

# Third Time's *Not* a Charm: *En Banc* First Circuit Permits IRS to Obtain Roadmap to "Soft Spots" On Textron's Returns

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For the last several years, Textron, Inc. has been seeking to keep its tax accrual workpapers away from the prying eyes of the IRS. That struggle took a turn for the worse on August 13, 2009, when a divided U.S. Court of Appeals for the First Circuit sitting *en banc* ruled that Textron's tax accrual workpapers were not protected by the work product privilege. A vigorous dissent effectively dissects the majority's opinion and suggests that it is time for the Supreme Court to intervene. Whether or not Textron's battle may have ended, the war over the disclosure of taxpayers' tax accrual workpapers will surely endure.

## Background of the *Textron* Dispute

During an audit of Textron's 1998-2001 tax cycle, the IRS discovered that Textron had engaged in a series of sale-leaseback transactions that the IRS alleged were substantially similar to the so-called SILO transactions that the IRS had "listed" as abusive tax shelters. In accordance with its audit policy, the IRS requested *all* of Textron's tax accrual workpapers.<sup>1</sup> Among the documents that were responsive to the request were a series of spreadsheets that contained Textron's 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 documenting the rationale behind the numbers in the spreadsheets. As part of its internal audit process, Textron permitted its auditor, Ernst & Young LLP (E&Y), to examine its workpapers with the express understanding that they were to be kept confidential. Textron asserted that the workpapers were protected from disclosure under the "work product doctrine." Textron's resistance to producing the workpapers was met by an IRS administrative summons, which the IRS enforced by bringing suit.

## Trial Court: Workpapers Are Protected from Disclosure

On August 29, 2007, the U.S. District Court for the District of Rhode Island ruled that the IRS could not forcibly obtain Textron's workpapers because they were protected under the work product doctrine and because disclosure by Textron to its independent auditor did not waive that protection.<sup>2</sup> The district court acknowledged that courts wrestling with this issue have employed two tests to determine if a document was prepared "in anticipation of litigation." A minority of courts employ the restrictive "primary purpose" test, which protects documents "as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation."<sup>3</sup> On the other hand, a majority of courts apply the more inclusive "because of" test, which asks whether the

document was prepared or obtained "because of" the prospect of litigation.<sup>4</sup>

Following the First Circuit's decision in *Maine v. Department of the Interior*,<sup>5</sup> which adopted the "because of" test, the district court held that the workpapers "would not have been created at all 'but for' the fact that Textron anticipated the possibility of litigating with the IRS." Furthermore, the court held that disclosure to E&Y did not waive work product protection since the disclosure did "not substantially increase the opportunity for potential adversaries to obtain the information." In fact, E&Y had a professional duty to keep the workpapers confidential.

The IRS appealed the district court's decision to the U.S. Court of Appeals for the First Circuit.

## First Circuit Panel Affirms Trial Court

On January 21, 2009, a three-judge panel of the First Circuit affirmed the district court's decision that Textron's workpapers were protected by the work product doctrine.<sup>6</sup> The court rejected the IRS's argument that "the mere presence of a business or regulatory purpose defeats work-product protection."<sup>7</sup> The court explained that "'dual-purpose' documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose." The court found that "the business purpose derives from and is inextricably related to anticipating litigation. That the anticipation of such disputes (and corresponding potential litigation) also triggered certain business and accounting obligations does not bar the protection of the work-product doctrine."

Moreover, the work product protection applied despite the fact that Textron did not have specific litigation in mind when the documents were created. Indeed, the court found that Textron had a subjective belief that litigation was a real possibility and that belief was objectively reasonable.

