The Impact of *Textron* on State and Local Tax Administration and Practice

By Blaise M. Sonnier

Blaise Sonnier examines the U.S. Court of Appeals for the 1st Circuit’s decision in *United States v. Textron* and explores the potential far-reaching implications of the court’s ruling on state and local tax administration and practice.

Those of us with an interest in taxation have heard and read much about the *en banc* decision of the U.S. Court of Appeals for the 1st Circuit in *United States v. Textron.* The issue in *Textron* is whether the tax accrual workpapers of a publicly-traded company can be withheld from the IRS during the course of a tax audit based on the work product privilege. Under the Federal Rules of Civil Procedure, documents are entitled to work product protection if they were prepared in “anticipation of litigation or for trial.” In *Textron,* the 1st Circuit held that Textron’s tax accrual workpapers were not protected by the work product privilege because they were prepared to assist with the preparation of the company’s financial statements in accordance with generally accepted accounting principles. Because the tax accrual workpapers were not “unquestionably prepared for potential use in litigation if and when it should arise,” the 1st Circuit held that Textron is required to turn over its workpapers to the IRS. Textron has petitioned the U.S. Supreme Court to review and reverse the 1st Circuit’s decision.

After providing some background information about tax accrual workpapers and the work product privilege, this article examines the 1st Circuit’s decision in *Textron* and explores the potential ramifications of the
court's ruling on state and local tax administration and practice. The article concludes with a call for the Supreme Court to grant writs of certiorari in Textron based on the need for uniformity and efficiency in the administration of federal, state and local tax laws and the federal court system.

What Are Tax Accrual Workpapers?

Publicly traded companies are required by federal securities laws to have their financial statements audited by an independent auditor. In preparing financial statements in accordance with generally accepted accounting principles, companies must account for and take into consideration contingent tax liabilities or uncertain tax positions. In examining its uncertain tax positions and contingent tax liabilities, companies usually rely on legal opinions and evaluations by the company’s in-house and outside attorneys. Tax experts, such as certified public accountants, are often retained to assist the company's attorneys in evaluating these uncertain tax positions. The work generated by the attorneys and the experts retained to assist them are usually reflected in written opinions or memoranda delivered to the company.

The company prepares and maintains tax accrual workpapers to document the contingent and uncertain tax positions reflected on its financial statements. Tax accrual workpapers will typically include the following: evaluations of potential or contingent tax liabilities; an explanation of complex transactions; an assessment of the taxpayer's position regarding uncertain tax positions; documents written by the taxpayer's employees describing or evaluating the transaction; and documents and memoranda reflecting the evaluation and analysis of the tax issues by in-house counsel, outside attorneys, and tax experts assisting the company’s attorneys. These workpapers may also include legal opinions obtained by the company prior to entering into the transaction evaluating the proposed transaction, possible tax ramifications and the potential outcome of litigation. Only those documents that reflect or contain the legal opinion, analysis, evaluations, or work by legal counsel or their consultants are eligible for work product protection. The IRS and state tax authorities have much to gain by obtaining access to the treasure chest of valuable, confidential information contained in a company's tax accrual workpapers, which makes the stakes in the Textron decision very high for corporate America.

For tax years beginning after December 15, 2006, the accounting rules for federal, state and local taxes have been changed. To bring uniformity to the way that corporations account for uncertain tax positions, the Financial Accounting Standards Board adopted FIN 48. FIN 48 requires corporations to undertake a more detailed analysis and evaluation of their uncertain tax positions then mandated under prior accounting rules. Additionally, FIN 48 requires that all tax positions be evaluated by management, instead of just those expected to lead to litigation as under the prior rules. Given the more stringent and detailed requirements of FIN 48, tax accrual workpapers of corporations will likely be of even greater interest to the IRS and other tax authorities.

Efforts by the IRS to obtain access to legal opinions and evaluations contained in tax accrual workpapers have generally been stopped by the application of the work product privilege. The IRS' victory in Textron has many in the corporate world justifiably concerned about the future protection of legal evaluations of tax positions and other contingent liabilities contained in the accounting workpapers of corporations.

