Court Rules on IRS Access to Tax Accrual Workpapers

By Kevin L. Kenworthy and Alan I. Horowitz

A new court case provides insight into whether the IRS can demand access to tax accrual workpapers reflecting a taxpayer's candid self-assessment of its tax exposure.

NEW CASE ➤ A divided panel of the First Circuit Court of Appeals has affirmed the key holdings of a lower court ruling regarding work-product protection of Textron's tax accrual workpapers. [*United States v. Textron, Inc.*, No. 07-2631 (Jan. 21, 2009)] The court of appeals ruled that these documents generally qualify for work-product protection when they contain analysis of the prospects of success on issues that might be challenged by the IRS. The court also ruled that this protection is not automatically waived by disclosure of the workpapers to an independent auditor. The court signaled, however, that the protection can be waived by such a disclosure if the taxpayer's own analysis is evident from the auditor's workpapers, and it remanded to the district court to resolve this question on the facts of this case. Thus, the fight over IRS access to tax accrual workpapers continues.

Case Background

In the course of examining Textron's participation in several sale-in, lease-out (SILO) transactions, the IRS issued a summons seeking tax accrual workpapers prepared by Textron or Ernst & Young (E&Y), Textron's independent auditor. The summons was issued under the IRS's modified policy of restraint regarding tax accrual workpapers. [Announcement 2002-63, 2002 CB 630.]

Textron's workpapers were prepared by its 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 that the company 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. Textron showed its workpapers to E&Y, but did not permit the auditor to retain copies. E&Y prepared its own workpapers as part of its examination of Textron's financial statements, but did not share those workpapers with Textron.

Textron resisted the IRS request, and the IRS sued to enforce its summons.

Workpapers Prepared "In Anticipation of Litigation"

The trial court ruled that the IRS could not compel the production of tax accrual workpapers prepared by Textron's attorneys under the work-product doctrine, which generally protects documents prepared in anticipation of litigation. The workpapers were considered to have been prepared in anticipation of litigation even though they also aided in computing the appropriate tax reserves for financial accounting purposes.

The First Circuit has now affirmed this central holding by the trial court. In determining whether dual-purpose documents such as tax accrual workpapers are "prepared in anticipation of litigation," and thus eligible for work-product protection, the First Circuit and several other circuits apply what has been termed the "because of" test. The First Circuit concluded that the documents "were prepared 'because of' the risk of disputes and litigation which gave rise to a need to compute and report tax reserves." In so ruling, the First Circuit also confirmed that adversary administrative proceedings before the IRS constitute "litigation" for purposes of the work-product doctrine.

Judge Boudin dissented, disagreeing with the majority's application of the "because of" test and arguing that only documents prepared to be useful in litigation come within the work-product protection. According to the dissent, the evidence presented here showed that the sole reason for the preparation of the tax accrual workpapers was to establish accounting reserves and to satisfy Textron's auditors that those reserves were adequate.

The majority soundly rejected the government's assertion that the trial court's holding was contrary to the Supreme Court's decision in *Arthur Young & Co*, SCt, 84-1 USTC ¶9305, 465 US 805 (1984). In that case, the Supreme Court had declined to recognize a new accountant's work-product privilege and thus refused to shield disclosure of tax accrual workpapers prepared by an independent auditor. The First Circuit found *Arthur Young & Co.* not pertinent, both because Textron was not seeking recognition of a new privilege and because that case did not involve the kind of dual-purpose documents at issue here.

The First Circuit readily acknowledged that its holding here highlights a split with the Fifth Circuit over the scope of the work-product protection. The Fifth Circuit has long limited work-product protection to documents whose "primary purpose" is to aid in future litigation, whereas the

First Circuit and other courts have rejected that approach in favor of the "because of" test. Applying the "primary purpose" test in *El Paso Co.*, CA-5, 82-2 USTC ¶9534, 682 F2d 530 (1982), the Fifth Circuit had ruled that a company's "tax pool analysis" did not qualify for work-product protection.

Issue of Waiver Remains Unresolved

The work-product doctrine is intended to preserve fairness in our adversarial system of dispute resolution. Unlike the attorney-client privilege, disclosure outside the confidential attorney-client relationship does not generally waive work-product protection. Instead, work-product protection is waived only by disclosures that are inconsistent with keeping the information from a litigation adversary. Thus, a waiver may occur if work product is disclosed to an adversary or to a conduit to a potential adversary.

The First Circuit joined a growing number of courts that have held that disclosures to an independent auditor do not generally waive work-product protection. The court noted that the relationship between reporting company and independent auditor is "cooperative not adversarial." Acknowledging that there might be circumstances in which Textron and E&Y might have a legal disagreement, the court found no evidence that there could be such a dispute arising from the disclosure of Textron's tax accrual workpapers. However, the First Circuit remanded the case to the trial court for further proceedings to determine if Textron waived the protection on the ground that, on these facts, E&Y was a potential conduit to the IRS.

On remand, the trial court first will determine if Textron can obtain E&Y's audit workpapers. Generally, the recipient of formal IRS demand for documents may be compelled to produce all relevant documents within its possession, custody or control. However, the trial court's ruling only addressed arguments concerning Textron's own workpapers and did not rule on whether Textron could be compelled to produce the E&Y workpapers. The First Circuit ruled the failure to address this question was an error. The First Circuit rejected Textron's contention that the record already establishes that the company does not have possession, custody or control of E&Y's workpapers. In the court's view, the record merely establishes that Textron did not receive the E&Y workpapers, not that it could not obtain copies of those workpapers upon request.

