

The Reversal in *Textron*: Anatomy of a Bad Decision

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John O. Everett, Cherie J. Hennig, Sharon S. Lassar and Blaise M. Sonnier critically examine the First Circuit's *Textron* decision and conclude with an examination of current financial reporting requirements and the possible impact of the *Textron* reversal.

Introduction

The First Circuit Court's recent reversal in the *Textron*¹ case came as a most unwelcome surprise to practicing tax professionals. In overturning a decision of the Court's own three-judge panel, the First Circuit has made it infinitely more difficult for taxpayers to shield internal documents supporting aggressive and questionable tax positions from IRS scrutiny.

The implications of this decision extend far beyond sanctioning the IRS objective of carving out a wide swath of the work-product doctrine. In making its ruling, the First Circuit seemingly adopts a legislative policymaking role by arbitrarily deciding that the interests of the public fisc override well-established jurisprudence regarding IRS access to tax accrual working papers.

This article critically examines the First Circuit's decision in the *Textron* case. The first part of the article

traces the roots of the work product immunity doctrine and evaluates the pre-*Textron* judicial application of the doctrine to tax accrual workpapers. Next is a detailed discussion of the *Textron* decisions and accompanying dissenting opinions, and this is followed by a critical analysis of the case and its implications for tax practice. This article concludes with an examination of current financial reporting requirements and the possible impact of the *Textron* reversal.

Background: The Issue of Work Product Immunity

In seeking access to a firm's tax accrual workpapers, the IRS is exercising the summons power conferred by Code Sec. 7602, which authorizes the Secretary of the Treasury to summon and "examine any books, papers, records, or other data which may be relevant or material"² to a given tax inquiry. The U.S. Supreme Court has noted that, subject to certain traditional privileges and limitations, no other restrictions on the IRS summons power should be imposed "absent unambiguous directions from Congress."³

The genesis of the question of IRS access to tax accrual working papers was the U.S. Supreme Court's decision in *Arthur Young*.⁴ In this case, the IRS sought access to the tax accrual workpapers that the CPA firm used to verify the company's reserve for contingent tax liabilities. Fearing that this would provide the IRS with a "roadmap" to all kinds of adjustments for questionable items, the taxpayers instructed the

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CPA firm not to comply. The IRS sought relief in the courts, and the U.S. District Court sided with the IRS, and the Second Circuit Court of Appeals agreed with the logic of the District Court but nonetheless ruled for the taxpayer because they believed that the public interest and integrity of the securities market demanded protection for the accountant's work. The Supreme Court agreed to hear the case because of the muddled decision of the Second Circuit (relevant but no access granted) and an earlier decision of the Tenth Circuit that said the papers were not relevant unless used in preparation of the tax return.⁵

In essence, the Second Circuit decision carved out a "work product immunity" doctrine for a taxpayer and his or her accountant. And this was the taxpayer's argument: to allow the IRS access would violate privileged communications between the taxpayer and the accountant, particularly since such documents were not related directly to the preparation of the return (a condition imposed by the Tenth Circuit). Nonetheless, the Supreme Court accepted the IRS argument that Code Sec. 7602 should provide the IRS access to any records that will "shed light" on the preparation of the return. In so doing, the Court noted once again that the government needs extensive information-gathering authority, and to rule otherwise the Court would need "unambiguous directions" from Congress.

Following the *Arthur Young* decision, the IRS announced that its employees would generally follow a policy of restraint in requesting tax accrual workpapers.⁶ However, in 2002 the IRS announced that it may request tax accrual workpapers if the taxpayer engaged in "listed transactions," defined as tax avoidance transactions within the meaning of Temporary Reg. §1.6011-4T(b)(2). Although such requests are generally limited to those listed transactions disclosed on the return, the IRS noted that *all* tax accrual workpapers will be requested if (1) the listed transaction was not disclosed, (2) tax benefits from multiple investments are claimed, or (3) financial reporting irregularities are present (such as those requiring earnings restatements).⁷

The IRS has followed through on this more aggressive approach to attacking abusive transactions by seeking discovery of workpapers for listed transactions disclosed in returns. And, as noted in Announcement 2002-63, the IRS believes that it is on firm legal ground in making such requests:

The Supreme Court confirmed the Service's right to obtain Tax Accrual Workpapers under its summons authority. *United States v. Arthur Young*

& Co., 465 U.S. 805 (1984). Since 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, Tax Accrual Workpapers are not privileged communications. Neither the attorney-client privilege nor the IRC §7525 tax practitioner privilege (which is based upon, but is more limited than, the attorney-client privilege) protects Tax Accrual Workpapers from production upon proper request by an authorized examining agent. See also Treasury Department Circular 230, 31 C.F.R. §10.20 (duty of practitioner to submit information upon a proper and lawful request by the IRS).⁸

The more aggressive posture by the IRS (along with subsequent developments noted below) has caused taxpayers to reassess possible methods of protecting their tax accrual workpapers from IRS scrutiny. Generally, taxpayers rely on one of three privileges to protect their workpapers from discovery during an IRS audit: (1) the attorney-client privilege, (2) the accountant-client privilege, or (3) the work-product privilege.

