

# Hands-Off My Tax Accrual Workpapers: *Textron*, FIN 48, and Related Issues

By Jean A. Pawlow, Stephen M. Ryan, and Kevin Spencer

The confidentiality of your company's tax accrual workpapers is under attack. The Internal Revenue Service wants access to these workpapers so it can discover without effort the creative tax transactions reviewed or structured by your tax advisers. Your independent auditor wants them so it can confidently comply with the dizzying myriad of rules promulgated by the American Institute of Certified Public Accountants, Congress (in the Sarbanes-Oxley Act of 2002), the Securities & Exchange Commission, and the Public Company Accounting Oversight Board. And now Chairman Carl Levin and his Senate Permanent Subcommittee on Investigations want you to cooperate with their investigators and provide the information in those workpapers for potential public hearings and, perhaps, legislation.

The American Bar Association's Attorney-Client Privilege Task Force issued an important report last year advocating the preservation of the attorney-client and work product privileges in the audit context. The ABA's Task Force confirmed that the privileges promote legal compliance through effective counseling, ensure effective client advocacy, and promote a proper and efficient American adversary system of justice.<sup>1</sup> The recent and much anticipated decision in *United States v. Textron, Inc.*<sup>2</sup> demonstrates that corporate America is resisting the attack on confidentiality — and, at least for the time being, winning.

## ***United States v. Textron, Inc.***

On August 29, 2007, the U.S. District Court for the District of Rhode Island ruled that the IRS could not force Textron, Inc. to turn over its tax accrual workpapers since they were protected from discovery under the attorney work product doctrine and disclosure to Textron's outside auditors did not constitute a waiver of that privilege.

## **A. A Policy of Restrained Restraint**

More than 20 years ago, the Supreme Court of the United States in *United States v. Arthur Young & Co.*<sup>3</sup> affirmed the IRS's right to obtain tax accrual workpapers prepared by a taxpayer's independent auditors. In Announcement 84-46, 1984-18 I.R.B. 18, the IRS notified taxpayers that, despite this victory, it would restrain itself, and request tax accrual workpapers only in unusual circumstances.<sup>4</sup>

That was then and this is now. In the wake of the proliferation of tax shelters, the IRS announced that it will routinely request tax accrual workpapers if a taxpayer has engaged in a "listed transaction."<sup>5</sup> Specifically, for tax returns filed on or after July 1, 2002, the IRS will routinely seek tax accrual workpapers that pertain only to the listed transaction for the year under examination if the taxpayer properly disclosed the transaction on its tax return. If the taxpayer did not properly disclose the listed transaction, or if the taxpayer claimed tax benefits from multiple listed transactions, the IRS has discretion to request all tax accrual workpapers for all years under examination.<sup>6</sup>

Of course, these are simply the IRS's internal guidelines and taxpayers may challenge the IRS's policy.<sup>7</sup> Textron did just that.<sup>8</sup>

## **B. *Textron's* Facts**

Textron is a \$15 billion, publicly traded conglomerate, known for manufacturing Cessna aircraft and Bell helicopters. During 2001 and 2002, Textron employed several in-house tax attorneys and certified public accountants. Like most large corporations, Textron's returns were regularly audited by the IRS, and in seven of the last eight audit cycles, Textron had administratively contested the IRS examiner's proposed adjustments. Three of those disputes ended up in court.

During its examination of Textron's 1998-2001 tax years, the IRS discovered that Textron had engaged in nine sale-leaseback transactions during the years under audit. The IRS contends that the transactions are substantially similar to the "sale in, lease out" or SILO transactions that it has categorized as listed transactions,<sup>9</sup> and in accordance with its audit policy, the IRS requested *all* of Textron's tax accrual workpapers, including those of its subsidiary, Textron Financial Corporation.<sup>10</sup> Textron refused to produce the documents, and the IRS issued an administrative summons. Textron again refused to yield, so the United States brought suit to enforce the IRS summons.

