

### FIRST CIRCUIT UPHOLDS WORK PRODUCT PROTECTION FOR TAX ACCRUAL WORKPAPERS

#### **Textron's Workpapers Were Prepared In Anticipation Of Litigation**

Tax accrual workpapers can be protected from disclosure by the work product doctrine, according to a January 21, 2009 decision by the First Circuit Court of Appeals in *United States v. Textron, Inc.*, No. 07-2631 (1st Cir. 2009). In this high profile case, the IRS argued that it should be entitled to enforcement of an administrative summons of Textron's workpapers because they were prepared in the ordinary course of business to comply with the company's financial reporting and securities obligations. The court concluded otherwise, ruling that because Textron's workpapers analyzed litigation risks for the purpose of creating an accounting reserve, they were prepared "in anticipation of litigation," and qualified for protection from disclosure under the work product doctrine.

The court, applying a legal standard known as the "because of" test, focused on "whether [the document] would have been prepared irrespective of the expected litigation." Affirming the district court below, the court ruled that the driving force behind the preparation of the workpapers was "the need to reserve money in anticipation of disputes with the IRS." Thus, the documents were prepared "because of the risk of disputes and litigation which gave rise to a need to compute and report tax reserves." Moreover, the privilege was not vitiated even though the documents were also prepared for a non-litigation purpose because the non-litigation purpose itself (i.e., the need to compute and report tax

reserves) "derives from and is inextricably related to [the] anticipated litigation."

#### **Disclosure Of Auditor's Workpapers May Waive Work Product Protection**

Although the court affirmed that the work product doctrine applies, the decision was not a complete victory for the taxpayer. Work product protection, like the attorney-client privilege, can be waived by disclosure to a third-party. However, unlike the attorney-client privilege, where disclosure to a third-party causes an outright waiver, work product protection is not waived merely by disclosure to a third-party unless the third-party is a potential adversary or the disclosure substantially increases the opportunities for potential adversaries to obtain the information disclosed.

In *Textron*, the court contemplated an unusual route by which a waiver of work product protection may have occurred. First, it held that the auditor's workpapers were discoverable by the IRS. Next, the court considered whether disclosure of the auditor's workpapers to the IRS could cause a waiver of Textron's protection for its own workpapers if the auditor's workpapers were considered to reveal Textron's analysis. This raised the question of whose analysis was contained in the auditor's workpapers – Textron's or the auditor's own independent analysis – which had never been addressed in the court below. Therefore, the case was remanded for further factual findings. The appeals court also remanded the question of whether the summons to Textron should



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have encompassed the auditor's workpapers on the ground that they were in Textron's "possession, custody or control."

## The Fight Over IRS Access To Taxpayer Workpapers Is Likely To Continue

By virtue of the remand in *Textron* and the fact that the decision is in conflict with at least one other circuit (*United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982)), the impact of the case remains uncertain. Although the historically robust breadth of the work product doctrine was upheld, the decision left unanswered the practical effect of that protection for taxpayer workpapers if a waiver can occur merely by disclosure of an auditor's separate workpapers. Moreover, the new disclosure regime under Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") adds further complications. Because FIN 48 requires a reserve analysis that is supposed to ignore the risk that a tax issue might be disputed, even a favorable outcome in *Textron* – a pre-FIN 48 case – may be distinguishable from future IRS attempts to obtain taxpayer workpapers.

In the end, a few lessons can be drawn. Most importantly, the involvement of in-house or outside counsel in performing the litigation risk assessment is critical to claiming work product protection. (In *Textron*, the taxpayer wisely ensured that in-house or outside counsel were involved in this process.) Also, taxpayers should consider how detailed to be in their analysis if the intention is to include it in workpapers shown to their auditors. The best course may be to provide a less detailed analysis for inclusion with the workpapers and to prepare a more comprehensive analysis for internal legal use only.

By following this methodology, the questions raised by the *Textron* decision are less likely to be confronted by other taxpayers. However, if withholding a detailed analysis does not satisfy the auditors, then taxpayers should at least seek to follow *Textron's* lead by showing the auditors a more comprehensive analysis but not providing them with a copy. For *Textron*, the taxpayer's prudent handling of these issues may turn out to be its salvation when a final decision is rendered in the remanded case.

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