TAX ACCRUAL WORKPAPERS

THE DISCOVERY STATUS OF TAX ACCRUAL WORKPAPERS AFTER *TEXTRON*

The Supreme Court should review the First Circuit en banc panel decision in Textron and address the split of authority regarding the discovery of tax accrual workpapers by the IRS.

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In a decision deserving of Supreme Court review, [1] the First Circuit in *Textron* [2] has vacated the district court's determination that a public corporation's tax accrual workpapers were protected from IRS summons by the work-product doctrine. Instead, the First Circuit held that the work-product privilege was not implicated with regard to the taxpayer's tax accrual workpapers, because it found that the workpapers were not prepared "for" litigation and were required to be produced pursuant to an IRS administrative summons. [3]

The First Circuit noted that the IRS's right to compel the production of these types of records was important in detecting and disallowing the benefits sought by taxpayers investing in potentially abusive tax shelters. The taxpayer had indeed invested in nine sale-in, lease-out (SILO) transactions which were "listed transactions." [4] After experiencing recent judicial defeats, the *Textron* case reflects the determination of the IRS Commissioner to have the judicial system reflect the proper goals and aims involved in administering the tax laws.

Effective administration requires the production of non-privileged information used in preparing returns, including underlying tax analysis that supports positions and details the anticipated risk that a deficiency in tax, penalties, and interest may follow. The need to obtain tax accrual workpapers is heightened where the returns reflect tax items attributable to tax-motivated transactions. The First Circuit essentially agrees with the IRS's efforts to obtain tax accrual workpapers during discovery in appropriate cases, such as *Textron.* It places corporate tax payers on notice that some courts will find that tax accrual workpapers or FIN 48 workpapers are not "work product" per se, as was the position taken by the First Circuit, while

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other courts may use the Fifth Circuit's standard [5] and determine that workpapers are not primarily prepared in anticipation of litigation.

Work-Product Doctrine

Related to, but distinctly separate from, the attorney-client privilege is the immunity from discovery granted to an attorney's work product (although qualifying work product

extends beyond a lawyer's work). Indeed, the work-product doctrine is broader in scope than the attorney-client privilege and the tax practitioner-client privilege under Section 7525, as it is not limited to confidential communications between an attorney and client. Technically, however, it is not a "privilege." Rather, it is a qualified protection against production. [6] The protection is not unqualified, however, and discovery may be permitted if the party seeking access establishes adequate reasons. [7]

In *Hickman v. Taylor*, [8] the Supreme Court's rationale for protecting work product as privileged was "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 rule was later adopted in Federal Rule of Civil Procedure (FRCP) 26(b)(3), which provides:

> "(3) Trial Preparation Materials.... a party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative ... only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means."

The work-product doctrine protects documents prepared "in anticipation of litigation" by or for another party, or by or for that other party's representative. Work product includes documents, statements, correspondence, affidavits, briefs, interviews, attorney notes, and

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other items, including models or exhibits prepared by an attorney in anticipation of litigation. Although the IRS may be able to compel production of a work-product document by establishing a substantial need for it, an attorney's mental impression is entitled to substantial protection, more so than factual information also contained in documents prepared in anticipation of litigation. [9] The Supreme Court in *Upjohn* made it clear that the work-product doctrine can be invoked by a taxpayer to block the attempt to compel the production of such materials by administrative summons or discovery request by the IRS.

The question of how imminent the litigation must be is very fact specific, requiring the courts to analyze the facts present in each case. Some decisions play down the "imminence" requirement. What all courts insist on, however, is that the work-product protection can apply only if the attorney "had a subjective belief that litigation was a real possibility, and that belief must be objectively reasonable." [10]

The class of documents that are protected under the work-product doctrine can be conceptually distinguished from nonqualifying documents. More particularly, materials that are "assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation" are not protected. [11] Courts have held that "[d]ocuments prepared ... pursuant to regulatory requirements are not classified as attorney work-product." [12]

Fact Work Product.

Fact work product includes correspondence, interview notes, and general fact memoranda involved in anticipation of trial. Thus, if a memorandum prepared with the requisite "view" towards litigation against the IRS discusses business records that might be

relevant to or introduced into evidence at trial, that memorandum is non-discoverable work product. [13] Still, the IRS could presumably summons the underlying business records. Similarly, witness statements given in anticipation of a tax trial may also be non-discoverable work product, but the IRS could depose or subpoena the witness to testify.

Documents that are not created in anticipation of litigation (like general business records), whether in a civil or

criminal case, including grand jury proceedings, are not fact work product and are discoverable.

Opinion Work Product.

Opinion work product has greater immunity from discovery than fact work product. Opinion work product involves notes, memoranda, or other documents reflecting the mental impression or processes of the attorney with respect to the potential litigation at hand. [14] Opinion work product includes materials reflecting a lawyer's or tax advisor's (under Section 7525(a)) analysis of the law, analysis of an adversary's position, potential legal theories, strategies for handling the controversy, and analyses of different forums. In general, the question of what constitutes opinion work product is construed broadly in favor of protecting this material.

Blend of Fact and Opinion Work Product.

Some documents contain both fact and opinion work product, which may make a determination of the underlying character difficult. In these instances, a court may order the opinions or mental impressions of legal counsel redacted rendering discoverable the remaining portion of the ordinary work product.

Overcoming the Work-Product Privilege: Proving "Substantial Need to Compel Production."

Unlike the attorney-client privilege, the work-product privilege is a qualified privilege that may be overcome by a showing of "substantial need" under FRCP 26(b)(3). The burden of establishing "substantial need" is on the party seeking to overcome the privilege. When "opinion work product" consisting of "mental impressions, conclusions, opinions or legal theories" of attorneys is involved, the burden of establishing substantial need is greater than it is with respect to documents that are merely obtained by a party. [15]

Standards Used by the Courts to Identify What Is "Work Product."

The Textron litigation and related cases involved the standards to be used by the courts in filtering out, on a document-by-document basis, documents and memoranda that are privileged under either the attorney-client privilege or federal tax practitioner privilege, and, as is more relevant in this article, what is work product. As to this last category of privileged information, the courts have applied two different tests.

Primary purpose test. Under the primary purpose test, the protected documents are those where the primary motivating purpose behind their creation was to aid in possible future litigation. [16] On the other hand, documents created primarily in the ordinary course of business are not work product. As discussed below, this is the holding in the First Circuit's decision in Textron. [17]

"Because of" test. Under the broader and far more protective "because of" test, the relevant inquiry is whether the document was prepared or obtained "because of" the prospect of litigation. In *Adlman*, [18] the Second Circuit determined that the "because of" test was more consistent with both the literal terms and the purposes of FRCP 26(b)(3). Thus, where a document is created "because of" anticipated litigation, and would not have been prepared in substantially similar form "but for" the prospect of litigation, it is within the protected class of work product.

Dual purpose documents. Tax accrual workpapers are frequently analyzed as "dual purpose" documents, i.e., documents prepared both in anticipation of litigation and for ordinary business purposes. Again, in a dual purpose context, some courts require that the primary motivating purpose for the creation of the document is to assist in pending or anticipated litigation. Others have held that the "but for" test, if satisfied, can protect dual purpose documents. An important case in this area is *Frederick*, [19] where the Seventh Circuit held that a "dual-purpose" document prepared for use in preparing tax returns and for use in litigation was not protected. The *Frederick* court felt that the dual purpose argument could be unfairly exploited by taxpayers in hiring accountants in filing their clients' tax returns. Under the facts of that case, the taxpayers were under investigation and the court felt that work-production protection was inappropriate. [20]

Waiver of Work-Product Privilege.

A "waiver" of the work-product doctrine is applicable, generally, where information or documentation is turned over to an adversary (or a conduit for eventual delivery to an adversary). In another context, where a party reveals privileged information to gain an advantage in litigation, a waiver of the subject matter of the information is deemed to have occurred. [21]

Voluntary disclosure of work product to third parties does not automatically waive work-product protection, unlike the principle applied to waivers of the attorney-client privilege and federal tax practitioner privilege. So what happens when tax accrual workpapers are turned over to an independent accounting firm for preparation of financial statements that are going to be submitted to the SEC? Are tax accrual workpapers work product? If so, does a taxpayer risk waiving

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work-product protection by sharing this information with an auditor? What if opinions or legal analysis of problem areas on returns for "open" years are shown to the outside auditors (and assuming that the disclosure waives attorney-client privilege), can these opinions or legal analyses be protected from discovery as work product? As discussed below, most courts that have considered this issue have held that there is no waiver of work product when tax accrual workpapers are shown to an independent accounting firm, because showing tax accrual workpapers to an independent auditor does not substantially increase the opportunity for potential adversaries to obtain the information.

