared "because of" the prospect of litigation. In other words, the relevant inquiry is whether the document would have been prepared in substantially the same form irrespective of the anticipated litigation.

The government asserted that the workpapers had not been prepared in anticipation of litigation, but rather had been prepared in the ordinary course of the taxpayer's business in order to comply with federal securities laws, which require public companies to prepare GAAP financials (including reserves for tax contingencies), and to provide comfort to its independent auditor in order to obtain an unqualified audit opinion.

Rejecting the government's argument, the court found that the tax accrual workpapers had, in fact, been prepared in anticipation of litigation. The court reasoned that the estimated hazards of litigation assessments would not have been prepared "but for" the fact that the company anticipated litigation with the IRS. In fact, the court suggested that if the company had not anticipated a dispute with the IRS, it would not have been necessary to record a tax contingency reserve or to prepare workpapers supporting such a reserve for its independent auditor to review.

Moreover, the court found that the work product protection had *not* been waived upon disclosure to the independent auditor. Unlike the attorney-client privilege or section 7525 privilege, work product protection is not automatically waived by disclosure to *any* third persons. Rather, courts generally find a waiver of the work product privilege only if the disclosure is made to *an adversary* or where the disclosure substantially increases the opportunity for potential adversaries to obtain the information.

In support of its conclusion that there had been no waiver, the court in *Textron* noted that a disclosure to the independent auditor did not substantially increase the chances that the work product would be obtained by an adversary because AICPA professional conduct rules impose confidentiality obligations upon auditors and Textron's auditor had in fact independently agreed not to provide the workpapers to any other party.

With this decision, the Rhode Island district court joined a growing list of district courts that hold that, notwithstanding the auditor's independence,

the auditor is not truly an "adversary" of its audit client. *See, e.g., In re Pfizer, Inc. Sec. Litig.*, 1993 WL 561125 (S.D.N.Y.); *Merrill Lynch & Co. v. Allegheny Energy Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004); *American S.S. Owners Mut. Protection and Indem. Assoc., Inc. v. Alcoa S.S. Co., Inc.*, 2006 WL 278131 (S.D.N.Y.); *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, 237 F.R.D. 176 (N.D. Ill. 2006); *In re JDS Uniphase Corp. Sec. Litig.*, 2006 WL 2850049 (N.D. Cal. 2006); *Gutter v. E.I. DuPont de Nemours and Co.*, 1998 WL 2017926 (S.D. Fla. 1998); *Frank Betz Assoc., Inc. v. Jim Walter Homes, Inc.*, 226 F.R.D. 533 (D.S.C. 2005); *In re Raytheon Sec. Litig.*, 218 F.R.D. 354 (D. Mass 2003).

However, it should be noted that a few courts have reached the opposite conclusion, holding that disclosure does give rise to a waiver of work product protection. *See, e.g., Medinol Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y 2002); *In re Diasonics Sec. Litig.*, 1986 WL 53402 (N.D. Cal.).

Impact

To be sure, the holding is a great victory for Textron and the opinion provides support to other taxpayers looking to protect tax accrual workpapers under the work product doctrine. But taxpayers should be cautious before assuming on the basis of this opinion that any and all documents that touch upon their tax reserve analyses are protected from disclosure as a blanket matter. It is important to keep the following aspects of the opinion in context:

- It is unclear whether the government will seek to appeal to the First Circuit at this point. The day after *Textron* was released, IRS Chief Counsel Don Korb indicated that the opinion would not result in a change to IRS practice.
- In finding that the taxpayer had in fact anticipated litigation, the court noted that seven of the company's last eight IRS audits had gone to IRS Appeals and three of these audits resulted in litigation. A company with a lesser history of contentious audits or litigation will have to make its own showing that it anticipated litigation.
- In analyzing whether the workpapers were created in anticipation of litigation, the court applied the "because of" standard prevailing in the First Circuit. It is unclear how the analysis would differ in those circuits that apply the "principal purpose" test (i.e., that a document constitutes work product only if created for the principal purpose of use in litigation).
- The court's view that the work product protection had not been waived by disclosure to the company's independent auditor was informed, at least in part, by the fact that the auditor had given the company assurances that it would keep the documents confidential and by the auditor's duty of confidentiality. While these factors may not be viewed as controlling, taxpayers would nevertheless be prudent to seek confidentiality agreements from auditors.
- The work product doctrine is a qualified protection. That means that on different facts not present in *Textron*, the government might be able to overcome the protection by showing a compelling need for the documents.

As companies evaluate and document their uncertain tax positions under the new framework of FIN 48, the *Textron* decision has important implications for their interactions with auditors from both the IRS and their independent audit firms.

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