The Attorney-Client Privilege

The traditional privilege afforded a taxpayer and its attorney is provided in federal courts by Federal Rules of Evidence 501. This privilege protects only confidential communications between an attorney and client relating to legal advice sought from the attorney. The attorney-client privilege does not apply to nonlegal work, even if performed by an attorney. Although this means that the routine preparation of a return by an attorney would not be covered by this privilege, the Fifth Circuit noted that "a lawyer's analysis of the soft spots in a return and his judgment on the outcome on the litigation on it"⁹ is privileged communication. However, the attorney-client privilege applies only to direct communications between the attorney and the client, and not to documents and tangible items prepared in anticipation of litigation (as opposed to advice). These documents, memos and other materials are more aligned with the concept of the work-product doctrine discussed below. Finally, it is important to note that the courts generally agree that "disclosure of any significant portion of a confidential communication waives the privilege as to the whole."¹⁰

The Accountant-Client Privilege

Code Sec. 7525 was enacted as part of the 1998 Tax Reform Act to extend the attorney-client privilege to federally authorized tax practitioners when rendering tax advice to clients. This privilege does not apply when tax shelters are involved. Note that the privilege is extended solely for the purposes of rendering tax advice, and not in other capacities such as the preparation of tax returns. And, according to the IRS in Announcement 2002-63, such privilege also does not apply to the tax accrual workpapers, since such workpapers are (as quoted above) “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.”¹¹

Work-Product Privilege

Perhaps the taxpayer’s most effective defense against tax accrual workpaper access is the work-product privilege. This doctrine was first established by the U.S. Supreme Court in *Hickman v. Taylor*,¹² where the Court rejected “an attempt, without purported necessity or justification, to secure written statements, private memoranda and personal recollections prepared or formed by an adverse party’s counsel in the course of his legal duties.”¹³

This privilege was subsequently codified as Federal Rule of Civil Procedure 26(b)(3), where privilege is extended to documents that are “prepared in anticipation of litigation or [emphasis supplied] for trial.” The rule also notes that the provision is intended to protect against “disclosure of mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.”¹⁴ The work-product privilege is not absolute: access to materials otherwise protected by work product may be allowed if it is demonstrated that there is a substantial need for the materials and such documents cannot be obtained by other means without undue hardship.

The work-product privilege is broader than the attorney-client privilege, since the former is not limited to lawyer-client communications. For example, the privilege would also extend to any documents prepared by nonlawyers hired by an attorney in anticipation of litigation.

Over the years, the courts analyzing the work-product doctrine as it relates to tax accrual workpapers have focused on the question of *why* the document

in question was prepared, and not the content of the document itself. In many cases, the documents are prepared for purposes other than in anticipation of litigation, such as complying with financial accounting rules by assisting management and auditors in assessing the company’s tax reserve or to evaluate the tax, litigation and other business risks related to a pending transaction. Since such documents are normally prepared in the ordinary course of business, the question of whether the documents were prepared “in anticipation of litigation” becomes a central issue.

Two tests have been developed by the courts in determining whether a dual purpose document is entitled to protection of the work-product privilege. These are the “primary purpose” test and the “because of” test.

Under the “primary purpose” test, a document is entitled to work-product privilege if the primary motivation in preparing the document is to aid in potential future litigation. Under this theory, all purposes must be weighed, and the “aid in potential future litigation” motive must be the dominant purpose. This position has been adopted by the Fifth Circuit in *El Paso Company*.¹⁵ In ruling that a taxpayer’s tax pool analysis was “only a means to a business end” and not primarily prepared in anticipation of litigation, the Court in *El Paso* noted the following:

El Paso establishes its non-current tax account to bring its financial books into conformity with generally accepted auditing principles. The desire to please the accountants, in turn, is compelled by the securities laws. The primary motivating force behind the tax pool analysis, therefore, is not to ready El Paso for litigation over its tax returns. Rather, the primary motivation is to anticipate, for financial reporting purposes, what the impact of litigation might be on the company’s tax liability.¹⁶

On the other hand, the “because of” test simply requires that the document be prepared (or obtained) *because of* the prospect of litigation; this only needs to be one motive, and not necessarily the dominant motive for the preparation of the document. This standard has been adopted in the Second Circuit, Third Circuit, Fourth Circuit, Seventh Circuit, Eighth Circuit and the D.C. Circuit.¹⁷ Until the *en banc* decision in *Textron*, it was also the test applied in the First Circuit.¹⁸ In a recent decision, the First Circuit in *Textron* abandoned both tests and adopted a new test that is even more restrictive than the Fifth Circuit’s “primary purpose” test. The

implications of the *Textron* decision go far beyond tax accrual workpapers as discussed later in this article.

