

# First Circuit in *Textron* Rules That Tax Accrual Workpapers Are Not Protected Work Product

ROBIN L. GREENHOUSE, JOSEPH H. SELBY, KEVIN SPENCER, AND LEAH ROBINSON

*The authors review the implications of a recent circuit court decision rejecting the argument that work product privilege protected tax accrual workpapers from disclosure.*

A divided U.S. Court of Appeals for the First Circuit recently ruled, in *United States v. Textron Inc. et al.*, that Textron's tax accrual workpapers were "independently required by statutory and audit requirements and that the work product privilege does not apply."<sup>1</sup>

## BACKGROUND

The Internal Revenue Service ("IRS") issued an administrative summons to Textron pursuant to I.R.C. § 7602 seeking tax accrual workpapers in the actual or constructive possession, custody or control of Textron or

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Robin L. Greenhouse, a partner in the law firm of McDermott Will & Emery LLP based in the firm's Washington, D.C., office, is a member of the firm's Tax Department. She can be reached at [rgreenhouse@mwe.com](mailto:rgreenhouse@mwe.com). Joseph Selby, a partner in the firm's Boston office, is a member of the firm's Tax Department. He can be reached at [jselby@mwe.com](mailto:jselby@mwe.com). Kevin Spencer, a partner in the firm's Washington, D.C., office, is a member of the firm's Tax Department. He can be reached at [kspencer@mwe.com](mailto:kspencer@mwe.com). Leah Robinson, an associate in the firm's New York office, can be reached at [lmrobinson@mwe.com](mailto:lmrobinson@mwe.com).

its accountants for Textron's 2001 tax returns. The workpapers at issue included summary spreadsheets showing for each disputable item the amount in controversy, estimated probability of a successful challenge by the IRS, and resulting reserve amounts, as well as back-up e-mail and notes. Textron refused to comply and asserted, among other defenses, that the tax-accrual workpapers sought were protected by the work product doctrine because the documents were prepared in anticipation of litigation, *i.e.*, in preparation for a tax dispute with the IRS. The IRS sued to enforce the summons.

In August 2007, the U.S. District Court for the District of Rhode Island refused to enforce the summons holding that the workpapers at issue were protected work product. In January 2009, a panel of the First Circuit affirmed. In a split decision, the panel agreed that one of the purposes behind the creation of the tax-accrual workpapers was the anticipation of litigation: "the need to estimate the likelihood of success in litigation was a result of the need to set up a reserve fund to cover tax positions for which Textron could foresee disputes with the IRS." Moreover, the panel rejected the government's argument that "the mere presence of a business or regulatory purpose defeats work-product protection," on the grounds that "dual purpose documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose."

Subsequently, the First Circuit granted the government's petition for rehearing *en banc*, vacating the panel's decision. The case was argued before the five active judges on the First Circuit on June 2, 2009. The First Circuit issued its decision on August 13, 2009.

## FIRST CIRCUIT OPINION

In a 3-2 decision, the First Circuit reversed the district court's decision and held, instead, that the tax accrual workpapers were not protected by the work product doctrine. The First Circuit stated that its decision was in line with its precedent, *Maine v. United States Dep't of Interior*<sup>2</sup> (which it reaffirmed *en banc*) — "the Textron work papers were independently required by statutory and audit requirements and that the work product privilege does not apply." Although the First Circuit couched its decision

under the “because of” test laid out in *Maine*, the First Circuit rearticulated the standard as whether the documents were “prepared for use in possible litigation.” The First Circuit addressed the disparity in its rearticulated standard with the phrase used in Rule 26(b)(3) of the Federal Rules of Civil Procedure (“FRAP”) — “prepared in anticipation of litigation or for trial” — and concluded that the phrase “meant only that the work might be done *for* litigation but *in advance* of its institution.”