Tax Accrual Workpapers

Tax accrual workpapers are comprised of documents and memoranda relating to a taxpayer's or independent accounting firm's evaluation of a company's reserves for contingent tax liabilities. Tax accrual workpapers frequently identify questionable positions the company may have taken on its tax returns and reflect the company's opinions regarding the validity of those positions. Tax accrual workpapers may include:

> (1) A summary of the transactions recorded in the taxpayer's general ledger pertaining to income tax account.

(2) Computations of the taxpayer's income tax position for the current year.
(3) Memoranda addressing items reflected in financial statements as income, expense, or chargeable to capital, etc., when the proper tax treatment is unclear or uncertain. [22]

Although sensitive to claims that the production of tax accrual workpapers and the underlying legal analysis used in establishing the amount of the tax reserve is unfair and overreaching as it provides a roadmap to the tax auditor of a taxpayer's perceived "soft spots" on its previously filed tax returns, the IRS nevertheless has continually asserted that under the required records doctrine, and in furtherance of its watchdog function in administering the tax laws, it has the right to compel the production of tax accrual workpapers. [23] In deference to widespread criticism from the business

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and professional communities on this issue, however, the IRS has adopted a policy of restraint in attempting to review these schedules. Namely, IRS audit guidelines direct the examining agent to the taxpayer's business records as the primary source of information, leaving access to tax accrual workpapers as only a remote possibility. This policy of restraint has been noted by the courts, including the First Circuit in the *Textron* opinion.

Impact of SEC Financial Statement Filings.

Public companies that file financial statements with the SEC are required by SEC regulations to use outside auditors to verify that the financial statements have been issued in accordance with Generally Accepted Auditing Principles (GAAP). [24] As part of financial statement production, the balance sheet must provide for contingent future tax liabilities beyond the tax liabilities reported on filed returns. In order to meet this obligation, a public company must prepare in-house, or have prepared by outside auditors, an analysis of their contingent tax liabilities or tax accrual workpapers. While the analysis must forecast the cumulative results of IRS audit, settlement, and litigation, the tax pool or tax accrual workpapers analysis itself is not prepared to respond to a specific charge by the IRS or to any pending or impending lawsuit. The tax pool analysis is undertaken solely to ensure that the corporation sets aside on its balance sheet a sufficient amount to cover contingent tax liabilities.

Impact of FIN 48 on Reporting in Accordance with GAAP.

In June 2006, the Financial Accounting Standards Board (FASB) approved the final version of FIN 48 (under FASB Statement 109 (1992)) for GAAP reporting with respect to uncertain tax positions. [25] FIN 48 applies to companies whose shares of stock are publicly traded and are required by the SEC to report "fair value" filings, as well as entities and enterprises that report financial results under GAAP. FIN 48's scope extends to all entities that use the GAAP method for financial accounting purposes, including tax-exempt organizations and pass-through entities.

Fin 48 Reporting Standards.

In abandoning the prior calculus of whether a tax item would probably, reasonably possibly, or remotely possibly survive IRS review, FIN 48 establishes a "recognition" or "nonrecognition" approach. For recognition of a tax position, the particular "unit of account" or item must have a more-likely-than-not chance of being sustained on the merits through audit, administrative, and judicial review. If the position is "recognized," the next or second step is to measure the expected benefit.

The portion not to be recognized is treated as a separate liability on the balance sheet. FIN 48 provides a detailed set of principles and applicable rules used to determine how to treat uncertain tax items. It then sets forth a two-step process to recognize and measure a tax position taken or expected to be taken on a tax return. FIN 48 is divided into various categories or segments, including guidance on the subjects of:

(1) Recognition.
(2) Derecognition.
(3) Classification.
(4) Interest and penalties.
(5) Accounting in interim periods.
(6) Disclosure.
(7) Transition.

In general, differences in financial and tax accounting with respect to uncertain tax items will result in an increase in a liability for income taxes payable or a reduction of an anticipated income tax refund and a reduction in a deferred tax asset or increase in a deferred tax liability. FIN 48 applies to "tax positions" contained in a previously filed tax return or a position that will result in a permanent reduction in taxes currently payable or a deferral of income taxes to be paid until a future year. The tax liability for uncertain tax positions under FIN 48 is not included in the general label of deferred taxes.

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Rather, this liability must be classified separately from other tax balances based on the expected timing of cash flows to or from taxing authorities.

Disclosures on Adoption of FIN 48.

A company adopting FIN 48 must, as of the date of adoption and in the statement of financial position, disclose the cumulative effect of the change in retained earnings resulting from the adoption. Additional disclosures for interest and penalties could be required. [26] Also, companies making reclassification adjustments between tax positions that failed to meet the more-likely-than-not (MLTN) standard in years leading up to FIN 48's effective date of FIN 48 should recognize those adjustments in the first subsequent financial reporting period in which the MLTN standard is met.

Annual FIN 48 Disclosures.

A reporting company is required to disclose at the end of each annual reporting period a reconciliation, presented in tabular form, of unrecognized tax benefits as a result of tax positions taken during a prior period. At a minimum, this disclosure must contain:

(1) Gross amounts of increases and decreases in unrecognized tax benefits as a result of the tax positions taken in a particular prior period.
(2) Gross amounts of increases and decreases in unrecognized tax benefits for positions taken in the current period.
(3) Decreases in previously unrecognized tax benefits relating to settlements with taxing authorities.
(4) Reductions to unrecognized tax benefits resulting from the lapse of applicable statutes of limitations.

A second disclosure requires the computation of the impact of the effective tax rate on the total unrecognized tax benefits that were recognized. A third required disclosure includes the aggregate interest and penalties recognized in the current year's statement of operations and in the statement of financial position. The fourth disclosure requires a projection, for the succeeding 12-month period, of anticipated increases or decreases in the total unrecognized tax benefits, detailing:

(1) The cause for the uncertainty of the tax position.
(2) The cause or event that would increase or decrease the unrecognized tax benefit.
(3) The estimated range of possibly outcomes or changes to deferred tax liabilities, or an acknowledgement, or statement that such estimate is not possible.

Also required is an exhibit that lists the tax years that remain subject to examination by major tax jurisdictions.

Thus, tax accrual workpapers and FIN 48 workpapers substantially overlap both in function and in content inasmuch as their purpose is to assess the taxpayer's tax reserve for contingent tax liabilities, including potential penalties and interest.

IRS's Approach Towards Tax Accrual Workpapers

Taxpayers, particularly corporations and business entities, are required to prepare both tax and financial statements. The financial statements require a reserve for unpaid or deferred taxes, and the reserves have been "super-charged" to meet FIN 48's more refined requirements, each with its own evaluation of reserves for uncertain or contingent liabilities.

There is a major difference between a taxpayer's books and records, worksheets, schedules, journals of account, and adjustments used in preparing tax returns from tax accrual workpapers and FIN 48 workpapers. Tax accrual workpapers are not produced for purposes of preparing and filing an income tax return. Rather, tax accrual workpapers are generally prepared by an independent accounting firm for the purpose of preparing financial statements. That is, these schedules and workpapers are directed towards establishing and justifying a reported tax reserve on the balance sheet. Frequently there will be supporting opinions and estimates of the taxpayer, its in-house or tax advisors, and the outside accountant as to the amount of the reserve and the basis from which it was determined. FIN 48 arguably involves a more rigorous and systematic approach than tax accrual workpapers to determine the proper amount of the tax reserve under GAAP.

Service Expands Summonses of Workpapers.

In 2002, the IRS announced its policy on tax accrual workpapers. [27] It stated that it would request a taxpayer's tax accrual workpapers where the taxpayer failed to disclose its participation in a listed transaction. Where a listed transaction was disclosed, however, the IRS would routinely ask for information contained in the tax accrual workpapers that was related to only the reported listed transaction. But the IRS could exercise its discretion and request all tax accrual workpapers if there were reported financial accounting irregularities, and for a return filed prior to 7/1/02 that claimed a benefit from a listed transaction the IRS could, in certain instances, request the tax accrual workpapers as to the listed transaction.

The IRS also stated its view of tax accrual workpapers. Namely, it said that tax accrual workpapers are not legal or tax advice and are produced primarily to evaluate a taxpayer's deferred or contingent tax liabilities for financial accounting and reporting purposes. They are not prepared for obtaining legal advice and are not subject to the attorney-client privilege or federal tax practitioner privilege under Section 7525. Nevertheless, the IRS concluded that it would otherwise continue its prior and still outstanding policy of restraint on summonsing tax accrual workpapers. [28]

IRS Takes Firm Stand on Discovery of Tax Reconciliation and Audit Workpapers.

