In a closely watched case, a district court last week quashed an administrative summons seeking disclosure of a company’s tax accrual workpapers. In United States v. Textron, 06-cv-198T (D. R.I. Aug. 29, 2007), the Government sought enforcement of an IRS summons issued to Textron near the conclusion of an IRS audit that included an examination of Textron’s participation in several sale in, lease out (SILO) transactions. The workpapers in dispute were prepared by Textron’s attorneys to ensure that the company placed appropriate amounts into its tax reserves for financial accounting purposes. They contained lists of items on Textron’s tax returns, including presumably the SILO transactions, that the company’s attorneys believed could be challenged by the IRS, as well as estimates by those attorneys of the company’s chances of prevailing in litigation over those issues. The workpapers were examined by the company’s external auditors.

Textron fought enforcement of the summons, asserting attorney-client privilege, tax practitioner-client privilege under Code § 7525, and attorney work product privilege. The court concluded that the workpapers were entitled to privilege under all three theories, but also held that Textron had waived its attorney-client and tax practitioner-client privileges by turning the workpapers over to the company’s auditors. Because, however, there had been no waiver of the work product doctrine, workpapers were shielded from the summons.

The Court’s Work Product Analysis

In defining when a document has been prepared in anticipation of litigation, the courts have moved away from a “primary purpose” test, under which documents will be treated as work product only if they were prepared primarily for a litigation purpose. The majority test is now a “because of” test (i.e., was the document prepared because of the prospect of litigation), which recognizes that documents can be prepared for multiple purposes. Applying the broad “because of” test, the Textron court concluded that the workpapers satisfied the “in anticipation of litigation” requirement of the work product privilege because “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.” The court was also satisfied that Textron reasonably believed litigation was likely, noting that the workpapers dealt with issues that were unclear and that in seven of its past eight audit cycles Textron had taken unresolved issues to Appeals and litigated three disputed issues.

Unlike the attorney-client privilege, and the derivative Code § 7525 protection, work product protection is waived only by disclosures that are inconsistent with keeping the information from adversaries. The court held that Textron’s disclosure of the workpapers to its auditors was not a waiver of any work product protection because the auditors agreed to keep the papers confidential and thus the disclosure did not increase the chance that an adversary would obtain the information.

Finally, the court concluded that the Government had not met its burden of demonstrating a “substantial need” for the workpapers. The Court noted that the determination of Textron’s tax liability must be based on factual information, which was not contained in the workpapers and which was readily available to the IRS through other means. The court noted that, “[w]hile the opinions and conclusions of Textron’s counsel and tax advisers might provide the IRS with insight into Textron’s negotiating position and/or litigation strategy, they have little bearing on the determination of Textron’s liability.”
Textron is a significant taxpayer victory illustrating that, although the IRS’s summons authority is a potent tool to gather relevant information, such authority does not trump the protections of the work product doctrine. The work product doctrine thus protects a taxpayer from forced disclosures of legal assessments and opinions on the strength of a case contained in its tax accrual workpapers.

The key holding in Textron is that the tax accrual workpapers were protected work product because the attorneys would not have created them but for the fact that the taxpayer reasonably anticipated litigation over the matters reflected in those workpapers. The decision could thus provide taxpayers with a roadmap for the creation and handling of tax accrual workpapers to capitalize on work product protections in the event of controversy with the IRS. The court’s decision:

- reinforces that work product applies when there is a reasonable expectation of an administrative dispute without necessarily showing that the issue will actually go to court;
- clarifies that disclosure to an independent auditor does not destroy the work product protection; and
- draws a clear distinction between tax accrual workpapers prepared by a taxpayer with the assistance of counsel and workpapers prepared by an outside auditor such as in United States v. Arthur Young & Co., 465 U.S. 805 (1984).

What Next?

Don’t expect the IRS to capitulate. IRS Chief Counsel Korb has already stated that the government is likely to appeal Textron to the First Circuit, and the Government will likely relitigate these issues in other circuits if Textron is affirmed. Further, Textron presented an unusually strong case for the taxpayer. Textron established that its workpapers were prepared by counsel and reflected counsel’s analysis of the hazards on an issue-by-issue basis. Textron also demonstrated that it had a longstanding and contentious relationship with the IRS, with unagreed issues routinely taken to Appeals or to court. Finally, Textron had complied with 500 IDR's in connection with the current audit, so the court could have reasonably concluded that the IRS had access to all relevant factual information. Expect the IRS to attempt to distinguish these facts in subsequent cases.

The Textron decision also comes during a general push for greater corporate transparency from multiple sources. In the post-Enron era, independent auditors are already compelled to scrutinize tax reserves more closely, and in this process auditors have frequently required taxpayers to disclose otherwise privileged opinions. FIN 48 further provides guidance on the accounting treatment of uncertain tax positions and increases the transparency of those positions through its enhanced disclosure requirements. Lastly, the Senate Permanent Subcommittee on Investigations has recently requested tax accrual information from several public companies as part of an investigation into tax compliance by U.S. multinationals. In the coming months, as taxpayers weigh disclosures on these multiple fronts, the full impact of Textron will be revealed.

For further information, please contact any of the following lawyers:

Kevin Kenworthy, kkenworthy@milchev.com, 202-626-5848

Alan Horowitz, ahorowitz@milchev.com, 202-626-5839

Laura Ferguson, lferguson@milchev.com, 202-626-5567
commercial purposes. If you give a copy to anyone else, it must be in its original, unmodified form, and must include all attributions of authorship, copyright notices, and republication notices. Except as described above, it is unlawful to copy, republish, redistribute, and/or alter this presentation without prior written consent of the copyright holder.