The *Textron* Decisions

District Court

Textron is a major aerospace and defense contractor with over 100 subsidiaries. Textron files a consolidated tax return and is audited by the IRS on a regular basis. During the preparation of its annual financial statements, Textron employees calculate and record any reserves necessary to account for contingent liabilities. Specifically, Textron's tax department (which included in-house lawyers) would estimate the potential liability if the IRS decides to challenge debatable items on the return. This was accomplished through a series of working papers that consisted of spreadsheets and supporting backup e-mails and notes. The spreadsheets were prepared based on the assessment of tax issues by in-house counsel in Textron's tax department, and were reviewed by outside counsel as well. The spreadsheets displayed each debatable item, the dollar amount potentially subject to dispute and the estimated chances of IRS success on each item. The sum of the expected values of each potential liability was then used as the reserve liability on the financial statements, and the work papers provided the necessary detail for external independent auditors to attest to the financial statements.

In auditing Textron's 2001 return, the IRS determined that Textron Financial Corporation, a Textron subsidiary, had engaged in nine "listed transactions" involving sale-in, lease-out (SILO) transactions. Pursuant to Announcement 2002-63, the IRS summoned *all* of the working papers for the year in question, since there were multiple listed transactions. (Interestingly, Textron offered to turn over the workpapers related to the nine listed transactions, but the IRS insisted on all work papers developed by the firm and its subsidiaries.) Although Textron had shared their workpapers with their outside auditor (Ernst & Young) under a confidentiality agreement, they refused to comply with the summons. As a result, the IRS initiated an enforcement action in federal District Court in Rhode Island.

In the District Court,¹⁹ Textron asserted that the workpapers were protected under the attorney-client, accountant-client and work-product privileges. Both parties stipulated that the immediate purpose of the workpapers was to establish and support the tax reserve figures for the audited financial statements. The IRS argued that the workpapers were prepared in the ordinary course of business in that the company was

complying with federal securities laws that require accounting presentations in conformity with generally accepted accounting principles. Textron contended that although it usually settled disputes with the IRS through negotiation, concession or the IRS administrative process, it had litigated tax issues in court on several occasions, and the workpapers would not have been prepared "but for" the anticipation of litigation (if litigation was not likely, there would be no need to do the analysis in the first place).

Applying the "because of" standard adopted by the First Circuit Court of Appeals in *Maine v. United States Department of Interior*,²⁰ the District Court concluded that the tax accrual workpapers were prepared in anticipation of litigation. The District Court concluded:

[I]t 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.

The District Court also ruled that the disclosure of Textron's tax accrual workpapers to its outside auditors did not constitute a waiver of the work-product privilege. As mentioned earlier, if confidentiality is breached with a disclosure to a third party, then the privilege is broken. Since Ernst & Young, Textron's auditor, had examined the company workpapers, the IRS attempted to obtain discovery of the workpapers through the conduit of the public accounting firm. Following generally accepted precedent, the District Court ruled that Textron *did* waive attorney-client and accountant-client privileges with such disclosures to Ernst & Young.²¹

Appeals Court Decision

The IRS appealed the District Court decision, and in a 2-1 decision, the Court of Appeals for the First Circuit upheld the lower court's decision that the workpapers were protected by the work-product doctrine. In response to the decision, the IRS requested an *en banc* review of the decision. On March 25, 2009, a majority of the First Circuit judges voted to vacate the original decision and to hear the case *en banc*.²²

En Banc Appeals Court Decision

On August 13, 2009, the full panel of the First Circuit Court of Appeals issued their *en banc* decision that es-

entially overturned the earlier decision.²³ In doing so, the court muddied the water even further by seemingly creating a new standard for privilege. The court began its analysis by observing that its decision was based on balancing policy concerns rather than just an application of abstract logic. After reviewing the origins of the work-product doctrine, the court noted that the language in the codified rules describes the work-product privilege as extending to documents and other tangible things that “are prepared in anticipation of litigation or for trial.”²⁴ Focusing exclusively on the “for trial” phrase in the rules, the court noted the following:

But in saying that Textron wanted to be “adequately reserved,” the district judge did not say that the work papers were prepared *for use* in possible litigation—only that the reserves would cover liabilities that might be determined in litigation. If the judge had made a “for use” finding—which he did not—that finding would have been clearly erroneous.²⁵

The court then seized upon the “for use” requirement, noting “that the purpose of the work papers was to make book entries, prepare financial statements and obtain a clean audit cannot be disputed.” Furthermore, the court quoted the testimony of an IRS expert witness, who noted that “even if the litigation were remote, the company would still have to prepare work papers to support its judgment.”²⁶ With this buildup, the court then quoted from a journal article to show their cards (finally!):

[I]t is doubtful that tax accrual workpapers, which typically just identify and quantify vulnerable return positions, would be useful in the litigations anticipated with respect to those positions.²⁷

The court is in essence contending that the phrase in the codified rule “prepared in anticipation of litigation or for trial” did not mean prepared for some purpose other than litigation. Rather, it meant simply that the work is done in advance *for* litigation. The court noted that it is not enough that the materials were prepared by lawyers or represent legal thinking, since much corporate legal work falls in that category.