Tax reconciliation workpapers, in contrast with tax accrual workpapers, are used in assembling and compiling financial data for placement on a tax return. Tax reconciliation workpapers may be routinely requested in the course of an examination. Typically they will include final trial balances of a tax entity and a schedule of consolidating and adjusting entries, as well as information used to trace financial information to the tax return.

The government's policy of restraint in summonsing tax accrual workpapers does not apply to other forms of accounting workpapers, such as book-tax

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reconciliations and other information, including audit workpapers. Audit workpapers are retained by independent accountants to establish the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to its examination. Audit workpapers may include:

- Work programs.
- Analyses.
- Memoranda.
- Letters of confirmation and representation.
- Abstracts of company documents.
- Schedules or commentaries prepared or obtained by the auditor.

The audit workpapers provide important support for the independent certified public accountants' opinion as to the fairness of the presentation of the financial statements in conformity with generally accepted auditing standards.

Procedures for requests for audit and tax accrual workpapers not covered by the announcement. The National Office announced that IRS auditors will request audit and tax accrual workpapers only in unusual circumstances and when the necessary factual data used to support the return cannot be obtained from the taxpayer's records. If a decision is made to seek this information, the examiner's request should be limited to the portion of the workpapers that are material and relevant to the examination.

Chief Counsel Notice, CC-2004-010. Less than one year later, the IRS clarified the definition of tax accrual workpapers. According to the notice, tax accrual workpapers consists of audit workpapers relating to the tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax liabilities appearing on audited financial statements. Tax accrual workpapers does not include documents created prior to or outside of the consideration of whether reserves should be created, even though these documents may have been subsequently used in the preparation of the tax accrual workpapers or are attached to workpapers. The IRS also stated again that reconciling workpapers are within the scope of the general IDRs issued during an examination. The existence, and the amount, of reserve accounts are not within the scope of the definition of tax accrual workpapers.

Policy update, LMSB-04-0507-044. On 5/10/07, the IRS published a policy update to its LMSB division on how to treat FIN 48 disclosures and workpapers. It acknowledged that Chief Counsel's position was that FIN 48 Workpapers are to be treated in the same manner as tax accrual workpapers and, therefore, are subject to its policy of restraint.

Prior to this release, on 5/1/07, the IRS issued a field examiners guide, LMSB-04-0507-045, on FIN 48 set forth in question and answer format.

Important Decisions on the Discovery of Tax Accrual Workpapers by the IRS

The policy rationales for protecting some forms of communication between an attorney and client and work product from disclosure to the IRS has, from time to time, directly collided with the government's interest in the administration of the tax law. This conflict evidences itself either in summons enforcement proceedings, production requests during the discovery stages of an administrative or judicial proceeding, or at trial. There are a series of cases, including a decision of the Supreme Court, that have attempted to resolve this conflict, with inconsistent standards and analysis.

Arthur Young & Co.

In *Arthur Young & Co.,* the independent auditor for Amerada Hess Corp. was responsible for reviewing the corporation's financial statements for federal securities laws. The accounting firm verified the corporation's statement of its contingent tax liabilities and prepared tax accrual workpapers relating to the tax reserves. In 1975, the IRS audited the corporation's tax years 1972 through 1974. When the audit revealed that Amerada made questionable payments of $7,830 from a "special disbursement account," the IRS instituted a criminal investigation and issued a summons to the accounting firm requiring it to produce all of its files relating to the corporation, including its tax accrual workpapers.

In a summons enforcement action instituted by the government in federal district court, the court held that the tax accrual workpapers in question were relevant to the IRS investigation under the *Powell* criteria [29] and refused to recognize an accountant-client privilege that was asserted as protecting the workpapers from discovery. While agreeing that the workpapers were relevant to the IRS investigation, the Second Circuit held that the public interest in promoting full disclosure to public accountants, and in turn ensuring the integrity of the securities markets, required protection under a form of work-product immunity doctrine for the work that independent auditors perform for publicly owned corporations. The Second Circuit, in essence, crafted a privilege for independent auditor's workpapers. Accordingly, because it found that the IRS had not made a sufficient showing of need to overcome the immunity and was not seeking to prove fraud on the corporation's part, the court refused to enforce the summons insofar as it sought the tax accrual workpapers.

The Supreme Court, after granting the government's writ of certiorari, held that tax accrual workpapers are relevant documents in examining a corporation's

tax return and that the summons power is critical to the IRS's investigative and enforcement functions. The court noted that tax accrual workpapers are not actually used in the preparation of tax returns, but found that the documents were relevant to the tax administration function and discoverable. While Section 7602 is subject to traditional privileges and limitations, the Court cautioned that other restrictions on the IRS summons power should be avoided—"absent unambiguous directions from Congress"—that might be used to justify a judicially created work-product immunity doctrine for tax accrual workpapers, as the Second Circuit had done.

More specifically, the Supreme Court rejected the adoption of an accountant work-product doctrine and ruled that an independent certified public accountant performs a

different role than an attorney whose duty, as his or her client's confidential advisor and advocate, is to present the client's case in the most favorable possible light. An independent accounting firm performs a public service responsibility in certifying the public reports that depict a corporation's financial status. This duty transcends any employment relationship with the client, as the firm ultimately owes its allegiance to the corporation's creditors and shareholders and the investing public.

The Supreme Court opinion explained that the IRS does not have an unfair advantage in obtaining the accountants' tax accrual workpapers since the SEC or a private plaintiff in securities litigation would be entitled to obtain the same documents. Specifically, the Court stated that "[i]t is the responsibility of the IRS to determine whether the corporate taxpayer in completing its return has stretched a particular tax concept beyond what is allowed. Records that illuminate any aspect of the return—such as the tax accrual workpapers at issue in this case—are therefore highly relevant to legitimate IRS inquiry." Furthermore, the independent auditor's obligation to serve the public interest assures that the integrity of the securities markets will be preserved, without the need for a work-product immunity for accountants' tax accrual workpapers.

El Paso Co.

In *El Paso*, [30] the IRS petitioned the district court to enforce two summonses issued to the El Paso Company as part of a tax audit. One summons sought El Paso's "tax-pool analysis", i.e., tax accrual workpapers, which was described as a summary of El Paso's contingent liability for additional taxes should it ultimately be determined that El Paso owed more taxes than indicated on its return.

El Paso was a holding company for several large corporations, which included 67 subsidiaries all involved in the natural gas business. El Paso's returns were audited annually, and a routine audit for the years 1976 to 1978 resulted in a summons request. Early in the examination process, the IRS team coordinator delivered a document request to El Paso for "all analyses prepared by the El Paso Company regarding potential tax liabilities and tax problems," which was followed by a list of all internal audit reports prepared by the company for the relevant years. On the company's refusal to produce, the IRS filed suit in Federal District Court. The court agreed with the IRS and held that the summonses were enforceable despite El Paso's claims against enforcement based on burdensomeness, relevance, attorney-client privilege, and work-product doctrine. On appeal, the Fifth Circuit held that by definition tax accrual workpapers are relevant documents in a tax audit. In the court's view, it "is hard to imagine a document more likely to shed light on the correctness of those aspects of a return that harbor doubts than the tax pool analysis."

The *El Paso* court felt it was not required to reach the issue of whether it should recognize an accountant work-product privilege, because the IRS had summonsed the tax pool analysis from the taxpayer itself and not from its outside accounting firm as in *Arthur Young*. Furthermore, it found that the requested materials were not protected by the attorney-client privilege even though the materials contained legal analysis, stating that the scope of the attorney-client privilege is shaped by its purpose and is essential for establishing the presence of the privilege that the communication

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be made in confidence for the purpose of obtaining legal advice from the lawyer. The court also noted that the attorney-client privilege "may not be tossed as a blanket over an undifferentiated group of documents but rather must be specifically asserted with respect to particular documents."

The IRS asserted that El Paso failed to prove that any of the elements of the attorney-client privilege were involved in creating written analysis used for producing tax accrual workpapers, because it asserted that tax pool analysis was not legal work and that El Paso's attorneys in performing the analysis were not giving legal advice. Instead, the IRS claimed that the tax pool analysis is a business document used to make a company's financial statements conform to GAAP. Thus, the IRS concluded, the tax pool analysis supports a record of the company's finances and is business, not legal, work.

The Fifth Circuit stated that distinguishing what is accounting work from legal work in rendering tax advice was difficult and noted that in *Davis* it had previously held that the preparation of tax returns was generally not legal advice within the scope of the attorney-client privilege. It added that the tax pool analysis at issue could also be considered an accounting service since it is often performed by accountants. Still, the court did not adopt a hard line rule.

