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Textron Wins Battle Over Internal Tax Accrual Workpapers

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by Hollis L. Hyans, Edward L. Froelich

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On August 28, the U.S. District Court for the District of Rhode Island dismissed a summons enforcement action against Textron, Inc. brought by the Department of Justice on behalf of the Internal Revenue Service. The IRS had sought Textron's internal tax accrual workpapers. The district court held that Textron's workpapers were work product created by its in-house counsel and accountants and that the work product protection was not waived by Textron.[1] The dismissal, if upheld on appeal, would limit the Government's use of the threat of forcing taxpayers to turn over tax accrual workpapers as a tool in its attack against alleged tax shelters.

In June 2005, the IRS issued a summons to Textron seeking its workpapers for the 2001 tax year. The summons sought not only the workpapers relating to the remaining issue on audit (involving what is commonly known as a SILO, Sale-In Lease-Out, transaction) but all tax accrual workpapers for the 2001 tax year. In issuing the broad request for tax accrual workpapers, the IRS was implementing its current tax accrual workpaper policy, as described in Announcement 2002-63, which requires an examining agent to request workpapers relating to a listed transaction entered into by the taxpayer under audit, and, in the case of multiple listed transactions entered into by the taxpayer, all tax accrual workpapers for the relevant tax years.

The summons came on the heels of an extended audit of Textron's 1998-2001 tax years in which more than 500 Information Document Requests (IDRs) were issued by the examining agents. Textron responded to all other IDRs, but refused to respond to an IDR seeking the tax accrual workpapers, and so the IRS backed up the IDR with an administrative summons. The focus of the summons was on the workpapers of Textron, Inc., the parent company, and one of its subsidiaries, Textron Financial Corporation or TFC. Textron took the position that the workpapers were protected from disclosure under the attorney-client privilege, the tax practitioner privilege (IRC Section 7525) and the work product doctrine.

As described by the district court, the workpapers, which were created after the corporate tax returns were filed, consisted of two parts. The first part was a spreadsheet that listed (i) each tax position considered by Textron's counsel to be arguable, (ii) estimates of litigation risks with respect to these position, and (iii) tax reserve amounts for each position. The second part comprised backup documents including the prior year spreadsheet, a draft spreadsheet, and accompanying memos from Textron's in-house counsel reflecting opinions regarding litigation risks.

The workpapers were prepared by Textron's in-house attorneys or in-house accountants under the ultimate supervision of Textron's in-house counsel. The workpaper files did not contain any "factual" materials, such as transaction documents and the like. Textron's in-house accountants created the initial workpaper package for circulation to Textron's in-house counsel. The accountants and counsel would later meet to finalize the package.[2]

The district court found that Textron created the workpapers to determine adequate reserves in case of later controversy or litigation. The court also found that the workpapers served the purpose of showing Textron's outside auditors, Ernst & Young, that its reserves were appropriate and thereby facilitating E&Y's approval of the audited financial statements. The court found further that had

Textron determined there was no risk of litigation for a particular return position, no tax accrual workpaper would have been created with respect to such position. This is an important fact in the court's work product analysis because if the workpapers had been created without regard to the potential for litigation, there would be no work product protection despite the content of the workpapers.

Privileges Apply but Were Waived

Textron asserted that the attorney-client and tax practitioner privileges applied to the workpapers. The court agreed but found that because the workpapers were shown to a third party, E&Y, these privileges were waived.

As to the attorney-client privilege, the court did not agree with the IRS's assertion that the in-house attorneys were performing an accounting function, i.e., helping to reconcile reserves to tax returns. Instead, the court found that the attorneys were acting in their traditional role of evaluating the legal merits of a tax return position and communicating that evaluation to the company by way of the workpaper package. The fact that this evaluation assisted in the financial accounting of Textron was of no consequence. The court analogized to the advice of tax planning attorneys, which, even though rendered in connection with the preparation of a tax return, is still legal advice protected by the attorney-client privilege. The IRS had argued that the 1984 Supreme Court decision, *United States v. Arthur Young & Co.*, 465 U.S. 805, supported the proposition that there was no privilege applicable to tax accrual workpapers. *Arthur Young* held that there was not an accountant-client privilege-like protection applicable to workpapers created by outside auditors. The district court correctly pointed out that *Arthur Young* did not address (i) internal tax accrual workpapers, (ii) whether the attorney-client privilege could apply to such workpapers, or (iii) the section 7525 tax practitioner privilege, which was enacted in 1998.