## **C. What Are Tax Accrual Workpapers?**

As the court in *Textron* recognized, there is no "immutable definition" of the term tax accrual workpapers, so what they are will differ from corporation to corporation and case to case. The IRS defines the term in the Internal Revenue Manual as:

[T]hose audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate 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 reserves on audited financial statements. These workpapers reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis.<sup>11</sup>

The tax accrual workpapers at issue in *Textron* were a series of spreadsheets that contained in-house counsel's lists of return items thought to involve unclear law, "hazards of litigation percentages," and tax reserve amounts quantifying the hazards of litigation, as well as backup workpapers, including in-house counsel notes and memoranda articulating the reasoning behind the numbers in the spreadsheets. The court found that the workpapers had the dual purpose of ensuring that Textron had adequately reserved for any potential future disputes and litigation and enabling the company

to satisfy its independent auditor that the reserve amounts complied with Generally Accepted Accounting Principles (GAAP), entitling it to a “clean” opinion for its financial statements filed with the SEC. As part of its internal audit process, Textron permitted its independent auditor, Ernst & Young, to examine the workpapers with the express understanding that they were to be kept confidential.

The decision in *Textron* itself does not address whether a document does or does not constitute a tax accrual workpaper. Most taxpayers have “layers” of workpapers providing more or less detail, both with respect to the computations and also with respect to underlying legal analysis.

#### D. The District Court’s Analysis

In acknowledging that the IRS has broad summons authority, which leans heavily toward disclosure in the face of a legitimate inquiry, the court disagreed with Textron’s argument that the IRS was improperly seeking the workpapers to gain leverage in settlement negotiations. The court explained that Textron did not prove bad faith and the IRS has discretion to determine how it will conduct an investigation. Indeed, the IRS is not required “to obtain relevant information by the least formal means possible.”

The court agreed with Textron, however, that the workpapers were privileged under the attorney-client privilege and the so-called tax practitioner-client privilege.<sup>12</sup> Nonetheless, the court held that Textron had knowingly waived both privileges when it provided the workpapers to Ernst & Young because the purpose of these privileges is to protect confidentiality.

The work product privilege, the court explained, is different. This privilege applies to material prepared and gathered by an attorney in anticipation of litigation or preparation for trial. Unlike the attorney-client privilege, the work product privilege is qualified and a showing of “substantial need” can overcome any work product privilege that may attach to otherwise discoverable material.<sup>13</sup>

Two tests have been used to determine if a document was prepared “in anticipation of litigation.” A minority of courts apply the “primary purpose” test that protects documents “as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation.”<sup>14</sup> The majority adopted and more inclusive “because of” test asks whether the document was prepared or obtained “because of” the prospect of litigation.<sup>15</sup>

Noting that the U.S. Court of Appeals for the First Circuit had adopted the “because of” test,<sup>16</sup> and that the work product doctrine does not apply if the materials were prepared in the ordinary course of business, the district court in *Textron* stated that it was clear that the workpapers “would not have been created at all ‘but for’ the fact that Textron anticipated the possibility of litigating with the IRS.” The court explained that, although the workpapers were useful in providing its auditor with justifications for reserve positions it took on its returns, the creation of a reserve itself was evidence that Textron anticipated litigation with the IRS. The court further noted that Textron’s subjective belief was reasonable based upon Textron’s litigious history with the IRS.

Moreover, because the work product doctrine serves a purpose different from the attorney-client and the tax-practitioner privilege, the conduct to waive it differs as well. The court explained that the

purpose of the work product doctrine is “to prevent a potential adversary from gaining an unfair advantage over a party obtaining documents prepared by the party or its counsel in anticipation of litigation which might reveal the party’s strategy or the party’s own assessment of the strengths and weaknesses of its case.” So only disclosures that are inconsistent with “keeping the information from an adversary constituted a waiver of the work product privilege.”

The court concluded that Textron did not waive its work product privilege by sharing its tax accrual workpapers with Ernst & Young, because the disclosure did “not substantially increase the opportunity for potential adversaries to obtain the information.” Under the AICPA Code of Professional Conduct, the auditor had a professional obligation not to disclose client information without Textron’s consent, and Ernst & Young expressly agreed not to provide the information to any other party. In distinguishing prior case law, the *Textron* court underscored the point that “E&Y was a truly independent auditor that had no obligation to the IRS to determine whether Textron’s tax return was correct and no authority to challenge the return.”

Finally, the court explained that while tax accrual workpapers are relevant to its investigation, the IRS failed to show a “substantial need” for the workpapers to overcome the work product privilege. In the case of opinion work product, which contains “mental impressions, conclusions, opinions or legal theories” of attorneys, the court stated that the IRS’s burden is even higher. The court found that while “the opinions and conclusions of Textron’s counsel and tax advisers might provide the IRS with insight in Textron’s negotiating position and/or litigation strategy, they have little bearing on the determination of Textron’s tax liability.” The court counseled that Textron’s tax liability depended on factual information, not the opinions of Textron’s lawyers.