The Fifth Circuit identified that the taxpayer's tax pool analysis or tax accrual workpapers and supporting memoranda were examined closely by the outside accounting firm in order to determine whether the company had set aside an adequate tax reserve. From this perspective, "confidentiality as to these documents is neither expected nor preserved." Because the securities laws require independent accountants to verify the financial statements, including the tax pool analysis, these documents are not protected from discovery by the IRS. The court stated that there is no common law accountant-client communications privilege recognized under federal law. Under these circumstances, El Paso's disclosure of the tax pool analysis to the auditors destroyed confidentiality with respect to it. With the destruction of confidentiality goes the right to claim the attorney-client privilege as to those documents or opinions explaining the basis from which the taxpayer established the tax reserve.

The court further held that even if an attorney-client privilege argument could be made on certain memoranda in the tax accrual workpapers, the corporation failed to prove the presence of privileged attorney-client communications on a document-by-document basis. As to the work-product argument, the court held that even assuming that El Paso's tax pool analysis qualified for work-product protection, the corporation did not prove that the tax pool analysis was prepared "in anticipation of litigation." Rather, the tax pool analysis was primarily prepared not for litigation over its tax returns but for meeting its financial reporting obligations. Furthermore, the legal memoranda prepared for the tax pool analysis did not "map out" El Paso's actual litigation strategy in the event that litigation actually occurred. Therefore, based on the need to produce the analysis to comply with SEC regulations, the Fifth Circuit held that the tax pool analysis and backup memoranda were not protected work-product materials.

Rockwell International, Inc.

In *Rockwell International*, [31] an IRS agent found in the course of an audit a memorandum by the company's tax accountant that indicated that Rockwell understated its 1983 taxable income by $13 million in connection with the closing of a plant in Chattanooga, Tennessee. The memorandum noted that documents establishing the mistake were in the company's "free reserve file," i.e., tax accrual workpapers. On finding the document, the IRS commenced a joint civil/criminal investigation to determine whether Rockwell or its employees had criminally violated any tax laws with respect to claiming the erroneously computed loss on the return. The criminal investigation was concerned, inter alia, with a possible cover-up of the deficiency. The IRS CID agent issued a summons demanding Rockwell produce the items contained in the free reserve file, i.e., "[t]he account or folder containing the summary of deferred tax items for potential tax liabilities for possible subsequent adjustments for the fiscal periods ended 9/30/82, 9/30/83, 9/30/84, and 9/30/85."

In the summons enforcement trial, the general tax counsel for Rockwell testified that he maintained the free reserve file which he kept in his office and that the file could not be reviewed without his permission. The file contained his mental impressions as to settlement positions, litigation strategy, and interpretation of the tax law. The general tax counsel testified that he never surrendered control of the file to the company's outside auditors, although he

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discussed with them some of the contents of the file for purposes of estimating the tax reserve.

On receipt of the summons, the company admitted the understatement of its taxable income by $13 million through the commission of several errors. In response to the summons, the company produced the requested documents except for the free reserve file. Instead, Rockwell offered to allow the CID agent to review the free reserve file on its premises. The CID agent refused and filed an action for enforcement in the district court for the Western District of Pennsylvania. The trial court followed the Fifth Circuit's reasoning in *El Paso* and, ironically, entered an order instructing Rockwell to pay an independent auditor (chosen by the IRS) to determine which, if any, documents in the free reserve file were relevant to the plant closing, and hence accessible by the government. Cross appeals were taken to the Third Circuit which reversed in favor of the IRS and remanded for further findings.

The Third Circuit, holding that the IRS was not required to await the outcome of the independent accounting firm's determinations before asserting its right to the file, ruled in the IRS's favor and remanded the case to the trial court for a determination on whether the information in the free reserve file was legal advice. The Third Circuit noted the Fifth Circuit's statement in *El Paso* that "the preparation of tax returns is generally not legal advice within the scope of the privilege," but also acknowledged the Fifth Circuit's refusal to adopt a blanket rule of disclosure for parts of the free reserve file containing legal advice.

The Third Circuit stated that information intended to be disclosed to the SEC results in a waiver of the attorney-client privilege if legal advice is rendered as part of the tax accrual workpapers. Rockwell asserted that it was inequitable to find a waiver of privilege where it was obligated to disclose the papers to comply with SEC requirements. The Third Circuit felt it did not have to address this issue and ruled that Rockwell would have to raise the privilege issue on a document-by-document basis (if the issue was reached at all) on remand.

The opinion noted that the work-product doctrine was founded on the private attorney's role as a client's confidential adviser and advocate, whereas an independent certified public accountant performs a different role and owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. As announced in *Arthur Young,* the *Rockwell* court agreed that insulating a certified public accountant's interpretations of the client's financial statements from disclosure would ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

Regions Financial Corporation.

In *Regions Financial*, [32] the district court held that a corporation's tax accrual workpapers were protected by the work-product privilege and that the privilege was not waived when the corporation turned the papers over to an independent auditor.

The case involved a summons action for the taxpayer's tax accrual workpapers pursuant to an audit for 2002 and 2003. The IRS was particularly interested in two "listed transactions." After issuing the summons to the taxpayer's accounting firm, Ernst & Young LLP (E&Y), E&Y was instructed to withhold 20 documents that related to the listed transactions based on the claimed work-product privilege. The 20 documents fell into two categories: core documents and derivative documents. The core documents were created at the request of Regions general counsel based on his suspicion that the IRS would audit the listed transactions. The memoranda in the files contained opinions, legal theories, and analysis of possible IRS attacks on Regions' reporting with respect to the listed transactions. Three of the documents were created by a law firm retained by Regions to analyze the transactions. The other core document was created by partners at E&Y who were not involved in auditing Regions. The E&Y document reviewed and evaluated both the listed transactions. The second category of documents consisted of 16 derivative documents that essentially discussed, quoted, or explained the core documents. The derivative documents were e-mails, memoranda, and

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other less formal documents created by both Regions and E&Y.

The main issue was whether Regions must produce its tax accrual workpapers pursuant to the IRS summons which was otherwise determined to be proper. The court focused on:

> (1) Whether the contested documents were eligible, as a matter of law, for protection under the work-product privilege.
> (2) Whether Regions waived the work-product privilege by disclosing the documents to E&Y.

The court began its analysis by wrestling with the meaning of the phrase "prepared in anticipation of litigation." It noted the split among the circuits and the fact that the Supreme Court had not provided a controlling standard. While the IRS argued that the Fifth Circuit's "primary motivating purpose" test should apply, the court concluded that no binding Fifth or Eleventh Circuit decision clearly adopted the "primary motivating purpose" test. After much discussion, the court concluded that if it were forced to decide the question, it believed that the Eleventh Circuit would align itself with the majority of the other courts of appeal and adopt the "because of litigation" test. The Regions court found it unnecessary to determine which test applied, however, "because a fair application of both tests yields the same outcome."

Relying heavily on the district court decisions in *Textron* and *Roxworthy* (discussed below), the court agreed with Regions and held that the tax accrual workpapers in issue would not have been prepared "but for" or "because of" anticipated litigation with the IRS of the listed transactions. The court speculated that without that concern, Regions would not have to worry about contingent liabilities and would have no need to elicit opinions regarding the likely results of litigation. The court rejected the IRS's argument that the work papers were created for use in public financial statements as unpersuasive, holding that there was no requirement that a party must show that it was motivated by preparation for litigation and nothing else in order to claim that a docu ment was protected work product. As in *Roxworthy*, the court observed that the IRS would obtain an unfair advantage by gaining access to the tax accrual workpapers, which the court found to be the kind of legal analysis that the work-product doctrine was designed to protect from discovery by an adversary.

The court noted that the fact that Regions undertook the time and expense of consulting outside firms to assess its potential liabilities showed that Regions believed litigation to be likely, therefore it could not say that Regions' subjective belief was objectively

unreasonable. Interestingly, the court provided yet another rationale for its holding, stating that the "IRS never clearly says why it needs these opinions to assess adequately Regions' tax liability when it already possesses the original factual documents from which these opinions were derived."

As concerned the argument that Regions had waived the privilege by disclosing the contested documents to E&Y, the court again sided with Regions finding that an independent auditor is not an adversary of the taxpayer for purposes of applying the work-product doctrine.

As expected, the Department of Justice, in a brief filed with the Eleventh Circuit on 8/29/08, argued that the district court erred in holding that a corporation's tax accrual workpapers were protected by the work-product privilege and need not be disclosed in response to an IRS summons, maintaining that the privilege was waived by providing the documents to an independent auditor. One month later the lawyers for Regions argued that the district court correctly held that tax accrual workpapers did not have to be disclosed in response to an IRS summons despite having been shared with an independent auditor, insisting the work-product doctrine and Federal Rule of Civil Procedure 26(b)(3) provide "almost absolute immunity" for the documents. Both sides requested oral argument. No decision has yet been rendered by the Eleventh Circuit.