In reviewing the facts of the case, the First Circuit explained that if the district judge had made the “for use” finding “that finding would have been clearly erroneous.” Instead, “the immediate motive of Textron in preparing the tax accrual work papers was to fix the amount of the tax reserve on Textron’s books and to obtain a clean financial opinion from its auditor.” Indeed, “the purpose of the work papers was to make book entries, prepare financial statements and obtain a clean audit cannot be disputed.”

The First Circuit employed a “you know it when you see it” approach to discerning the purpose for which Textron’s workpapers were prepared: “Any experienced litigator would describe the tax accrual work papers as tax documents and not as case preparation materials.” The First Circuit further explained “[e]very lawyer who tries cases knows the touch and feel of materials prepared for a current or possible (*i.e.*, ‘in anticipation of’) law suit...[n]o one with experience of law suits would talk about tax accrual work papers in those terms.” The First Circuit found that “the only purpose of Textron’s papers was to prepare financial statements.” In fact “[t]here is no evidence in this case that the work papers were prepared for such a use or would in fact serve any useful purpose for Textron in conducting litigation if it arose.”

## THE DISSENT

The dissent vigorously argues that the majority has abandoned the “because of” test laid out in *Maine*, substituting a new, stricter standard, the “prepared for” test. The dissent argues this new standard is “an even narrower variant of the widely rejected ‘primary motivating purpose’ test used in the Fifth Circuit and specifically repudiated” by the First Circuit. Moreover, the dissent points out that *Maine* explicitly adopted the stan-

dard set forth by the Second Circuit in *United States v. Adlman*,<sup>3</sup> which held that similar workpapers are protected work product. Moreover, in *Adlman*, the Second Circuit explicitly rejected the majority's interpretation of FRAP Rule 26(b)(3) (the text of Rule 26(b)(3) does not limit its protection to materials prepared to assist at trial but also to documents prepared in anticipation of litigation). Thus, according to the dissent, the *en banc* court's decision is not only contrary to the precedent of the First Circuit, but also creates a conflict with the Second Circuit.

The dissent also disagreed with the majority's characterization of the facts. The dissent explained that "Textron's litigation hazard percentages contain exactly the sort of mental impressions about the case" that the Supreme Court of the United States in *Hickman v. Taylor* sought to protect. "In fact, these percentages contain counsel's ultimate impression of the value of the case...[r]evealing such impression would have clear free-riding consequences."

The dissent urges that under the "because of" test articulated in *Maine*, the majority should have concluded the workpapers were protected work product. To begin the analysis, the proper starting point is the district court's factual findings. The dissent argues that the majority fails to reject the lower court's findings and instead simply recharacterizes them to suit their fancy. The majority "should accept the district court's factual conclusion that Textron created these documents for the purpose of assessing its chances of prevailing in potential litigation over its tax return in order to assess risks and reserve funds."

The dissent also accuses the majority of stretching to reach a result-oriented decision: "In straining to craft a rule favorable to the IRS as a matter of tax law, the majority has thrown the law of work-product protection into disarray." The majority has succeeded to "further the split [among the Circuits] by purporting to apply the 'because of' test while rejecting the test's protection for dual purpose documents." In fact, the majority has applied a new test that "requires that documents be actually 'prepared for' use in litigation." The dissent sends an invitation for resolution: "The time is ripe for the Supreme Court to intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country."

## **NEXT STEPS: PETITION FOR WRIT OF *CERTIORARI***

There are two reasons the Supreme Court may be inclined to grant a petition for *certiorari*. First, as described above, the dissent's view is that the majority's decision is in direct conflict with the Second Circuit's decision in *Adlman* and the Fifth Circuit's minority "primary motivating purpose" test. Second, the decision may wreak havoc, outside the context of tax accrual workpapers, in non-tax civil litigation. This decision may open the door for one party in litigation to discover the opposing party's litigation reserve.

## **SPECIAL NOTE REGARDING STATE TAX IMPLICATIONS OF THE *TEXTRON* DECISION**

As noted above, the implications of the *Textron* decision are not limited to the question of discovery of tax accrual workpapers or, indeed, discovery in the federal tax context. There could be implications to litigations in a variety of circumstances (most directly, of course, for parties located in the First Circuit). The discussion that follows highlights certain potential implications in the context of state tax disputes.