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The Work Product Doctrine and the Anticipation of Litigation Standard

The work product doctrine was first articulated by the U.S. Supreme Court in Hickman v. Taylor and later codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure. Under Rule 26(b)(3), a party generally may not obtain in litigation “... the
documents and tangible things . . . prepared in anticipation of litigation or for trial by or for another party.” In Hickman, the Court stated that the purpose of the privilege “is 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.” The privilege is also intended to prevent one side from taking unfair advantage of the other in litigation. In U.S. v. Frederick, the 7th Circuit noted that as a matter of fundamental fairness the work product doctrine is necessary “to prevent a litigant from taking a free ride on the research and thinking of his opponent’s lawyer.”

All fifty states have adopted a work product privilege that applies in civil litigation, including tax disputes. The work product privilege adopted by the states is identical or substantially similar to Rule 26(b)(3). Because the states have patterned the language of their work product privilege on the federal rule, state courts often look to federal court decisions for guidance in interpreting their state work product privilege. Accordingly, the impact of the Textron decision will likely extend beyond disputes pending in federal court.

As discussed above, the work product privilege protects documents “prepared in anticipation of litigation or for trial.” Since the Supreme Court’s recognition of the work product privilege in 1947, there has been much litigation over the meaning of the phrase “in anticipation of litigation.” Unfortunately, the Supreme Court has not provided any guidance regarding the breadth and scope of the work product privilege since its decision in Hickman over sixty years ago. As a result, two different standards have historically been used by the courts in determining whether a document was “prepared in anticipation of litigation.” These standards are the “because of” standard followed by a majority of the appellate courts and the “primary motivating purpose” standard applied only in the U.S. Court of Appeals for the 5th Circuit. In Textron, the 1st Circuit muddled up the waters by articulating a third standard: the “prepared for use” standard. Each of these will be discussed in turn.

Under the “primary motivating purpose” standard, a document is entitled to work product protection only if the “primary motivating purpose behind its creation was to aid in possible future litigation.” To satisfy this test, the driving force behind the creation of the document must be in connection with possible future litigation. However, a document need not be prepared for use in the litigation to qualify for work product protection under this standard. Applying the “primary motivating purpose” standard, tax accrual workpapers have been denied protection by the 5th Circuit.

Only the 5th Circuit has adopted the “primary motivating purpose” standard. In rejecting this standard, the U.S. Court of Appeals for the 2nd observed that Rule 26(b)(3) does not require that the document “be prepared to aid in the conduct of litigation in order to constitute work product, much less primarily or exclusively to aid in litigation.”

The “because of” standard has been adopted by eight circuits of the U.S. Court of Appeals: the D.C. Circuit, 2nd Circuit, 3rd Circuit, 4th Circuit, 6th Circuit, 7th Circuit, 8th Circuit, and the 9th Circuit. A document meets the “because of” test if “it was prepared or obtained ‘because of’ the prospect of litigation.” Under the “because of” test, a document need only have been prepared by an attorney or his agent because of pending litigation or anticipated litigation to be entitled to work product protection. In U.S. v. Adlman, the 2nd Circuit opined in dicta that legal opinions obtained by a company to assist in estimating adequate reserves for litigation losses would be protected by the work product privilege. Other courts have more recently reached the same result. In these decisions, the courts have reasoned that were it not for the anticipated litigation with the IRS over tax positions, the respective company would have no need to elicit legal opinions regarding the likely results of litigation. Having been obtained “because of” the prospect of litigation with the IRS, the courts ruled that the legal opinions obtained to support the tax reserves on the financial statements were protected by the work product privilege.

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In *Textron*, the 1st Circuit adopted a new standard, which provides that only documents prepared for use in litigation or those documents that would serve a useful purpose in conducting litigation qualify for the work product privilege. In denying work product protection to tax accrual work papers, the court reasoned that:

Every lawyer who tries cases knows the touch and feel of materials prepared for a current or possible (i.e. in ‘anticipation of’) lawsuit . . . No one with experience of law suits would talk about tax accrual work papers in those terms. A set of tax reserve figures, calculated for purposes of accurately stating a company’s financial figures, has in ordinary parlance only that purpose: to support a financial statement and the independent audit of it.

This language echoes the guidance provided by Justice Potter Stewart in *Jacobellis v. Ohio* when defining obscenity: “I know it when I see it.” Just as the definition of “obscenity” by Justice Stewart has provided little guidance to the courts over the years, the 1st Circuit’s expression of certainty that trial preparation materials are easily identifiable is of little comfort. If this standard is allowed to stand by the Supreme Court, much litigation can be expected over the 1st Circuit’s assertion that trial preparation materials can easily be identified. It is doubtful that attorneys on opposing sides of the issue will often agree on what constitutes trial preparation materials in a discovery dispute and such disagreements will certainly give rise to much litigation over the issue if *Textron* is allowed to stand.