The IRS argued that Textron had waived protection when the workpapers were shared with E&Y. The court acknowledged that disclosure of protected material "in a way inconsistent with keeping it from an adversary waives work product protection." Indeed, "disclosure to a conduit to a potential adversary can also waive work-product protection," which "occurs upon disclosure to a third party that 'substantially increased the opportunities for potential adversaries to obtain the information.'" Despite the IRS's argument, the court found that E&Y was not a potential adversary to Textron: "While it is possible to imagine circumstances where E&Y's professional obligations could cause E&Y and Textron to come into conflict on some legal question, the IRS can point to 'no conceivable scenario in which E&Y would file a lawsuit again

[Textron] because of something that E&Y learned from [Textron's] disclosures.”

The court did find evidence that, although E&Y did not retain any of Textron's documents, the auditor had used the workpapers in preparing its own assessment of Textron's reserve tax liability. Thus, “the only remaining documents which could be subjected to a risk of discovery are E&Y's own assessment, which incorporate Textron's analysis.” Since E&Y's documents, unlike Textron's workpapers, could be discovered, the court remanded the case to the trial court to determine to what extent the disclosure of E&Y's workpapers “would effectively constitute disclosure of Textron's own assessment.”

Judge Michael Boudin dissented from the panel's decision, arguing that “tax-accrual workpapers are not protected because they are prepared for reasons independent of the need to prepare for or conduct litigation.”

The IRS sought a rehearing *en banc*, which was granted, thereby vacating the First Circuit's panel decision.

### First Circuit *En Banc* Rules Tax Workpapers Are Not Protected

On August 13, 2009, the First Circuit reversed the district court's ruling, holding that “the Textron workpapers were independently required by statutory and audit requirements and that the work product privilege does not apply.” The 3-to-2 decision averred that it was reaffirming existing precedent, which had adopted the “because of” test,<sup>8</sup> but the appeals court rearticulated the test as whether the documents were “prepared for use in possible litigation.”

The appeals court reasoned that Textron was required to have its financial statements certified by independent auditors. To prepare those financial statements, Textron had to enter reserves on its books to account for contingent tax liabilities. The calculation of such reserves required the preparation of workpapers describing those liabilities. The independent auditor had to examine the workpapers to determine if Textron's reserves were reasonable and sufficient.

The appeals court recognized that one of the “problems” presented by the case was that “how far work product protection extends turns on a balancing of policy concerns rather than application of abstract logic, here . . . [we are dealing with a situation] in which a document is not in any way prepared ‘for’ litigation but related to a subject that might or might not occasion litigation.” Finding that “the IRS is unquestionably right that the immediate motive of Textron in preparing the tax accrual workpapers was to fix the amount of the tax reserve on Textron's books and to obtain a clean financial opinion from its auditor,” the appeals court observed that “[t]he district judge did not say the workpapers were prepared *for use* in possible litigation — only that the reserves would cover liabilities that might be determined in litigation.”<sup>9</sup> Indeed, “even if litigation were ‘remote,’ the company would still have to prepare workpapers to support its judgment.”

The First Circuit glibly employed a “you know it when you see it approach” to ascertaining the purpose for which Textron prepared its tax accrual workpapers: “Any experienced litigator would describe the tax accrual workpapers as tax documents and not as case preparation materials.” The court further explained, “[e]very law-

yer who tries cases knows the touch and feel of materials prepared for a current or possible (*i.e.*, ‘in anticipation of’) law suit . . . . No one with experience of law suits would talk about tax accrual workpapers in those terms.”<sup>10</sup> Tax accrual workpapers, according to the appeals court, are created to support financial statements and the independent audit of them.

The First Circuit concluded that the connection between the creation of the workpapers and the potential for litigation was too remote: “It is not enough to trigger work product protection that the *subject matter* of a document relates to a subject that might conceivably be litigated.”<sup>11</sup> Even if a document is prepared by lawyers or represents “legal thinking,” if it was assembled in the ordinary course of business or pursuant to public requirements not related to litigation, protection is not warranted. Here, the appeals court found that the workpapers were prepared in the ordinary course of Textron's business: “There is no evidence in this case that the workpapers were created for such a use and would in fact serve any useful purpose for Textron in conducting litigation if it arose.”