In denying enforcement of the IRS’s summons, the court explained that what is good for the goose is good for the gander: Forcing Textron to disclose the opinions “would put Textron at an unfair disadvantage in any dispute that might arise with the IRS, just as requiring the IRS to disclose the opinions of its counsel regarding areas of uncertainty in the law or the likely outcome of any litigation with Textron would place the IRS at an unfair disadvantage.”<sup>17</sup>

The Department of Justice has announced that it will appeal the *Textron* decision.<sup>18</sup>

#### FIN 48 — “The Sky Is Falling!”

On July 13, 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. Since then many tax professionals have wondered if the proverbial sky is falling.

FIN 48 is an interpretation of FASB Statement No. 109 and relates to how financial reserves are calculated and disclosed for uncertain tax positions. For tax years beginning after December 15, 2006, all enterprises subject to GAAP must perform a special evaluation for uncertain tax positions. This is a two-step process. First, the taxpayer must determine whether the tax position will more likely than not be sustained upon examination based on the technical merits of the position and assuming the IRS has complete knowledge of the facts. The second step is to measure the uncertain tax position. For any tax position that clears the first hurdle, for example, will more likely

than not be sustained, the position is valued as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Sounds simple, but execution has been found to be difficult, frustrating, and very, very expensive.<sup>19</sup>

FIN 48's relationship to tax accrual workpapers may be profound if companies must disclose more information (and related legal opinions) to their independent auditors to comply with FIN 48 and the IRS then decides to seek access to those documents. Already, it is clear that it is "open season" on publicly available FIN 48 disclosures.<sup>20</sup> And, further, that because the IRS regards FIN 48 workpapers as tax accrual workpapers, they are potentially fair game, subject to the IRS policy of restraint.<sup>21</sup>

Do companies have any assurance that their FIN 48 workpapers are protected? If they have the same or substantially similar facts as *Textron* and are in a jurisdiction that recognizes the "because of" test for work product privilege, they may be breathing a sigh of relief. But they should not get too comfortable.

Under FIN 48, a company must decide which of its tax positions are "more likely than not" to prevail. If a company uses in-house counsel or accountants or its independent auditor to make that determination, the IRS considers those opinions to be tax accrual workpapers and the rule in *Textron* may apply. But since the FIN 48 analysis is now required, does that make FIN 48 opinions created in the ordinary course of business and not "in anticipation of litigation"? The *Textron* court, following the more inclusive "because of" test, treats this point as almost a given, explaining that the hazards of litigation and calculation of reserve amounts would not have been performed "but for" the fact that *Textron* anticipated problems with the IRS.

FIN 48 opinions, however, are prepared for a somewhat different purpose — to comply with FIN 48. Does that make them any less litigation inspired? Logic says no. If the FIN 48 opinion assesses a company's chances of succeeding against the IRS as being anywhere less than 100 percent, the opinion is being prepared "because of" the prospect of litigation with the IRS. If a position is not uncertain, FIN 48 would not even be at issue. It should not matter, therefore, as the *Textron* court pointed out, that the FIN 48 opinion was also created to give the auditors a measure of comfort. That the FIN 48 opinion serves a dual purpose is not the end of the inquiry.

But do you automatically have a reasonable belief that litigation is possible just because you go through the FIN 48 analysis? The *Textron* court focused on the litigious history of the parties; *Textron* went to the mat with the IRS in seven of its previous eight audit cycles and thrice ended up in court. Each company should analyze its own situation. Ironically, as the IRS continues to add listed transactions and "Industry Issue Focus" items (*i.e.*, Tier I and Tier II transactions) taxpayers may have stronger arguments that they expect to square off with the IRS at some point in the future.

What if a company hires outside counsel to prepare the FIN 48 more likely than not opinion? According to the IRS's definition, that opinion may not be a tax accrual workpaper because the IRS's definition of tax accrual workpapers refers only to documents prepared by the taxpayer, the taxpayer's accountant, or the independent auditor.<sup>22</sup> Arguably a company might have a stronger claim

that the opinion was not created in the ordinary course of business since it hired a tax lawyer to draft the opinion. Additionally, hiring an outside tax lawyer to draft the opinion might make for a stronger claim that litigation was anticipated. Going outside the organization for assistance grants an air of importance that may be perceived as taking the issue more seriously.