In summary, the *en banc* decision seems to be creating a new “prepared for” test for work product immunity, in place of the “because of” and “primary purpose” tests. This may have a chilling effect on disclosures in the era of ASC Topic 740 (formerly

FIN 48) disclosures which now are required in lieu of the ASC Topic 450 (formerly FAS 5) contingent liability requirements in effect at the time of the *Textron* litigation. The court’s final summary statement also indicates that policy concerns about abusive tax transactions played a role in their final decision:

To sum up, the work-product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron’s work papers 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.²⁸

Dissent to the *En Banc* Decision

The dissenters to the *en banc* decision provide a ringing defense of the “because of test” and its support of dual purpose documents, including tax accrual workpapers. The dissenters begin by noting that the proposed “prepared for” test of the *en banc* majority is even more restrictive than the “primary motivating purpose test” developed by the Fifth Circuit. They also note that the majority blithely brushes aside the actual text of Rule 26(b)(3). In this regard, the dissenters quote from *M. Adlman* discussed in greater detail below. The dissenters also note that the majority can point to no court requiring that documents must be “for use” in litigation in order to be protected by the work-product privilege. The dissenters observed that the majority ignored the solid and well-reasoned conclusions of the case law supporting the “because of” test adopted by a majority of the appellate courts.

The dissenting judges note that the majority stunningly dismisses the important policy considerations of a new “prepared for” standard and considers only a tax workpaper rationale. Specifically, the dissenters note that “the majority’s new rule will have ramifications that will affect the form and details of documents attorneys prepare when working to convince auditors of the soundness of a corporation’s reserves.”²⁹ The dissenters state that the majority fails to understand that documents supporting the computation of a reserve go far beyond the numbers; such documents explain the legal rationale underpinning the taxpayer’s view of its litigation chances. In this regard, the dissenting judges refer to the clear “free-riding” consequences of the new

approach: The IRS will be able to immediately identify the “soft spots” and know exactly how much the taxpayer would be willing to spend to settle each item.

The dissenting judges conclude by once again reiterating the “but for” argument; there would have been no need to create the reserves but for the possibility of litigation with the IRS. If no reserves were needed, then no workpaper analysis would have been required in order to obtain a clean opinion. Under the generally accepted “because of” test, the tax accrual workpapers are entitled to work-product protection.

Analysis

The *en banc* decision of the First Circuit Court of Appeals in *Textron* is inconsistent with the weight of authority on the work-product doctrine. The rule articulated by the court, if read literally, would extend work-product protection only to documents “prepared for use in possible litigation,”³⁰ and to “work done by counsel to help him or her in litigating a case.”³¹ This test is even narrower than the “primary purpose” test adopted by the Fifth Circuit U.S. Court of Appeals, which has been rejected by all but a few courts. In adopting the extremely narrow and draconian “prepared for use in litigation” standard, the majority of the First Circuit Court of Appeals does not give any consideration to its ramifications if applied outside of the context of tax accrual workpapers.

The “prepared for use in litigation” standard is adopted in *Textron* based on a “balancing of policy concerns”³² and the important function that providing IRS access to the tax accrual workpapers serves “of detecting and disallowing abusive tax shelters.”³³ Sitting *en banc*, a majority of the First Circuit U.S. Court of Appeals is swayed to abandon well-established jurisprudence on the work-product doctrine based on the public policy considerations that “underpaying taxes threatens the essential public interest in revenue collection”³⁴ and “the practical problems confronting the IRS in discovering under-reporting of corporate taxes.”³⁵

At least for the time being in the First Circuit, the IRS has succeeded in obtaining an exception to the traditional work-product doctrine for tax accrual workpapers without having to obtain an amendment of the Federal Rules of Civil Procedure by an act of Congress. Instead, the First Circuit usurps the legislative role of Congress by assuming a policymaking roll, which it boldly and proudly announces in its decision in *Textron*. The good news is that the *Textron* decision is binding authority only within the First Circuit,

which includes the states of Maine, Massachusetts, New Hampshire and Rhode Island.