The new standard articulated in *Textron* is narrower and more stringent than any standard previously adopted by a federal court. In adopting its new “prepared for use” standard, the court ignored the language of Rule 23(b)(3), which extends work product protection to documents “in anticipation of litigation or for trial by or for another party.” The “or” in Rule 23(b)(3) is disjunctive applying to documents prepared either (i) in anticipation of litigation or (2) for trial. In adopting its new standard, the court appears to delete or redact the “anticipation in litigation” clause from Rule 23(b)(3). In doing so, it denies protection to documents entitled to work product protection, as evidenced by the clear, unambiguous wording of Rule 23(b)(3).

The 1st Circuit’s decision in *Textron* appears to be driven by the court’s desire to assist the IRS in tax audits and its tax collection efforts. In language more appropriate for a preamble to legislation than a judicial opinion, the court observes that “how far work product protection extends turns on a balancing of policy concerns.” The opinion also contains two statements that reflect the court’s undue attention to policy considerations. First, the court observed that “underpaying taxes threatens the essential public interest in revenue collection.” Second, the court noted that “the practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious.” While both statements may have merit, they are matters more appropriately addressed by the legislative, rather than the judicial, branch of government. They should have no place in the court’s interpretation of the phrase “in anticipation of litigation” in Rule 26(b)(3), a statute that applies in all civil proceedings in the federal courts, not just tax cases.

Policy decisions on how to deal with the underpayment of taxes lie within the realm of the legislative branch of government. If Congress wants to amend the Federal Rules of Civil Procedure to exclude tax accrual workpapers from work product protection, it is free to do so. However, it violates the basic premises of our constitutional system of government for the judiciary to ignore an entire phrase in a federal statute to address an issue of tax policy that it deems important. In doing so, the court is acting as a legislative, rather than a judicial, body.

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In light of the approach taken by the 1st Circuit, litigants in states that have historically applied the “because of” standard can expect to face arguments that the test has been modified by the 1st Circuit’s “prepared for use” in litigation standard.
As mentioned earlier, Rule 23(b)(3) applies in all civil disputes in federal courts. Therefore, in the 1st Circuit, will attorneys representing injured parties in mass tort or products liability actions in federal court now be able to obtain the evaluations of the case by legal counsel for the corporate defendant, if used to establish reserves for financial statement purposes, citingTextron as authority? In the absence of the court's policy concerns regarding the collection of taxes, will the 1st Circuit apply its "prepared for use" standard in non-tax civil actions? If not, how will the 1st Circuit justify different standards for work product protection depending on the type of case before the court?

With the new “prepared for use in litigation test” adopted by the 1st Circuit, there are now three standards applied within the federal court system to determine whether a document has been prepared in anticipation of litigation. The standard applied in a given case will depend on the circuit that the defendant finds itself in as a litigant. Given these different standards and the importance of the work product privilege to the administration of the federal court system, the Supreme Court should grant writs in Textron so that it may adopt a uniform rule to be applied in all federal courts. In addition, the total disregard of the “in anticipation of litigation” phrase in Rule 23(b)(3) by the 1st Circuit gives the Supreme Court the perfect opportunity to articulate a clear, unambiguous, and uniform national standard to determine whether a document is entitled to work product protection.

**SALT Implications of Textron**

As discussed earlier, all fifty states have adopted a work product privilege modeled on Rule 23(b)(3). As a result, state courts look to federal court decisions in interpreting their state’s work product privilege statute. With three standards now adopted by the federal courts to determine whether a document is entitled to work product protection, a party seeking the production of a document will argue for application of the “prepared for use” standard while the party seeking protection of the document will seek application of the traditional “because of” standard.

Even if the highest court of a state has already adopted the traditional “because of” standard, the Textron decision may put the application of that standard at issue. Prior to the Textron decision, the 1st Circuit adopted the “because of” standard in Maine v. United States Department of Interior. The 1st Circuit gave lip service to the “because of” standard and the Maine decision in Textron, but then went on to articulate the new “prepared for use” standard. It did so without reversing the “because of” test adopted in Maine; in fact, the dissenting opinion in Textron observed that “the majority purports to follow the ‘because of’ test” while articulating a new test “asking if the documents were prepared for use in possible litigation.”