Although it is not settled whether disclosing a FIN 48 opinion to independent auditors will waive the work product privilege, *Textron* has given companies another arrow in their quiver.


## The Congressional Inquiry and Work Product Privilege

This summer two dozen or more corporations have received letters from the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, requesting them to complete a questionnaire disclosing information concerning their FIN 48 numbers and tax reserves for uncertain tax positions.<sup>23</sup> The letter and the questionnaire are part of an investigation that the PSI is conducting. Given the PSI's last two major investigations,<sup>24</sup> taxpayers should expect hearings, a lengthy report, the introduction of legislation designed to curb any perceived tax abuse, as well as possible additional pressure on the IRS to request tax accrual workpapers.<sup>25</sup>

Voluntarily providing information for which the attorney-client and work product privileges apply to a governmental agency is considered a waiver of the privileges.<sup>26</sup> To preserve either privilege in the face of a congressional request or subpoena, a company must do more than object.<sup>27</sup> Indeed, some courts have gone as far as to require a party to force a contempt citation and then challenge it in court. Resisting the PSI's request raises numerous strategic and legal issues, but companies facing a request such as the PSI's should know that turning over the information may waive any privilege they may have and, thus, might open the door for the IRS to gain access to related tax accrual workpapers.

## Lessons to Be Learned

*Textron* holds many lessons for corporate taxpayers (though some or all of them may be short-lived).

- First, disclosure to an independent auditor should not, in and of itself, waive the work product privilege. Having said this, precautions should be observed, including conspicuously labelling what is shared as "Confidential" and "Protected by the Work Product Privilege," and seeking an express confidentiality agreement with the independent auditor that provides for his non-disclosure of materials and information provided.
- Second, prior to a disclosure, a thorough analysis should be performed to determine whether the materials are privileged. The analysis should consider why the document was created, by whom, in what role or capacity, and does the document have multiple uses, and which test will apply: the more inclusive "because of" test or the minority "primary purpose" test.
- And third, before handing over materials to anyone who could be considered an "adversary," analyze whether it is worth resisting to preserve your privilege against future disclosure. 