In *Textron*, the majority admits that “Textron’s evidence was to the effect that litigation over specific items was always a possibility” and that “the IRS did not deny that in certain cases litigation could result although it said that this was often unlikely.”³⁶ The court determines that the likelihood of litigation between Textron and the IRS was not relevant because the tax accrual workpapers were not “prepared for use in possible litigation.”³⁷ The court ruled that because Textron, a publicly traded company, compiled the tax accrual workpapers pursuant to its obligation under federal securities laws to have its financial statements audited that the workpapers were not protected by the work-product privilege. Instead of being prepared for use in possible litigation, the court determined that the workpapers were prepared by Textron to satisfy its statutory and audit requirements as a publicly traded company.

Under the “prepared for use in litigation” test adopted in *Textron*, a document is either prepared for use in litigation or it is not. There is no gray area and there is no room for multiple use documents. Additionally, the First Circuit states that it will be easy to identify documents protected by the work-product privilege under its new “prepared for use in litigation” test. The court provides assurance that “every lawyer who tries cases knows the touch and feel of materials prepared for a current or possible lawsuit.”³⁸ The dissenting opinion in *Textron* astutely observes that this is similar to the definition of pornography articulated by Justice Stewart in 1964: “I know it when I see it.”³⁹ The amount of litigation over the years on what constitutes work product, and for that matter pornography, certainly calls such a simple test into question.

The narrow test adopted in *Textron* ignores the issue of multiple purpose documents commonly generated in the due course of business that have traditionally been protected by the work-product privilege. In *Adlman*, the IRS was seeking production of a memorandum prepared by an attorney that evaluated the tax implications of a proposed corporate restructuring. It was expected that the tax benefits from the corporate restructuring would be challenged by the IRS and ultimately lead to litigation. The legal memorandum was prepared to assist the client in evaluating whether to proceed with the restructuring, which decision was largely influenced on the likely outcome of the tax issue if litigated. The memorandum at issue in *Adlman* was prepared to inform a business decision taking into consideration the outcome of possible litigation with the IRS.

The IRS argued in *Adlman*, as it did in *Textron*, that the work-product privilege only applied to documents prepared to assist in litigation. The Second Circuit in *Adlman* rejected this argument on the basis that the wording of Fed. R. Civ. P. 26(b)(3) was clear that the work-product privilege applies to “documents and tangible things prepared in anticipation of litigation or for trial” (emphasis added).⁴⁰ Unlike the *en banc* majority opinion in *Textron*, the court in *Adlman* opted to give meaning to the phrase “in anticipation of litigation” in Fed. R. Civ. P. 26(b)(3). The Court in *Adlman* reasoned that:

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 sufficient.

The text of Rule 26(b)(3) ... expressly states that work-product privilege applies not only to documents “prepared ... for trial” but also to those prepared “in anticipation of litigation.” If the drafters of the Rule intended to limit its protection to documents made to assist in preparation for litigation, this would have been adequately conveyed by the phrase “prepared ... for trial.” The fact that documents prepared “in anticipation of litigation” were also included confirms that the drafters considered this to be a different and broader category.⁴¹

In *Adlman*, the court noted that the work-product privilege is designed “to preserve a zone of privacy in which a lawyer can prepare and develop legal theories and strategy with an eye toward litigation, free from unnecessary intrusion by his adversaries.”⁴² The work-product doctrine provides a privileged area in which the attorney can prepare and analyze his client’s case free from intrusion.⁴³ The court reasoned that “the work-product doctrine suggest strongly that work-product protection should not be denied to a document that analyzes expected litigation merely because it is prepared to assist a business decision.”⁴⁴ If work-product protection is denied to such a document, it places the business person in a precarious position: (i) obtain a legal opinion or analysis setting forth the strength and weaknesses of its position that is subject to discovery by its litigation adversaries, or (ii) decline to make such an analysis due to the risk of discovery

by its litigation adversaries and subject itself and its co-venturers to ill-informed decision making. The court in *Adlman* concluded that “nothing in the policies underlying the work-product doctrine or text of the Rule itself would justify subjecting a litigant to this array of undesirable choices.”⁴⁵ After a thorough analysis, the court concluded that a document created “because of” the prospect of litigation is protected by the work-product doctrine even if prepared for another purpose, such as to assist with a business decision.⁴⁶

In *Adlman*, the court discussed whether “a memorandum prepared by the company’s attorney estimating the likelihood of success in litigation and an accompanying analysis of the company’s legal strategies and options to assist it in estimating what should be reserved for litigation losses”⁴⁷ reviewed by the auditor in assessing the adequacy of reserves for projected litigation is protected by the work-product privilege. In opining that the memorandum was protected by the work-product privilege, the Court rejected the notion that the thoughts, analysis, processes and strategy of an attorney should be provided to his or her adversaries simply because a document served a business purpose. The court in *Adlman* reasoned that such a rule would “allow one party to take advantage of the other’s assessment of his prospects for victory and an acceptable settlement figure.”⁴⁸ The *en banc* majority in *Textron* opted to disregard this issue.