Valero Energy Corp.

In Valero Energy, [33] the taxpayer, Valero Energy Corporation, owned and operated 18 refineries and marketed refined oil and gas products. One of Valero's refineries located in Canada was acquired in 2001 by merger. Valero retained Arthur Anderson, LLP in 2001 and 2002 to provide cross-border tax and accounting advice in connection with the merger. The advice, as implemented, produced a $112 million foreign currency loss which reduced the corporation's U.S. tax liability by $46 million in 2002.

In November 2006, the IRS summonsed Arthur Anderson for "[a]ll documents ... related to, or reflecting, tax planning, tax research, or tax analysis, by or for, Ultramar Diamond Shamrock ... and Valero Energy Corporation ... in connection with 2001, 2002 and 2003 Canadian and U.S. income taxes...."

Valero challenged various aspects of the summonses, asserting that some of the requested documents were subject to the work-product privilege and some were privileged under the "tax practitioner" privilege of Sections 7525(a)(3)(A) and (B). The government countered that Valero's transactions surrounding the merger were significantly motivated by tax savings and fell within the tax shelter exception to the tax practitioner privilege under Section 7525(b). The court found that the IRS summons was not overly broad and that the work-product doctrine did not apply

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to the documents Valero withheld because Valero had not shown that they were prepared in anticipation of litigation. The court also found, however, that the tax practitioner privilege applied to certain documents and that the government, which had the burden of showing that the tax shelter exception applied, failed to meet its burden of persuasion that the exception applied.

As to the federal tax practitioner privilege, the court held that the privilege did not apply to communications based on foreign tax advice, to business advice, or accounting services. Noting the similarities to the common law attorney-client privilege, the court stated "just as communications from an attorney to a client are privileged only if they constitute legal advice, or tend to reveal the substance of a client confidence,

communications from a tax practitioner to a client are also privileged only in those circumstances." The court held that many of Valero's purported privileged documents failed to meet the requirements of Section 7525(a). After ruling that communications pertaining to Canadian tax advice were not privileged under Section 7525, the court then examined whether it was feasible to redact the privileged material from the documents in question, which contained references to Canadian taxes, so that the non-privileged portions could be produced to the government.

The court found that the government made a prima facie showing that Valero had engaged in sets of circular cash flows that generated foreign tax losses and should be regarded as involving a tax shelter. Therefore, regardless of whether the tax practitioner privilege applied, the court held that under the tax shelter exception in Section 7525(b), which covers "the promotion of the direct or indirect participation of the person in any tax shelter," some of the papers lost their privilege. Finally, the court concluded that "to establish the applicability of the tax shelter exception, the government need not demonstrate that the underlying transaction lacked economic reality or was driven solely or primarily by tax avoidance concerns; that is not what the statute requires when it provides that the government must show that the communication relates to a plan or arrangement 'a significant purpose of which' was the avoidance or evasion of federal income tax."

The taxpayer appealed to the Seventh Circuit on various grounds. The Seventh Circuit largely affirmed the decision reached by the District Court below. [34] The Seventh Circuit provided a liberal or broad view to the Section 7525(b)(2) exception "in connection with the promotion of the direct or indirect participation of the person in any tax shelter." The taxpayer argued that "promotion" required a nexus with prepackaged, tax-shelter products or the active sale of tax shelters through advertising or other means of publicity. Valero continued to argue that an accounting firm providing an individual a tax reduction plan designed for the taxpayer did not fall within the tax shelter exception. The government's far broader position was that promotion meant "furtherance" or "encouragement." After reviewing the legislative history to the definition of "tax shelter" contained in Section 6662, the court disagreed with Valero that promotion of tax shelters was limited to the peddling of cookie-cutter tax shelters. Rather, the court found that the promotion of tax shelters extended to the promotion, i.e., the encouragement, of any plan or arrangement the significant purpose of which is to avoid or evade federal taxes. While there are limits on the meaning of the term "promotion" for purposes of Section 7525(b), the Seventh Circuit's view was that the term should be broadly interpreted for purposes of applying the summons provision.

Roxworthy.

In *Roxworthy*, [35] the vice-president of tax (Roxworthy) at Yum! Brands, Inc., was issued a summons by the IRS to obtain production of what ultimately proved to be two memoranda prepared by KPMG. The memoranda were prepared in connection with KPMG's task of analyzing certain transactions that could result in tax liabilities for Yum! Brands that were part of the company's tax reserves for 1997-1999. The transactions at issue resulted in a tax loss of $112 million for deductions attributable to payments made to a captive insurance company without an accompany reduction in book value. Despite the claim of privilege, the federal magistrate presiding over the enforcement hearing held that the memoranda were not work product but were created to assist Yum! Brands in the preparation of its tax return and financial statements. Roxworthy appealed.

The Sixth Circuit stated that it was charged with reviewing the record and deciding:

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(1) Whether each document in question was created based on a party's personal belief of litigation and not as part of ordinary business practices and reporting requirements.
(2) Whether such subjective anticipation of litigation was objectively reasonable.

The court noted that the documents in question did not lose their protection from discovery as work product "merely because [they were] created in order to assist in a business decision." In reversing the lower court, it held that based on the size and nature of the transactions at issue, and Roxworthy's perception of the probability and risks of litigation with the IRS, the litigation was foreseeable when the memoranda were prepared. Thus, it applied a "because of" test as the appropriate standard in determining whether the documents were prepared "in anticipation of litigation" and protected by the work-product doctrine.

The Sixth Circuit added, however, that documents prepared in the ordinary course of business or pursuant to public requirements unrelated to litigation or for other non-litigation purposes were not work product. A document fell into non-work product status in the view of the court where the document would have been prepared in the same manner irrespective of the anticipated litigation. A taxpayer seeking to quash production of documents that survived this first hurdle would also have to prove that the "because of" test had both a subjective and objective element to the inquiry; that is, a party must "have had a subjective belief that litigation was a real possibility, and that belief must have been objectively reasonable."

Thus the court found that Roxworthy reasonably anticipated litigation with the IRS with regard to the captive insurance loss issue [36] and concluded that the taxpayer met its burden of persuasion regarding whether the memoranda at issue sought to protect Yum "from future litigation about a particular transaction."

Deloitte & Touche USA LLP.

In *Deloitte & Touche*, [37] the U.S. moved to compel Deloitte & Touche (Deloitte) to produce two categories of documents pursuant to a FRCP Rule 45 subpoena:

(1) Three documents that Deloitte was withholding on the basis of privileges asserted by its client, Dow Chemical (Dow).
(2) All responsive documents maintained at Deloitte's affiliate in Zurich, Switzerland.

The government moved to subpoena the documents in connection with a civil tax refund case pending in Louisiana brought by Chemtech Royalty Associates, L.P. and Chemtech II, L.P., partnerships that were formed by subsidiaries of Dow in 1993 and 1998, respectively.

The court viewed the first category of documents as generally protected from discovery as attorney work product since they were created in anticipation of future litigation over the tax treatment of Chemtech. The government contended that the work-product privilege was waived when Dow disclosed the documents to Deloitte. The court disagreed, reasoning that Dow's disclosure to its auditor was not disclosure to a potential adversary and that it was not unreasonable for Dow to expect Deloitte to hold the documents in confidence (citing *Regions Financial Corp.* and *Textron* (discussed below)). [38]

Textron Inc. and Subsidiaries.

In *Textron*, [39] the taxpayer was a publicly traded corporation with close to 200 subsidiaries, including Textron Financial Corporation (TFC), which provided commercial lending and financial services. Textron had several tax lawyers and CPAs staffing its tax

department during 2001 and 2002, while TFC's tax department consisted only of CPAs. Textron was audited each year and engaged in litigation with the IRS on three occasions.

While examining Textron's 2001 return, the IRS learned that TFC had engaged in nine "sale-in, lease-out" (SILO) transactions which were "listed transactions." The IRS issued more than 500 IDRs in connection with the 1998-2001 audit cycle. Textron complied with all of the IDRs, except for those seeking tax accrual workpapers.