In light of the approach taken by the 1st Circuit, litigants in states that have historically applied the “because of” standard can expect to face arguments that the test has been modified by the 1st Circuit’s “prepared for use” standard in litigation standard. If the U.S. Supreme Court does not grant writs in the Textron case, the law of each “because of” state may remain uncertain until the highest court in that state considers the impact of the 1st Circuit’s Textron decision.

Finally, if the Textron decision is allowed to stand, corporations facing litigation in multiple jurisdictions may feel the impact of Textron even outside of the 1st Circuit. The work product privilege is waived upon the disclosure of the protected document to an adversary or a potential adversary. A litigant forced to disclose a document to an adversary in a jurisdiction adopting Textron’s “prepared for use” test will likely face the argument that such involuntary disclosure waives the privilege in all other jurisdictions. As a result, even litigants in “because of” jurisdictions may be required to disclose a document in a suit to their adversary if they were forced to produce the document in a suit in a “prepared for use” jurisdiction. This should be of particular concern to businesses operating regionally or nationally that may face litigation arising out of a single transaction or controversy in multiple jurisdictions.

It is not uncommon for a company operating in multiple states to litigate the same state tax issue in several states (e.g., allocation of gain on sale of assets among states, apportionment of income between states, and physical presence of company in state). The same issue exists in non-tax controversies where a company may face suits such as product liability actions arising out of the same product in multiple jurisdictions. In non-tax suits, plaintiffs may actually forum shop and file their suit in a jurisdiction that is more apt to apply Textron’s “prepared for litigation” standard to gain access to confidential corporate documents for use in all pending suits. This is yet another reason why the Supreme Court should grant writs and reverse Textron.
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Conclusion

The “prepared for use” in litigation standard adopted in Textron threatens to vitiate the work product privilege, putting at risk confidential corporate documents historically protected from discovery. Applying the rule adopted in Textron provides adversaries in litigation access to the mental impressions, thoughts, theories, legal strategy, and work product prepared by an attorney for his client that have historically been protected by the work product doctrine. The “prepared for use” standard will provide a free ride to the party obtaining discovery of attorney work product allowing it “to perform its functions either without wits or on wits borrowed from its adversary.”24 In addition, the 1st Circuit in Textron simply disregarded language in Rule 23(b)(3) that protects documents prepared “in anticipation of litigation” in addition to documents “prepared for use” in litigation. The Supreme Court should grant writs to correct the 1st Circuit’s erroneous decision in Textron.

In any event, now is the time for the Supreme Court to bring uniformity to the application of the work product privilege. Three standards have now been adopted by the U.S. appellate courts in determining whether a document is entitled to work product protection. The result is that documents entitled to protection in some jurisdictions, such as tax accrual workpapers, are not entitled to protection in other jurisdictions. The result will be unnecessary complexity in the administration of our federal, state and local tax systems. It will also result in the unequal treatment of corporate taxpayers in tax disputes depending on where their corporate headquarters are located.

ENDNOTES

1 United States v. Textron Inc., 577 F.3d 21 (1st Cir. 2009).
3 Supra note 1, at 30.
5 Legal opinions and communications included as part of tax accrual workpapers would generally be protected by the attorney-client privilege and the federally authorized tax practitioner privilege. However, those privileges are waived by disclosure of the opinions and communications to a company’s independent auditor.
7 Id. at 510-11.
8 U.S. v. Frederick, 182 F.3d 496, 500 (7th Cir. 1999).
9 U.S. v. El Paso Co., 682 F.2d 530, 542 (5th Cir. 1982).
10 Id.
11 U.S. v. Adlman, 134 F.2d 1194, 1198 (2nd Cir. 1948) (emphasis in original court opinion).
12 Id. at 1202.
13 Id.
15 Supra note 1.
16 Supra note 1, at 30.
18 Supra note 1, at 26.
19 Supra note 1, at 31.
20 Maine v. U.S. Department of Interior, 298 F.3d 60 (1st Cir. 2002).
21 Supra note 1, at 32 (Torruella, J. dissenting).
22 The U.S. Court of Appeals for the 1st Circuit includes the states of Maine, Massachusetts, New Hampshire, and Rhode Island.
24 Supra note 6, at 516 (Jackson, J., concurring).

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