As discussed earlier, a majority of circuits of the U.S. Court of Appeals have adopted the “because of” test in determining whether a document is entitled to work-product protection as did the court in *Adlman*. Under this test, a document is subject to the work-product rule if it was “prepared or obtained because of the prospect of litigation.”⁴⁹

The decision in *Textron* is out of sync with other courts that have been called upon to decide whether tax accrual workpapers are protected by the work-product privilege. In *P.J. Roxworth and Regions Financial Corp.*,⁵⁰ access to tax accrual workpapers was denied to the IRS based on the work-product privilege. In both cases, the workpapers included detailed memoranda prepared by or for legal counsel analyzing the tax consequences of certain transactions. In each case the memoranda outlined the likely challenges to be mounted by the IRS to the tax treatment proposed by the taxpayer, the potential legal arguments and defenses available to the taxpayer, and an evaluation of the

likely outcome of tax litigation. In both cases the respective Court determined that the documents at issue were prepared “because of” the prospect of litigation. In *Roxworthy*, the Court observed that the IRS would obtain an unfair advantage in the pending litigation if it was allowed to gain access to the detailed analysis of the strengths and weakness of the taxpayer’s position. The issue of fundamental fairness was apparently of little concern to the Court in *Textron*.

As in *Textron*, the IRS argued in the *Regions Financial Corp.* case that the tax accrual workpapers “are not entitled to work-product protection because they would have been prepared, even in the absence of the prospect of litigation, to comply with Regions’ public reporting requirement.”⁵¹ The court in *Regions* rejected this argument, reasoning that “Regions would not have to worry about contingent liabilities and would have no need to elicit opinions regarding the likely results of litigation.”⁵² The *en banc* majority in *Textron* acceded to the IRS position given its policy concern of assisting the agency in the discovering the under-reporting of corporate taxes.

The majority opinion in *Textron* emphasizes that its decision is based in large part on public policy: the need for the IRS to detect under-reporting of corporate taxes. That narrow focus gives rise to questions about the applicability of the “prepared for use in litigation” test in nontax cases. Accounting workpapers are prepared to support reserves for potential claims and pending litigation against corporations, whether arising out of tax or nontax issues. For example, corporations are often required to establish reserves on their financial statements for product liability, environmental liability, and contract claims. It is common for auditors to review the opinions or evaluations of such claims by the corporation’s attorney handling the claim or suit. The evaluation of the case will likely point out weaknesses in the case and may point to evidence that is detrimental to the corporation’s case. Making this information available to opposing counsel will certainly give the plaintiff an unfair advantage in the case.

While the Court in *Textron* emphasized the important public policy considerations that support its decision, it uses tunnel vision by focusing exclusively on the impact on the public fisc of allowing access to a corporation’s tax accrual workpapers. It does so to the exclusion of taking into consideration the impact of its decision on nontax cases. Is it the intention of the Court in *Textron* in a product

liability, environmental liability or other similar type claim to allow plaintiff’s counsel to have access to the evaluation of the case by defense counsel provided to the corporation’s auditor in assessing the adequacy of reserves? It is likely that the decision in *Textron* will give rise to a flood of subpoenas (at least in federal courts located within the First Circuit) by plaintiffs’ attorneys seeking the evaluation of cases by attorney’s used for the purpose of setting financial statement reserves. This is not likely the result envisioned by the First Circuit, however, it would seem difficult to fashion one rule for tax cases and another for nontax cases.

Financial Reporting Considerations

During the years at issue in *Textron*, accounting for income tax exposure was guided by FASB Statement No. 5, *Accounting for Contingencies* (FAS 5, now ASC Topic 450). Under FAS 5, financial statements included reserves for projected litigation, including tax litigation which was just one of the many risks of litigation an auditor was required to assess. On July 13, 2006, the FASB issued final Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48, now ASC 740), which amends FAS 5 by removing all references to income tax accruals.

FIN 48 requires a tax position be “more likely than not” to be sustained on its merits before it is recognized in the financial statements. FIN 48 applies to all tax positions, even those that are routine.⁵³ Accordingly, all tax positions need to be assessed in preparing financial statements whether or not litigation is anticipated and whether or not the documents would ultimately be used in litigation proceedings. Given this requirement of FIN 48, it is arguable that tax accrual workpapers will lose work-product protection because they are developed in the “ordinary course of business” of preparing financial statements and not prepared for use in litigation.

Currently, there is no uniform definition of the term “tax accrual workpapers.” In a FAS 5 environment, the term likely was used to mean those workpapers describing the contingent tax liability accrued when the taxpayer took a tax position on the tax return that did not meet a “more likely than not” test as to the sustainability of the position should the tax return be audited by the taxing authorities. These workpapers were likely maintained separately from other workpapers regarding the tax accrual required by FAS 109

to determine the current and noncurrent tax expense including any addition to the deferred tax asset or deferred tax liability accounts.