The tax practitioner privilege protects communications relating to tax advice to the extent the attorney-client privilege would apply (save for the fact that the advisor is not an attorney). Here, the court found that TFC's in-house accountants were providing "tax advice" in preparing the workpapers and, therefore, the workpapers were protected communications under section 7525. The district court framed the question as whether the accountants were "doing lawyers' work" in creating the workpapers. "Since TFC's tax accountants participated in advising Textron regarding its tax liability with respect to matters on which the law is uncertain and/or estimating the hazards of litigation percentages, they were performing "lawyers' work." This holding is itself a setback for the IRS, which has sought to limit the applicability of Section 7525. The IRS was to some extent successful in a 2004 decision by the District Court for the District of Columbia involving KPMG's assertion of the privilege in the context of tax planning memoranda provided by KPMG to its clients. That court rejected the assertion of the Section 7525 privilege on the ground that KPMG was providing tax return preparation services and not tax advice. As noted above, the *Textron* court found that Textron's accountants were providing tax advice in their estimation of risks of litigation and not providing purely accounting services such as mere tax return preparation. The court also rejected the notion that Textron's accountants were somehow "promoting" a tax shelter in providing the advice. Tax shelter promotion is a statutory exception to the Section 7525 privilege.

Despite agreeing with Textron that its workpapers were privileged documents, the district court nonetheless held that Textron had waived both the attorney-client and tax practitioner privilege. As a general matter, disclosing privileged materials to certain third parties will waive the protection of the privilege. The court found that E&Y was a third party, the disclosure to which waived the privilege.

Work Product Applied and Was Not Waived

Textron successfully argued that its workpapers were protected by the work product privilege. Work product protects documents that are created in anticipation of litigation. As described by the court, the workpapers contained specific discussions regarding the merits of tax return positions where the law was unclear and conclusions about the risks of litigation on such return positions. In the court's view, this analysis was nothing if not directed towards prospective litigation: "[I]t is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared *at all* 'but for' the fact that Textron anticipated the possibility of litigation with the IRS." (Emphasis added.) The court thus dispensed with the IRS's argument that the workpapers were really created in the ordinary course of business for financial accounting purposes. Following the majority of circuits, including the First Circuit, the court reasoned that a document might be used for business reasons, such as for financial accounting requirements, while

still retaining work product status. Here, there was no question in the court's mind, especially given Textron's past history of controversy and litigation with the IRS, that Textron reasonably anticipated a dispute with respect to the return positions reflected in the workpapers.

Did Textron's disclosure of the workpapers to E&Y waive work product protection? The court, following the trend in cases dealing with disclosure to outside auditors, said no. The question of waiver of work product, unlike waiver of privilege, is not settled merely by determining that the document was shown to a third party. A further question must be asked: whether the disclosure substantially increases the opportunity for a potential adversary to obtain the document. Several recent district court cases have examined the issue and concluded that an outside auditor who receives or reviews documents such as internal reserve estimations does not break the work product protection. While an auditor may have an independent duty as regards its public accounting role, this does not mean information it has received is thereby public information. In fact, as noted by the court, E&Y was bound by a professional code of conduct to maintain the confidentiality of Textron's information and was separately bound to confidentiality by way of its engagement with Textron. Thus, the disclosure of the workpapers to E&Y did not waive work product. The court went on to conclude that the IRS had not carried its burden in showing "substantial need" for the information contained in the workpapers. The court noted that allowing the IRS to obatin Textron's workpapers would unfairly disadvantage Textron in any subsequent litigation with the IRS.

FIN 48?

The Textron decision might have implications regarding whether the IRS can successfully compel disclosure of internal FIN 48 workpapers. FIN 48 requires a determination that an uncertain tax return position has a more likely than not chance of prevailing in order to book the tax benefit. The tax benefit recognized is the largest amount that has a more than 50% chance of being realized on ultimate settlement with the taxing authority. Reasoning similar to that of the Textron court could apply inasmuch as, for example, it is unlikely any FIN 48 workpapers would be created if the taxpayer believed its return positions were not uncertain. In other words, FIN 48 workpapers are created specifically for those return positions for which the outcome is uncertain and with respect to which the IRS could decide the taxpayer took the wrong position. Similar to Textron's list of positions for which the law was "unclear," the FIN 48 positions are those that are "uncertain." Thus, the court's analysis regarding the application of work product at least in theory would apply to FIN 48 workpapers.

The analysis applied by the district court in *Textron* is also of interest in state tax matters. Just like the IRS, many state departments of revenue have become much more aggressive in seeking taxpayers' internal workpapers. Many states' laws on work product are similar to the federal principles applied in *Textron*, and some provide protection that is arguably even broader than that available under federal law.

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[1] The district court rejected Textron's argument that the summons was issued for an improper purpose, i.e., to use the workpapers as leverage to force concessions from Textron.

[2] With regard to TFC's workpapers, TFC's accountants relied on outside tax advisors to review the draft workpaper package. After receiving input from the outside advisors, TFC's accountants then met with a Textron tax attorney to finalize the package.