Textron refused to produce its tax accrual workpapers, asserting privilege and claiming that the summons was issued for an improper purpose. The tax accrual workpapers subject to the summons consisted of a spreadsheet containing:

> (1) Lists of items on Textron's tax returns, which, in the opinion of Textron's counsel, involved issues on which the tax laws were unclear, and, therefore, could be challenged by the IRS.
> (2) Estimates by Textron's counsel expressing, in percentage terms, their judgments regarding Textron's chances of prevailing in any litigation over those issues (the "hazards of litigation percentages").
> (3) The dollar amounts reserved to reflect the possibility that Textron might not prevail in litigation (the "tax reserve amounts").
> (4) Backup workpapers, including notes and memoranda written by Textron's in-house tax attorneys reflecting their opinions on the questionable items and hazards of litigation percentage on each such item.

The tax accrual workpapers were compiled so the outside auditors could determine that the tax reserves stated on the financial statements filed with the SEC by Textron conformed to GAAP. That is, the tax accrual workpapers allowed the outside auditors to issue a "clean opinion" as to Textron's financial statements. During the course of an audit conducted by Ernst & Young (E&Y), Textron's independent auditor, Textron permitted E&Y to examine the final tax accrual workpapers at issue with the understanding that the information was to be treated as confidential.

The district court first determined that the IRS, in issuing the summons, did not act in bad faith. Textron argued that its tax accrual workpapers were protected by the attorney-client privilege, the tax practitioner-client privilege under Section 7525, and the work-product privilege. The IRS disagreed, countering that the workpapers were privileged or qualifying work product and, therefore, were subject to compelled production under its summons.

On the attorney-client privilege, Textron argued that the tax accrual workpapers were prepared by its counsel, reflected counsel's legal conclusions with regard to items on Textron's return that could be challenged by the IRS, and assessed the hazards of litigation. The IRS argued that in preparing the tax accrual workpapers, Textron's attorneys were not providing legal advice; rather, they were performing an accounting

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function by reconciling the company's tax records and financial statements.

The district court held that because Textron's and TFC's tax accrual workpapers consisted of counsel's opinions regarding items that might reasonably be challenged by the IRS, they were protected by the attorney-client privilege. The district court rejected the IRS's reliance on the Supreme Court's decision in *Arthur Young*, noting that the Court did not hold that the attorney-client privilege was inapplicable to legal conclusions of counsel contained in the tax accrual workpapers. The court added that in *Arthur Young* the workpapers had been prepared by the corporation's independent auditor whose "obligation to serve the public interest assures that the integrity of the securities markets

will be preserved." By contrast, Textron's workpapers were prepared by its in-house counsel whose function was to provide legal advice to Textron.

Textron further argued that to the extent that the workpapers reflected the advice that TFC received from CPAs in its tax department, they should be privileged under Section 7525. The IRS countered that the opinions of TFC's tax accountants did not qualify for protection under Section 7525(a), or, alternatively, they fell within the exception contained in Section 7525(b). The court found that since TFC's tax accountants participated in advising Textron regarding its tax liability with respect to matters on which the law is uncertain and estimating the hazards of litigation percentages, they were performing "lawyers' work." Thus, the court held that the exception under Section 7525(b) was inapplicable because TFC did not make the communications in connection with the promotion of TFC's participation in the transactions. Accordingly, the advice would qualify for the privilege conferred by Section 7525(a).

Textron next argued that the tax accrual workpapers were protected by the work-product privilege because they were prepared in anticipation of litigation with the IRS. The IRS disagreed, arguing that the tax accrual workpapers were prepared in the ordinary course of business and to satisfy securities law that requires publicly traded companies to file financial statements that comply with GAAP (which, in turn, require the creation of reserves to meet contingent liabilities).

The court sided with Textron, stating that the estimated hazards of litigation percentages and calculation of tax reserve amounts by Textron's counsel and accountants would not have been prepared at all "but for" the fact that Textron anticipated the possibility of litigation with the IRS. The court stated it would apply the "because of" test it had previously adopted in *Maine*, [40] and rejected overruling its prior standard with the Fifth Circuit's "primary motivating purpose" standard announced in *El Paso.*

Textron further argued that providing the tax accrual workpapers to E&Y did not waive the protection of either privilege, and it sought to distinguish the cases holding that disclosure to an outside auditor affected a waiver of the attorney-client privilege on the ground that those cases were decided prior to the enactment of Section 7525. More specifically, Textron argued that because it occasionally revised its reserve based on the opinions of the independent auditor, the auditor's review of Textron's workpapers should be viewed as performed in connection with providing "tax advice" to Textron and, therefore, privileged under Section 7525. The court disagreed, treating the disclosure as a waiver of both the attorney-client and Section 7525 privileges.

The final issue was whether the work-product privilege was waived by showing the workpapers to the outside auditors. The court held that no waiver occurred because showing the tax accrual workpapers to E&Y was not tantamount to showing that information to an adversary. [41] The court added that the IRS failed to carry the burden of demonstrating a "substantial need" for ordinary work product, let alone the heightened burden applicable to Textron's tax accrual workpapers, which was opinion work product.

While noting that the opinions and conclusions of Textron's counsel and tax advisers might provide the IRS with insight into Textron's negotiating position or litigation strategy, the court found they had little bearing on the determination of Textron's tax liability. Still, the IRS argued that it was entitled to the tax accrual workpapers because the hazards of litigation percentages would assist in determining whether Textron owed a penalty for underpayment of taxes. Because the IRS never asserted that Textron owed any further tax, the court regarded this argument as premature, at best. The district court, therefore, quashed the IRS's summons to compel by application of the work-product doctrine.

The First Circuit Court of Appeals Panel *Textron* Decision.

On appeal to the First Circuit, [42] a three judge panel, in a two to one decision, affirmed the trial court's determination that the work-product doctrine shielded Textron's tax accrual workpapers from the IRS summons, finding that the workpapers were prepared "because of" anticipated litigation concerning nine SILO transactions and that they were not prepared "irrespective of litigation."

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The court acknowledged the three issues for appeal:

> (1) Whether the work-product doctrine protects Textron's workpapers.
> (2) Whether any such work-product protection was waived through disclosure to E&Y.
> (3) Whether the trial court erred in not considering the IRS's request for E&Y's workpapers in accordance with the Supreme Court's decision in *Arthur Young.*

On the issue of whether the workpapers were work product, the panel held that the tax accrual workpapers were prepared "because of the prospect of litigation," a phrase used in a prior decision of the same court. [43] Even though there may also be a second or dual purpose for filing financial statements with the SEC, said the panel, a second purpose did not defeat the work-product doctrine. The First Circuit panel rejected El Paso's "primary purpose" test for work-product protection, and it found there was no waiver of the protection when Textron allowed E&Y to inspect its tax accrual workpapers because E&Y was not an adversary or even a conduit to an adversary despite the IRS's contention that the SEC could subpoena the records were it necessary. Moreover, Textron did not seek blanket protection for its workpapers. Instead, it addressed a specific set of transactions and positions that could be questioned or challenged by the IRS and lead to litigation.

Finally, the court asked whether the disclosure of E&Y's workpapers would substantially increase the risk that the contents of Textron's workpapers would be disclosed to an adversary. Since the district court failed to address the question of whether the IRS could gain discovery of E&Y's workpapers through a subpoena to Textron, no fact finding was made as to the actual contents of the E&Y workpapers or the extent to which disclosure would constitute a work-product waiver by E&Y's documenting Textron's workpapers, mental impressions, and analysis of the items making up its tax reserves.

First Circuit En Banc Panel Holds Textron's Tax Accrual Workpapers Discoverable.

On appeal, the IRS asked for review of the panel decision, which was granted. The First Circuit, in a three to two decision [44] written by the lone dissenter from the panel decision, reversed and found for the government. The en banc opinion viewed the panel's holding that tax accrual workpapers were protected from IRS discovery as flawed or as misconstruing the purpose of the *Hickman v. Taylor* rule. The en banc court held that the workpapers were not, in fact, prepared "for use" in actual litigation. Instead, the court found that the tax accrual workpapers's purpose was to "make book entries, prepare financial statements and obtain a clean audit." The majority of the court noted that one witness for Textron suggested that in the event of litigation, the workpapers could be useful, but there was no further explanation on the record to substantiate this claim.

In an attempt to set a line of demarcation to prevent the work-product doctrine from becoming too broad, the court applied a functional use test to determine if the

workpapers were deserving of the status of being produced "for use in" litigation. Under this standard, the court found that Textron's workpapers were not work product.

According to the court, work product does not exist simply because the subject matter of a document relates to a subject that might conceivably be litigated. Instead, the doctrine applies to only work done in anticipation of or for trial that is protected. Even if prepared by lawyers and reflecting legal thinking, "[m]aterials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not under the qualified immunity provided by this subdivision." [45] A set of tax reserve figures calculated for purposes of accurately stating a company's financial figures has only that purpose—to support the financial statement and an independent audit of it.

