THE NATIONAL LAW JOURNAL

IRS fights for tax papers

Marcia Coyle / Staff reporter
July 28, 2008

WASHINGTON — The business and legal communities, concerned about the erosion of the attorney-client privilege in corporate investigations by federal prosecutors, face another privilege battlefront, one with potentially wide-ranging impact — attorney work-product demands in tax investigations.

While the attorney-client privilege controversy plays out in the halls of the Department of Justice and Congress, the work-product fight is now taking clear shape in the federal courts.

The 1st U.S. Circuit Court of Appeals has set a Sept. 5 date for arguments in the closely watched *U.S. v. Textron Inc.*, No. 07-2631, and the government has filed its notice of appeal to the 11th Circuit in a similar tax case, *Regions Financial Corp. v. U.S.*, No. 2:06-CV-00895 (N.D. Ala. 2008).

In each case, a federal trial judge, relying on the work-product doctrine, rejected the Internal Revenue Service's demand for the company's so-called tax accrual workpapers. Such workpapers are prepared with the assistance of in-house and external counsel and relied upon by independent auditors to determine the accuracy of financial statements.

As in the *Textron* and *Regions* cases, those workpapers often contain legal analyses and evaluations of potential litigation risks associated with particular tax transactions.

The two key issues facing the circuits in this controversy are whether the workpapers are protected work product and, if they are, whether that protection is waived when a company shares the workpapers with its auditors.

Good policies bumping heads

The work-product controversy is a "classic case of very good public policies bumping heads," said Alexander L. Gabbin, professor of accounting at James Madison University, who has studied the *Textron* case.

Or it is "something of a perfect storm," triggered by post-Enron demands for greater financial disclosures, said Robin L. Greenhouse, a tax partner in the Washington office of McDermott, Will & Emery, and an authority on the attorney-client, work-product and tax-practitioner privileges.

The competing interests here, they explained, are the Internal Revenue Service (IRS) having an obligation to ensure that companies pay the correct amount of taxes; companies needing to consult attorneys to meet their obligation to present full and accurate financial statements without fear that their adversaries will obtain sensitive information; and auditors requiring full disclosure to meet their own obligation to protect the public.

If the courts accept Textron's arguments, there will be "a level of protection" for company management, said Gabbin.

THREE KEY CASES

Precedents involving tax accrual workpapers:

- *U.S. v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982): work-product protection does not apply.
- *U.S.v. Textron Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007): work-product protection applies (now on appeal to the 1st Circuit).
- *Regions Financial Corp. v. U.S.*, No. 2:06-CV-00895-RDP (N.D. Ala. May 8, 2008): company's tax workpapers are protected (now on appeal to the 11th Circuit).

If they follow the Internal Revenue Service's arguments, there will be "open season" by companies' adversaries, said a number of tax litigators, and not just in the tax arena.

The work-product protection at issue in *Textron* and *Regions* is there because companies need to be able to prepare their litigation positions without fear that their adversaries are going to benefit from them, said litigator Robert Malionek, a partner in the New York office of Latham & Watkins who filed a brief for the Association of Corporate Counsel and the U.S. Chamber of Commerce supporting Textron.

"There are adversaries that think of these [workpapers] as gold mines," said Malionek. "The IRS stance, and perhaps its more aggressive posture of late, is probably only the latest battleground on this issue."

Seeking guidance

The 1st Circuit decision in *Textron* would be the first appellate decision to provide guidance on whether sharing work-product documents with auditors is a waiver of the protection, said Malionek and others, but before the court reaches that issue it must decide whether the tax accrual workpapers are protected work product.

Federal Rule of Civil Procedure 26(b)(3) says that to qualify for work-product protection, a party must show that the document was "prepared in anticipation of litigation or for trial." Courts have struggled to articulate a clear test for applying that standard, said Greenhouse, but two tests essentially have emerged.

In 1982, the 5th Circuit denied protection to tax accrual papers under a test requiring that "the primary motivating purpose" behind the creation of the documents be "to aid in possible future litigation." *U.S. v. El Paso Co.*, 682 F.2d 530.

But since then, Greenhouse said, circuits that have faced the question, including the 1st Circuit, have rejected the 5th Circuit test in favor of the inclusive "because of" test articulated by the 2d Circuit. To be protected, the document must "have been prepared or obtained because of the prospect of litigation."

In the 1st Circuit, Nathan Hochman, assistant attorney general for the Justice Department's Tax Division, argues that the relevant case law and the facts in *Textron* demonstrate "that tax accrual workpapers are prepared in the ordinary course of a public company's business in order to comply with federal securities laws, not because of litigation," and would have been created regardless of potential litigation.

Textron's counsel, John A. Tarantino of Adler Pollock & Sheehan in Providence, R.I., and Arthur L. Bailey of Washington's Steptoe & Johnson LLP, counter that the workpapers — spreadsheets containing the attorneys' litigation-hazard analyses — are protected because they were prepared by Textron's attorneys in anticipation of litigation with the Internal Revenue Service. The fact that the document is used for some other purpose does not cause the document to forfeit work-product protection under the "because of" test.

"The district court found that Textron's regular disputes with the IRS created a reasonable anticipation of litigation," Textron's attorneys wrote in their brief.

On the waiver question, the government argues that disclosure of work product to a potential adversary, or to a potential conduit to a potential adversary waives the protection. Here, the Ernst & Young auditors are a potential adversary and a potential conduit to other adversaries, such as the U.S. Securities and Exchange Commission.

But Textron counters that "the great weight of the caselaw" and the facts support the district court's finding that the independent auditors were not Textron's adversaries or potential conduits.

Potential carryover

"This has been closely watched in the tax community but the untold story is the potential carryover into the nontax context," said Kevin Kenworthy, a member at Washington's Miller & Chevalier, who filed a brief for Financial Executive International, supporting Textron.

"There seems to be no reason to me why tax is unique here."