FIN 48 took the tax accrual for uncertain tax positions and essentially integrated it as a part of the FAS 109 computations. Thus, the taxpayer may have workpapers that would have previously been FAS 5 workpapers that have now been integrated into the FAS 109 workpapers. This presents a potential dilemma should the IRS make a request for the “tax accrual workpapers” post-FIN 48.

Another confounding factor is that corporations, partnerships, and S corporations with gross assets greater than \$10 million must prepare a detailed disclosure of their book-tax differences on Schedule M-3. Included on the M-3 are two lines that require the breakdown of the financial tax expense into its current (*i.e.*, the tax currently payable on the tax return) and its noncurrent (*i.e.*, the change to the net deferred tax asset and liability accounts) tax components. Workpapers prepared to analyze book-tax differences are not protected from summons because they are prepared for financial and tax reporting requirements.

If any sensitive documents were prepared to meet the FIN 48 or tax return disclosure requirements, the only hope of protecting them is to segregate them into a separate folder. For taxpayers who do not reside in the First Circuit, this folder can include documents prepared “in anticipation of litigation,” while taxpayers residing in the First Circuit should use the more restrictive “prepared for use in litigation” standard. To best protect legal opinions and mental impressions of the attorney, the taxpayer should do the following:

- Segregate the summary sheet detailing the composition of the deferred asset and liability accounts from the legal analysis upon which the summary is based.
 - An estimated amount on a summary sheet should reflect that it is an expected value based on the probability of succeeding in litigation as evaluated by an attorney.
 - The attorney’s evaluation should be referenced, but filed separately.
- Directly request an evaluation (legal analysis) of a tax issue from the attorney.
 - The client should request that the attorney prepare a legal analysis of the tax position (as opposed to the CPA making the request).
 - The legal opinion should be addressed and delivered directly to the client by the attorney.
- Any CPA or other nonattorney professional hired to evaluate the tax issue should be engaged by the client’s attorney.
- All opinions and evaluations by a nonattorney should be addressed exclusively to the client’s attorney.
- Indicate if litigation with the IRS is anticipated and the basis of that belief.
 - Is there subjective belief litigation is likely and is the belief objectively reasonable for protection under the “prepared for” or “anticipation of” litigation standard?
 - If a particular transaction has a high audit risk and the intent is to litigate the issue, a statement to such effect included by the client in the instructions to the attorney will bolster the argument that the document is protected from summons.
- Clearly indicate the attorney-author and intended client recipient of the document by name and title.
 - Label or mark the analysis “Attorney Work Product—Privileged and Confidential, Prepared in Anticipation of Litigation” to remind the recipient to file the analysis separately from other workpapers used to prepare tax returns or financial statements.
- Implement policies and procedures to insure the legal analysis is protected from disclosure to any third party.
 - Execute confidentially agreements prohibiting further disclosure or distribution of the documents to third parties.

Conclusion

Corporate taxpayers who find themselves in a post-FIN 48 disclosure world should consider the factors enumerated in *Textron* when preparing workpapers related to disclosures made in the financial statements. Given that these workpapers must be reviewed by the firm’s auditor in order to issue an opinion on the financial statements, they are not protected by the attorney-client privilege or the tax practitioner-client privilege from summons by the IRS. However, the workpapers may be protected by the work-product doctrine under either the “anticipation of litigation” or “prepared for use in litigation” standards used in the *Textron* decisions.

Taxpayers can increase the probability of protecting from summons legal analysis underlying the tax accrual workpapers by taking steps to separately request, mark,

file and protect the mental impressions, opinions and conclusions of their attorneys. Workpapers prepared by nonattorneys that fall outside the steps listed above should be limited to information relevant to the disclosures required under current FASB pronouncements since these workpapers are likely to be considered routinely prepared documents because of FIN 48 and not protected by the work-product doctrine.

Taxpayers who reside in the First Circuit face an uphill task in protecting the “soft spots” in their tax

accrual workpapers from disclosure to the IRS unless *Textron* successfully appeals to the Supreme Court. In the meantime, taxpayers in all circuits face an increased possibility that tax workpapers will fail a “because of” test under FIN 48. Perhaps accounting standard setters could have a meaningful discussion with IRS concerning its policy of restraint regarding tax accrual workpapers and reach a more favorable understanding of what the IRS will and will not request in the audit of a company’s tax return.