The court said that its holding was consistent with the application of the "because of" test it announced in *Maine.* The *Maine* decision required a finding that the tax accrual workpapers were prepared in the ordinary course of business for purposes of the financial statements and to obtain auditor approval, not "for" litigation. The doctrine was not intended or designed to help shield a lawyer's preparation of corporate documents or other materials in the ordinary course of business. In other words, said the court, "[w]here the rationale for a rule stops, so ordinarily does the rule." As to policy concerns, the court found the government's public policy more compelling:

> Underpaying taxes threatens the essential public interest in revenue collection. If a blueprint to Textron's possible improper deductions can be found in Textron's files, it is properly available to the government unless privileged. Virtually all discovery against a party aims at securing information that may assist an opponent in uncovering the truth. Unprivileged IRS information is equally subject to discovery.

The court examined the practical problems confronting the IRS in discovering under-reported corporate taxes, which it believed likely to be endemic. Textron's return was massive—more than 4,000 pages—and the IRS requested the work papers only after finding a specific type of transaction that had been shown to be abused by taxpayers. The court noted that it was because the collection of revenue is essential to government

that administrative discovery, along with many other comparatively unusual tools, was granted to the IRS.

The dissenting opinion was issued by Judge Torruella, who had previously issued the "majority" opinion in the panel decision of the First Circuit. Judge Lipez joined the dissent. The dissent was highly critical of the decision reached by the majority, claiming that the majority opinion contained many errors of law and alleging that the majority had effectively abandoned its "because of " test, as applied in accordance with its own precedent, in determining whether a document was entitled to work-product protection. While the dissent acknowledged that the majority did not state that it was departing from this precedent, i.e., *Maine*, the dissenters were skeptical that the majority could have it both ways. Indeed, by stating that the standard to be applied was whether the document was prepared at that particular time "for" the purpose of litigation, the majority relied a far narrower test or standard than that applied in *Maine*. The dissent noted that this standard was narrower than the Fifth Circuit's primary motivating purpose test announced in *El Paso*. Thus, concluded the dissent, the First Circuit chose to ignore the case law and standards it and other appellate courts had formulated in defining the breadth of the term "work product."

In contrast to the holding reached by the First Circuit in *Textron*, the dissenters noted the leading precedent from the Second Circuit, in *Adlman*, which held that opinion or mental impression work product prepared "because of" the prospect or in anticipation of litigation could extend to a tax opinion issued prior to entering into a transaction by the taxpayer that the government was later expected to challenge. According to the majority's "for" the purpose of actual litigation approach, a pre-transaction opinion would not meet the definition of "work product." This change in the applicable legal standard for identifying work product worried the dissent, who were concerned that the government would enjoy an unfair advantage since they could easily obtain tax accrual workpapers and associated work product not only as to issues that were of concern to the taxpayer but as to taxpayer's settlement posture (i.e., settlement amounts, terms) on each particular issue.

Implications of First Circuit's Decision in *Textron*

It is undeniable that the First Circuit has given the IRS a "green light" to pursue the production of tax accrual workpapers and FIN 48 workpapers without having to meet the burden of "necessity" or "inability to acquire such information otherwise" to overcome the qualified work-product privilege. Instead, the First Circuit simply held that tax accrual workpapers in question were not work product. The issue of "waiver" was not implicated in the reversal. The question as to whether delivery of tax accrual workpapers to an outside auditor was also, in effect, deemed irrelevant.

While the First Circuit's decision and underlying rationale has and will continue to receive a stentorian cry of "no thank you" from tax lawyers, tax managers, and in-house counsel to public and private corporations and companies, it does reaffirm one circuit court's concern that the work-product doctrine not be used to generally shield tax accrual workpapers or FIN 48 workpapers from discovery. Rather, the First Circuit determined that the documents did not fall within the definition of work product prepared "for" litigation because they were essentially business records used to prepare financial statements and assess tax returns even though couched in the language of legal analysis. Some legal advisors may view the analysis in *Textron* as more darkly asserting a broad impact on the issue of documents and memoranda in a company's files pertaining to all liability reserves, not just tax reserves.

The Supreme Court's decision in *Arthur Young* can be viewed as weighing heavily on the First Circuit's thinking in *Textron.* After all, if an accounting firm's tax accrual workpapers for a particular taxpayer are not protected from discovery, why should similar schedules and memoranda prepared by the taxpayer for essentially the same purposes be shielded?

It should be expected that taxpayers, in-house counsel, and outside legal counsel will not rollover in response to the First Circuit's decision. They will surely seek effective methods for protecting portions of its tax accrual workpapers or FIN 48 workpapers as work product or they will refrain from showing tax opinions from law firms or federally licensed tax practitioners to outside independent auditors to prevent a waiver of the attorney client or Section 7525 privileges. These efforts may prove to be delicate, if not problematic, since it is equally predictable that independent accounting firms hired to prepared GAAP financial statements may insist, as a requirement of its engagement letter, that opinion analysis be disclosed.

It would be helpful for the Supreme Court to address a *Textron* type fact pattern and decide whether *Arthur Young* applies, as the First Circuit has held. A clear and predictable legal standard should be announced to resolve an issue of great importance that has resulted in divergent holdings by the circuit courts.

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Just prior to the publication of this article, Textron, Inc., filed a petition for writ of certiorari on 12/29/09 requesting review of the First Circuit en banc opinion.

[2]

104 AFTR 2d 2009-5719, 577 F3d 21, 2009-2 USTC ¶50574 (CA-1, 2009), *vacating and remanding* 100 AFTR 2d 2007-5848, 2007-2 USTC ¶50605, 507 F Supp 2d 138 (DC R.I., 2007), *aff'd in part and remanded in part* 103 AFTR 2d 2009-509, 553 F3d 87, 2009-1 USTC ¶50167 (CA-1, 2009), *vac'd by* 560 F.3d 513, 103 AFTR2d 2009-1436 (CA-1, 2009).

[3]

Compare, the Fifth Circuit's decision in El Paso Co., 50 AFTR 2d 82-5530, 682 F2d 530, 82-2 USTC ¶9534 (CA-5, 1982) (primary purpose test) with various circuits applying the broader "because of ... in anticipation of litigation" or "but for ... in anticipation of litigation" tests used in describing work product. As applied to tax accrual workpapers, Roxworthy, in general, Binks Mfg. Co. v. Nat'l Presto Indus., Inc., 709 F2d 1109 (CA-7, 1983); Senate of Puerto Rico, 823 F2d 574 (DC D.C., 1987); In re Sealed Case, 146 F3d 881 (DC D.C., 1998); In re Grand Jury Proceedings, 604 F2d 798 (CA-3, 1979); Simon v. G.D. Searle & Co., 816 F2d 397 (CA-8, 1987); In re Grand Jury Subpoena, 357 F3d 900 (CA-9, 2004); National Union Fire Insurance Co. v. Murray Sheet Metal Co., Inc., 967 F2d 980 (CA-4, 1992).

[4]

See Notice 2005-13, 2005-1 CB 630 (SILO transactions are "listed transactions" for purposes of Reg. 1.6011-4(b)(2)). A SILO transaction generally involves a tax-exempt entity that enters into a sale-leaseback transaction with a domestic taxable entity which further involves an option to repurchase the property at the end of the lease term and a "service contract option" exercisable by the taxable entity immediately after the lease expiration. The repurchase option price generally is for an amount sufficient to repay the taxable investor's liabilities and initial equity investment plus a predetermined after-tax rate of return. The service contract option is designed to ensure that, in case the tax-exempt seller does not exercise the repurchase option, the taxable investor will be able to collect payments sufficient to reimburse it for operating costs and to provide a minimum after-tax rate of return. See also Section 470.

[5]

See 26 U.S.C. section 6001 (required records doctrine); Section 7602 (administrative summons); Section 7609 (third-party recordkeeper summons).

[6]

See, e.g., Coastal States Gas Corp. v. Dep't. of Energy, 617 F2d 854 (DC D.C., 1980). "[Work-product] doctrine stands in contrast to the attorney-client privilege; rather than protecting confidential communications from the client, it provides a working attorney with a 'zone of privacy' within which to think, plan, weigh facts and evidence, candidly evaluate a client's case, and prepare legal theories." See also Nobles, 422 US 225, 45 L Ed 2d 141 (1975).

[7]

Hickman v. Taylor, 329 U.S. at 511-512.

[8]

329 US 495, 91 L Ed 451 (1947); FRCP 26(b)(3). For recent articles written by Messrs. August and/or Grimes for this Journal on this subject see August and Grimes, "Ability of IRS to Discover Tax Accrual and FIN 48 Workpapers", 10 BET 6 (November/December 2008); August "Attorney-Client Privilege and Work-Product Doctrine in Federal Tax Matters," 10 BET 4 (July/August 2008); and August, "Understanding Fin 48: Accounting for Uncertainty in Income Taxes," 10 BET 30 (May/June 2008).