The state and local tax implications of the *Textron* decision cannot be overemphasized. As discussed below, state departments of revenue request tax accrual workpapers in more circumstances than the IRS does. Like federal tax accrual workpapers, state tax accrual workpapers are highly likely to include information and analysis that reflect the taxpayer's litigating hazards in multiple jurisdictions. Few state courts, however, have defined "in anticipation of litigation" for state tax purposes and therefore look to federal law for guidance. Most importantly, providing the workpapers to one state department of revenue can result in the waiver of work product protection in other jurisdictions, even where the other jurisdictions have higher standards for determining when work product protection applies. But there are steps a company can take to retain work product protection even after *Textron*.

Unlike the IRS, state departments of revenue have not adopted a "policy of restraint" that limits requests for tax accrual workpapers to issues

involving so-called “listed transactions.” State departments of revenue can — and do — request tax accrual workpapers that are wholly unrelated to listed transactions (*e.g.*, workpapers supporting nexus reserves). Specifically, state departments of revenue routinely request the workpapers created to support FIN 48 tax reserves, which include analysis of uncertain tax positions, arguments in favor and against a company’s positions, and the expected range of settling future and current litigation of the issues.

Unlike previous accounting standards, FIN 48 requires a state-by-state analysis of each uncertain tax position. These analyses often include documentation detailing the company’s facts and legal arguments in favor of and against its uncertain tax position. While the facts themselves would likely be discoverable by a state department of revenue if it inquired, the legal analysis of the issues, as well as opinions regarding how the issue would likely settle during litigation, likely would be protected from disclosure by the attorney-client privilege, unless that privilege was waived (which is arguably the case if the documents are provided to an accounting firm as part of the FIN 48 analysis).

Few state courts have formalized what “in anticipation of litigation” means with regard to tax accrual workpapers in that state, and therefore are likely to rely on the federal case law in their circuit. The vitality of the leading state court decision on this issue, *Commissioner of Revenue v. Comcast Corp.*,<sup>4</sup> which held that tax accrual workpapers were prepared in anticipation of litigation, is questionable in light of *Textron*. State departments of revenue (within and outside of the First Circuit) are likely to argue that the new *Textron* standard for determining when a document was prepared “in anticipation of litigation” is the correct one for state as well as federal income tax purposes.

Perhaps the greatest concern from a state tax perspective is that, unlike in the federal realm, companies are not accountable to just one government body (such as the IRS). Instead, they must answer to the department of revenue in each state in which they do business and in each state where the department of revenue takes the position that they do business (even if, ultimately, the Supreme Court would determine that the state did not have sufficient jurisdiction over the company). Thus, a company may receive formal and informal requests for copies of its tax accrual workpapers from

every state department of revenue, and voluntary disclosure to one may waive work product protection in other jurisdictions.

Voluntary compliance with a department of revenue request or even a court-issued subpoena may constitute a waiver of work product protection. However, rigorous resistance to a request or subpoena (*e.g.*, formally objecting to the request, producing a privilege log and litigating the issue if necessary) may maintain the protection even if a court ultimately orders production. In other words, voluntary disclosure in one jurisdiction based on the new, lower standard of *Textron* may waive protection in the other jurisdictions even if the other jurisdiction employs the “because of” test; however, compelled disclosure in one jurisdiction may not necessarily waive the work product protection elsewhere. Thus, companies should continue to rigorously defend the applicability of the work product doctrine in each jurisdiction in order to protect its documents in other jurisdictions.

## NOTES

<sup>1</sup> No. 07-2631 (1st Cir. Aug. 13, 2009).

<sup>2</sup> 298 F.3d 60 (1st Cir. 2002).

<sup>3</sup> 134 F.3d 1194 (2d Cir. 2002).

<sup>4</sup> 901 N.E.2d 1185 (Mass. 2009).