Assuming the trial court determines on remand that Textron can be compelled to secure and produce copies of E&Y's workpapers, the trial court will evaluate whether and to what extent E&Y's workpapers reveal Textron's own work-product analysis. The First Circuit assumed without discussion that the IRS can obtain access to everything in E&Y's own tax accrual workpapers under the authority of *Arthur Young & Co.*, Based on this assumption, the First Circuit reasoned that, "[s]ince E&Y's workpapers may be discoverable, the question we must ask is whether disclosure of those workpapers substantially increased the risk that the contents of Textron's workpapers would be disclosed to an adversary." In order to answer this question, the trial court was instructed to make this determination on remand through testimony or inspection of the documents in a judge's chamber.

The court's reasoning in ordering a remand is unclear given that the court had already held that Textron had not waived work-product protection by disclosing its tax accrual workpapers to E&Y. Ordinarily, otherwise discoverable documents that contain privileged information can be redacted to protect the privilege. Although the IRS can demand disclosure of an independent auditor's workpapers under the authority of *Arthur Young & Co.*, there was no claim in that case that any of the summoned material incorporated protected attorney work product. Consequently, the Supreme Court's decision does not suggest that an auditor's workpapers cannot be redacted before production to the IRS if they contain privileged information.

The First Circuit's reasoning in ordering a remand to the trial court is fundamentally circular. It assumes that Textron's legal analysis must be disclosed when embodied in the auditor's workpapers, but the only reason given for the loss of work-product protection is that Textron should be deemed to have waived that protection because of the possibility of this disclosure. Moreover, the extent to which Textron's analysis can be found in the auditor's workpapers is outside of Textron's control; it depends entirely on the auditor's method of preparing its workpapers. The better analysis is that the work-product protection remains intact—and can be safeguarded through redaction—when the information is incorporated into an auditor's workpapers. Hence, there is no waiver and no disclosure.

What Next?

The next step in the litigation over the Textron summons is unclear at this time. The most orderly way to proceed would be for the parties to return to district court and resolve the remaining issues framed by the majority opinion. It is possible, however, that the government will seek further appellate review at this time. Indeed, the sharply worded dissent of Judge Boudin appears

to invite a petition for rehearing *en banc* (*i.e.*, by the full court) in explicitly suggesting that the majority's ruling exceeded the authority of a court of appeals panel. And given the clear conflict with *El Paso* and the disharmony in the circuits regarding the test for work-product protection, a petition for Supreme Court review is also a distinct possibility. A petition for en banc rehearing would be due on March 9, and a petition for certiorari would be due on April 21.

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MANAGING YOUR BUSINESS

Some Execs See Recession Lasting Into 2011

Executives in the United States and abroad have a gloomy outlook on economic conditions—at least in the near future, according to recent surveys.

As Economy Falters, Outlook Is Dim

On a global basis, CEOs' confidence about future prospects for business is at its lowest level since PricewaterhouseCoopers (*www.pwc.com*) started tracking CEOs' forecasts in 2003. A mere 21 percent said they are confident of revenue growth in the coming year, compared to 50 percent in last year's survey. More than one quarter of respondents are pessimistic about the prospects for 2009.

Only 34 percent of CEOs worldwide are very confident about growth over the next three years, compared to 42 percent last year, according to PricewaterhouseCoopers.

"The speed and intensity of the recession has rocked the psyches of CEOs and created a global crisis of confidence," said PricewaterhouseCoopers Global CEO Samuel A. DiPiazza, Jr. "CEOs are most concerned about the immediate survival of their companies. Even in once rapidly emerging economies, companies are now coping with issues like unavailable credit, sluggish capital markets, and collapsing demand."

He added, "The severity and duration of the recession are difficult to predict and CEOs are balancing the challenges of successfully managing through the downturn while also remaining prepared for economic turnaround. Their prospects for recovery are truly connected."

Meanwhile, more than 58 percent of U.S. finance executives participating in a recent online survey by Deloitte (*www.deloitte.com*) expect the recession to last for two to three more years.

But that might be a bit of a pessimistic view. "Given the dollar amount of stimulus funds currently being pumped into the banking system, we are more likely to experience a faster recovery than the survey results suggest, and it could come as soon as late 2009," Carl Steidtmann, chief economist at Deloitte Research, said in late January. "For our economy to recover, it is imperative that our banking system is restored to health and balance sheets are stabilized."

Credit Crisis Impacts Businesses

Nearly 70 percent of CEOs in PricewaterhouseCoopers' survey said the credit crisis will impact their companies. Among those CEOs, almost 80 percent have been confronted with higher financing costs, and as a result, nearly 70 percent expect to delay planned investments.

In Deloitte's survey, 45 percent of U.S. executives expect it to take at least one year for liquidity in the credit markets to increase, while nearly 43 percent expect it will take two to three years.

Companies Anticipate Regulatory Changes

About 32 percent of executives surveyed by Deloitte expect a "very active" level of government regulatory and enforcement activity in their industry over the next five years.

Meanwhile, 55 percent of CEOs in the PricewaterhouseCoopers survey see over-regulation as an obstacle to growth. Paradoxically, however, survey participants also said that their governments have not done enough to create a skilled workforce (nearly 50 percent) or improve infrastructure (38 percent).

In addition, more than 80 percent of the CEOs favor clear, consistent government policies to address climate change, but only 28 percent indicate that their governments have such policies, according to PricewaterhouseCoopers.

Top Issues Affecting U.S. Executives

A separate Deloitte report, *Challenging Times, Emerging Opportunities*, examines the top issues facing U.S. executives across more than a dozen industries in 2009.

"In 2009, the United States must deal with some of the greatest economic challenges it has encountered in two genera-