ENDNOTES

- ¹ *Textron Inc.*, CA-1, 2009-2 USTC ¶ 50,574.
- ² Code Sec. 7602(a)(1).
- ³ *R.V. Bisceglia*, SCt, 75-1 USTC ¶ 9247, 420 US 141, 150.
- ⁴ *Arthur Young & Co.*, SCt, 84-1 USTC ¶ 9305, 465 US 805.
- ⁵ *Coopers & Lybrand*, CA-10, 77-1 USTC ¶ 9216, 550 F2d 615.
- ⁶ INTERNAL REVENUE MANUAL, §4.10.20.
- ⁷ Announcement 2002-63, 2002-2 CB 72.
- ⁸ *Id.*
- ⁹ *El Paso Co.*, CA-5, 82-2 USTC ¶ 9534, 682 F2d 530.
- ¹⁰ *C.E. Davis*, CA-5, 81-1 USTC ¶ 9193, 636 F2d 1028.
- ¹¹ Announcement 2002-63, 2002-2 CB 72.
- ¹² *Hickman v. Taylor*, 329 US 495 (1947).
- ¹³ *Id.*, at 510.
- ¹⁴ Fed. R. of Civ. P. 23(b)(3).
- ¹⁵ *El Paso Co.*, *supra* note 9.
- ¹⁶ *Id.*, at 540.
- ¹⁷ *M. Adlman*, CA-2, 98-1 USTC ¶ 50,230, 134 F3d 1194; *In re Grand Jury Proceedings*, CA-3, 604 F2d 798 (1979); *National Union Fire Ins. Co. v. Murray Sheet Metal Co., Inc.*, CA-4, 967 F2d 980 (1992); *Binks Mfg. Co. v. National Presto Indus., Inc.*, CA-7, 709 F2d 1109 (1983); *Simon v. G.D. Searle & Co.*, CA-8, 817 F2d 397 (1987); and *Senate of Puerto Rico v. United States Dept. of Justice*, CA-DC, 823 F2d 574 (1987).
- ¹⁸ *Maine v. United States Dept. of the Interior*, CA-1, 298 F2d 58 (2002).
- ¹⁹ *Textron*, DC-RI, 2007-2 USTC ¶ 50,605, 507 FSupp2d 138.
- ²⁰ *Maine v. U.S. Department of the Interior*, CA-1, 298 F3d 60.
- ²¹ *Textron*, *supra* note 19, at 152.
- ²² *Textron*, CA-1, 2009-1 USTC ¶ 50,439, 560 F3d 513.
- ²³ *Textron, Inc.*, CA-1, 2009-2 USTC ¶ 50,574.
- ²⁴ *Id.*
- ²⁵ *Id.*
- ²⁶ *Id.*
- ²⁷ Pease-Wingenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of United States v. Textron*, 8 HOUSTON BUS. & TAX LAW J. 337, 346 (2008).
- ²⁸ *Id.*
- ²⁹ *Textron, Inc.*, *supra* note 23.
- ³⁰ *Id.*
- ³¹ *Id.*
- ³² *Id.*
- ³³ *Id.*
- ³⁴ *Id.*
- ³⁵ *Id.*
- ³⁶ *Id.*
- ³⁷ *Id.*
- ³⁸ *Id.*
- ³⁹ *Jacobellis v. Ohio*, 378 US 184 (1964).
- ⁴⁰ Fed. R. Civ. P. 26(b)(3)
- ⁴¹ *Adlman*, *supra* note 17, at 1198.
- ⁴² *Adlman*, *supra* note 17, at 1196, citing *Hickman v. Taylor*, *supra* note 12.
- ⁴³ *Adlman*, *supra* note 17, at 1197, citing *United States v. Nobles*, 422 US 225, 238 (1975)
- ⁴⁴ *Adlman*, *supra* note 17, at 1199.
- ⁴⁵ *Adlman*, *supra* note 17, at 1200.
- ⁴⁶ *Adlman*, *supra* note 17, at 1202.
- ⁴⁷ *Adlman*, *supra* note 17, at 1200.
- ⁴⁸ *Adlman*, *supra* note 17, at 1202, citing Edward H. Cooper, *Work Product of the Rulemakers*, 53 MINN. L. REV. 1269, 1283 (1969).
- ⁴⁹ *Adlman*, *supra* note 17, at 1202.
- ⁵⁰ *P.J. Roxworthy*, CA-6, 2006-2 USTC ¶ 50,458, 457 F3d 590 and *Regions Financial Corp.*, DC-AL, 2008-1 USTC ¶ 50,345.
- ⁵¹ *Regions Financial Corp.*, DC-AL, 2008-1 USTC ¶ 50,345.
- ⁵² *Id.*
- ⁵³ Proposed FASB Staff Position (FSP) FIN 48-b (ASC Topic 740-10-65), Effective Date of FASB Interpretation No. 48 for Nonpublic Enterprises, would delay the effective date of FASB Interpretation (FIN) 48, Accounting for Uncertainty in Income Taxes, for all nonpublic entities, including nonpublic not-for-profit entities, to fiscal years beginning after December 15, 2008. Nonpublic entities that have already adopted FIN 48 would not be eligible for the deferral.

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