[9]

See Upjohn Co., 47 AFTR 2d 81-523, 449 US 383, 66 L Ed 2d 584, 81-1 USTC ¶9138, 1981-1 CB 591 (1981). See also Abdallah v. The Coca-Cola Co., *2000*, WL 33249254 (DC Ga., 2000).

[10]

In re Sealed Case, *supra*, note 3. See Adlman, 76 AFTR 2d 95-7188, 68 F3d 1495, 95-2 USTC ¶50579 (CA-2, 1995) (memorandum containing opinion work product relating to potential tax litigation arising out of a proposed merger may be protected); Deseret Mgmt. Corp., 99 AFTR 2d 2007-1891, 76 Fed Cl 88 (Fed. Cl. Ct., 2007) (IRS audit reports were protected work product where, due to the size of the corporation and significance of the business transaction, both parties "knew or should have known that the audit could lead to litigation"); In re Sealed Case, 146 F.3d at 887 (documents prepared prior to the transaction that formed the basis for the claim were protected work product).

[11]

FRCP 26(b)(3) (advisory committee's note on 1970 Amendment); In re Grand Jury Subpoenas, 318 F3d 379 (CA-2, 2003) (work-product protection did "not extend to documents in an attorney's possession that were prepared by a third party in the ordinary course of business and that would have been created in essentially similar form irrespective of any litigation anticipated by counsel"). But see, Adlman, *supra* note 10.

[12]

Syngenta Crop Prot., Inc. v. E.P.A., *No. 1*, 02CV0334, WL 31778791 (DC N.Car., 2002). Compare, Pacific Gas & Elec. Co., 69 Fed Cl 784 (Fed. Cl. Ct., 2006) (holding adversarial aspects of proceedings before the state public utility commission and nuclear regulatory commission constituted litigation for purposes of work-product doctrine). See also, Brown v. Hart, Schaffner & Marx, 96 FRD 64, CCH Fed Secur L Rep ¶99142, 12 Fed Rules Evid Serv 812, 35 FR Serv 2d 1332 (DC Ill., 1982) (pre-existing documents not prepared for litigation were not protected despite later transfer to attorney in anticipation of litigation).

[13]

In re ContiCommodity Servs., Inc. Sec. Litig., 123 FRD 574, 14 FR Serv 3d 935, 1988 WL 142148 (DC Ill., 1988) (work-product doctrine does not prevent discovery of tax refund claim form prepared by an accountant, but documents prepared by the accountant as agent for lawyer protected).

[14]

See, e.g., Chevron Texaco Corp., 91 AFTR 2d 2003-664, 241 F Supp 2d 1065 (DC Calif., 2002).

[15]

See Upjohn, *supra* note 9; In re Grand Jury Subpoena, 220 FRD 130, 2004 WL 515651 (DC Mass., 2004).

[16]

See, e.g., Davis, 47 AFTR 2d 81-941, 636 F2d 1028, 81-1 USTC ¶9193 (CA-5, 1981) (litigation need not be imminent, as some courts have suggested, as long as the primary motivating purpose behind the creation of the document is to aid in possible future litigation).

[17]

See, e.g., In re Subpoena Duces Tecum served on Wilkie Farr & Gallagher, *No.*, 1997 WL 118369 (DC N.Y., 1997) (law firm compelled to produce audit committee documents generated in connection with internal investigation; reports prepared primarily for business purposes).

[18]

81 AFTR 2d 98-820, 134 F3d 1194, 98-1 USTC ¶50230 (CA-2, 1998).

[19]

182 F3d 496 (CA-7, 1999).

[20]

See FRCP 26(b)(3) advisory committee's notes (1970). In re Sealed Case, 146 F3d 881 (CA-D.C., 1998).

[21]

In re Sealed Case, 50 AFTR 2d 82-5637, 676 F2d 793, 82-1 USTC ¶9335 (DC D.C., 1982).

[22]

See IRM 4.10.2.9.4(4)(C) (request for books, records and accountant's workpapers).

[23]

In Arthur Young & Co., 53 AFTR 2d 84-866, 465 US 805, 79 L Ed 2d 826, 84-1 USTC ¶9305, 1984-1 CB 270 (1984), the Supreme Court held that tax accrual workpapers prepared by a taxpayer's independent auditors can be summonsed under Section 7602(a). The Supreme Court's rationale for its holding in Arthur Young was:

> "An important aspect of the auditor's function is to evaluate the adequacy and reasonableness of the corporation's reserve account for contingent tax liabilities. This reserve account, known as the tax accrual account, the noncurrent tax account, or the tax pool, represents the amount set aside by the corporation to cover adjustments and additions to the corporation's actual tax liability. Additional corporate tax liability may arise from a wide variety of transactions. The presence of a reserve account for such contingent tax liabilities reflects the corporation's awareness of, and preparedness for, the possibility of an assessment of additional taxes."

See Caplin, "Government Access to Independent Accountants' Tax Accrual Workpapers," 1 Va. Tax Rev. 57 (1981).

[24] 17 C.F.R. section 210.1-02(d).

[25] FIN 48 is effective for fiscal years beginning after 12/15/06 for public companies, and for fiscal years beginning on 1/1/07 for nonpublicly traded or privately held calendar-year companies.

[26] See FAS 154, paragraphs 17 and 18.

[27] Ann. 2002-63, 2002-2 CB 72.

[28] See CC-2003-012, 4/9/03.

[29] Powell, 14 AFTR 2d 5942, 379 US 48, 13 L Ed 2d 112, 64-2 USTC ¶9858, 1965-1 CB 547 (1964). To enforce a summons, subject to claims of privilege asserted on a document by document basis, the Supreme Court held that the IRS need show only:

(1.) The investigation will be conducted pursuant to a legitimate purpose.
(2.) The inquiry may be relevant to the purpose.
(3.) The information sought is not already within the Service's possession.
(4.) Administrative steps required by the Code have been followed.
(5.) The time and place of an examination made pursuant to the summons authority of Section 7602 must be "reasonable under the circumstances."

[30] 50 AFTR 2d 82-5530, 682 F2d 530, 82-2 USTC ¶9534 (CA-5, 1982).

[31] 65 AFTR 2d 90-833, 897 F2d 1255, 90-1 USTC ¶50151 (CA-3, 1990).

[32] 101 AFTR 2d 2008-2179, 2008-1 USTC ¶50345 (DC Ala., 2008).

[33] 102 AFTR 2d 2008-5196 (DC Ill., 2008), *aff'd* 103 AFTR 2d 2008-2683 (CA-7, 2009).

[34] 103 AFTR 2d 2008-2683 (CA-7, 2009).

[35] 98 AFTR 2d 2006-5964, 457 F3d 590, 2006-2 USTC ¶50458 (CA-6, 2006).

[36] Citing Adlman, *supra* note 10.

[37] 103 AFTR 2d 2009-2655, 2009-1 USTC ¶50450, 623 F Supp 2d 39 (DC D.C., 2009).

[38]

The court rejected the government's reliance on MIT, 80 AFTR 2d 97-7981, 129 F3d 681, 97-2 USTC ¶50955 (CA-1, 1997), a case in which MIT disclosed work-product materials to a Department of Defense branch on contract work it was performing for the Pentagon, because the court said that MIT's disclosure to the government was, in fact, made to a potential adversary and resulted in a waiver.

[39] 100 AFTR 2d 2007-5848, 2007-2 USTC ¶50605, 507 F Supp 2d 138 (DC R.I., 2007).

[40] Maine v. U.S. Dept. of the Interior, 298 F3d 60 (CA-1, 2002).

[41] See, e.g., In re Subpoenas Duces Tecum, 738 F2d 1367 (CA-D.C., 1984); Meoli v. Am. Med. Serv., 287 BR 808 (DC Calif., 2003) ("Voluntary disclosure of attorney work-product to an adversary in the litigation defeats the policy underlying the privilege"); Shulton, Inc. v. Optel Corp., *No. 85-2925*, 56 USLW 2307, 1987-1 CCH Trade Cases ¶67436, 1987 WL 19491 (DC N.J., 1987).

[42] 103 AFTR 2d 2009-509, 553 F3d 87, 2009-1 USTC ¶50167 (CA-1, 2009).

[43] Maine, *supra* note 40, 298 F.3d at 68.

[44] 104 AFTR 2d 2009-5719, 577 F3d 21, 2009-2 USTC ¶50574 (CA-1, 2009).

[45] FRCP 26, advisory committee note (1970).