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1. See ABA Task Force Examines Attorney-Client Privilege and Audit Disclosures, Tax Analysts, 2006 TNT 214-84 (Jun. 14, 2006).
2. CA No., 06-198T (D.R.I. Aug. 29, 2007).
3. 465 U.S. 805 (1984).
4. An "unusual circumstance" is when the IRS cannot obtain the factual data it needs to support the information provided on the tax return from the taxpayer's records or from third parties. See I.R.M. 4.10.20.3.1 (7/12/2004).
5. See Announcement 2002-63, 2002-2 C.B. 72. A "listed transaction" is a transaction that the IRS has identified as a tax avoidance transaction and that the IRS has publicly identified by notice. See Treas. Reg. § 1.6011-4(b)(2).
6. See I.R.M. 4.10.20.3.2.3 (1/15/2005).
7. The IRS has recently indicated that its policy on tax accrual workpapers is under review to ensure that it is "still appropriate in today's environment." See *FIN 48 and Tax Accrual Workpaper (TAW) Policy Update LMSB Commissioner Memorandum*, LMSB-04-0507-044 (May 10, 2007).
8. Regions Financial Corporation is also fighting an IRS summons for its tax accrual workpapers in the U.S. District Court for the Northern District of Alabama.
9. See IRS Notice 2005-13, 2005-9 I.R.B. 630.
10. In an April 24, 2007, posting on its web site under the heading "Tax Accrual Workpapers Frequently Asked Questions," the IRS has announced that "In general, the taxpayer should be given an opportunity to explain why it believes the transaction is not a listed transaction or substantially similar to a listed transaction." In practice, taxpayers are battling workpaper issues before a determination (by a court) of whether a transaction is or is not substantially similar to a listed transaction, and indeed, prior to any determination that the transaction is in fact a tax shelter.
11. I.R.M. 4.10.20.2 (7/12/2004).
12. I.R.C. § 7525 provides a privilege against disclosure of tax advice communicated between a federally authorized tax practitioner and a taxpayer if that communication would be privileged if it were between a taxpayer and a lawyer.
13. See Fed. R. Civ. P. 26(b)(3).
14. See *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982).
15. See *United States v. Aldman*, 134 F.3d 1194 (2d Cir. 1998).
16. See *Maine v. Department of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002).
17. The IRS has sought shelter in the work product privilege as well. In *Ratke v. Commissioner*, 129 T.C. No. 6 (Sept. 5, 2007), the IRS claimed that its internal memoranda that suggested and analyzed various litigation positions were protected from discovery by a taxpayer based upon the work product privilege. The IRS had previously provided the taxpayer with redacted versions of the memoranda, but the taxpayer sought unredacted copies claiming that the IRS had waived any privilege against disclosure. The Tax Court agreed with the IRS, finding that the memoranda were privileged, the taxpayer had failed to demonstrate a substantial need for the redacted material, and the IRS had not waived the privilege.
18. *Government Files Notice It Is Appealing "Textron" Work Product Ruling*, BNA Daily Tax Report No. 205, at K-1 (Oct. 24, 2007). Speaking at the TEI conference in New York on October 10, 2007, IRS Chief Counsel, Donald Korb, argued against the *Textron* decision, stating that "the court's application of the work product doctrine is simply wrong." 2007 TNT 197-3 (Oct. 4, 2007).
19. Nancy B. Nichols, John W. Briggs, and Charles P. Baril, *And the Impact Is . . . First-Quarter Results From Adopting FIN 48*, 2007 TNT 147-39 (Jul. 31, 2007); Thomas Jaworski and Jeremiah Coder, *Panel Debates Effect of FIN 48 on Transparency, Compliance*, 2007 TNT 136-1 (Jul. 16, 2007).
20. Christine Harris, *Korb Discusses IRS's Policy of Restraint for FIN 48 Tax Accrual Papers*, Tax Analysts, 2007 TNT 99-4 (May 22, 2007).
21. See *FIN 48 and Tax Accrual Workpaper (TAW) Policy Update LMSB Commissioner Memorandum*, LMSB-04-0507-044 (May 10, 2007).
22. See note 11 *supra*.
23. *Levin Asks Corporations for Information on Tax Benefits, FIN 48 Compliance*, Tax Analysts, 2007 TNT 170-24 (Aug. 23, 2007).
24. *Tax Haven Abuses: The Enablers, the Tools and Secrecy*, 2006 TNT 147-18 (Aug. 1, 2006); *Role of Professional Firms in the U.S. Tax Shelter Industry*, Senate Report 109-54 (April 2005).
25. Chairman Levin's lead investigator, Robert Roach, has stated: "[W]hy is it that even though the Supreme Court said that the IRS can look at the tax accrual workpapers, the IRS says, we won't do it? Why is it that companies are so afraid, with the IRS looking at it, if they really believe the position they took is a good one?" *Financial Reporting and Corporate Transparency: How Do Releases of New Information Under FIN 48 Affect the IRS's Disclosure Needs?*, Tax Analysts, 2007 TNT 144-39 (Jul. 13, 2007).
26. See *In re Sealed Case*, 676 F.2d 793 (D.C. Cir. 1982); *In re Subpoenas Duces Tecum*, 738 F.2d 1367 (D.C. Cir. 1984); *In re Steinhardt Partners, LP*, 9 F.3d 230 (2d Cir. 1993); *Westinghouse Electric Corp. v. Republic of Philippines*, 951 F.2d 1414 (3d Cir. 1991) (since Westinghouse was a target of the investigation, when it voluntarily disclosed the work product it waived the privilege); *United States v. Massachusetts Institute of Technology* 129 F.3d 681 (1st Cir. 1997) (MIT's disclosure of work product to a government audit agency that was a "potential adversary" waived its privilege); *Permian Corp. v. United States*, 665 F.2d 1214 (D.C. Cir. 1981) (applying the same rationale to waiver of the attorney client privilege).
27. In finding that R.J. Reynolds Tobacco Company had waived its work product privilege by voluntarily producing documents to a congressional committee, the court in *Tompkins v. R.J. Reynolds Tobacco Co.*, 92 F. Supp. 2d 70, 78 (N.D.N.Y. 2000), explained, "a party must take steps to preserve claims of privilege against a [congressional] subpoena . . . case law suggests that mere objections to Congress' refusal to extend a privilege are insufficient to contest a congressional subpoena."

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