Underlying the majority's opinion was the concern that the IRS is disadvantaged in its battle against tax dodges: “The practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious.” Textron's tax return, for example, was more than 4,000 pages. For the First Circuit majority, “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.”<sup>12</sup> The IRS only sought Textron's workpapers after finding that Textron had engaged in what the IRS describes as an abusive tax shelter.

### First Circuit Dissent Lays a Path to Supreme Court

A vigorous dissent by Judge Juan Torruella — whose pro-Textron opinion for the panel was vacated when the First Circuit decided to hear the case *en banc* — argues that the majority has abandoned the “because of” test in favor of its newly fashioned “prepared for use in litigation” test. Judge Torruella suggests the majority's test is “an even narrower variant of the widely rejected ‘primary motivating purpose’ test.” Indeed, “[t]he majority ignores a tome of precedents from the circuit courts and contravenes much of the principles underlying the work-product doctrine.” Furthermore, the majority's formulation is not consistent with the plain language of Federal Rule of Civil Procedure 26, which provides protection for documents “prepared in anticipation of litigation *or* for trial.”<sup>13</sup>

The dissent argues that the “because of” test “is not limited to documents prepared *for use* in litigation,” even when applied to documents that serve the dual purpose of anticipating litigation and a non-litigating business purpose, like financial statement preparation. The dissent claims that the appeals court's opinion is not only inconsistent with existing First Circuit precedent, but also creates a conflict with the Second Circuit's “because of” test.

To Judge Torruella, “Textron's litigation percentages contain exactly the sort of mental impressions about the case that [the Supreme Court in] *Hickman [v. Taylor]* sought to protect.”<sup>14</sup> “In fact, these percentages contain counsel's ultimate impression of the value of the case . . . . With this information, the IRS will be able to immediately identify weak spots and know exactly how much Textron should be willing to spend to settle each item.”

The dissent also discusses the ramifications of the majority's ruling beyond the context of tax accrual workpapers: "The scope of the work-product doctrine should not depend on what party is asserting it." Thus, the appeals court's ruling would permit discovery of an opposing party's analysis of business risks, including the amount of money set aside in a litigation reserve fund. Indeed, "documents analyzing anticipated litigation, but prepared to assist in a business decision rather than to assist in the conduct of litigation" would be open to scrutiny and discovery.

To add insult to injury, the dissent argues that the majority "misrepresents and ignores the findings of the district court," seeking to bend them to meet its needs: "Accepting the district court's findings regarding purpose compels a finding of work-product protection, since the precedents are clear that under the 'because of' test, dual purpose documents are protected." The dissent argues that the correct analysis should begin with the district court's finding 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." If the court correctly employed the "because of" test, Textron's workpapers would be considered protected work product.

Judge Torruella argued that the real aim of the majority was not to reach the correct legal decision but rather to ensure an IRS victory: "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." Circuit courts, the dissent explains, were already split on how to interpret the "in anticipation of litigation" standard with some employing the "primary purpose" test while others using the "because of" test. The majority splintered the law further by adding a third test "that requires that documents be actually 'prepared for' use in litigation." The dissent implores the Supreme Court to finally resolve the issue: "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."

### The End Does Not Justify the Means

The *en banc* decision in *Textron* represents a tremendous victory for the IRS in a long fought war to obtain a road map to corporate America's tax returns. Even assuming the appeals court was correct in saying the IRS is often at a disadvantage in collecting tax from large corporations, that reality should not be the standard by which courts vitiate the work product privilege; it does not justify handicapping taxpayers' rights in favor of the IRS.

The appeals court in *Textron* fashioned a new test for determining whether materials are considered work product not by employing sound legal reasoning, but by stacking the deck in favor of the IRS. Although the case involves Textron's battle over the confidentiality of its workpapers, the majority's decision lays the foundation for new battles over all sorts of documents and information that were not "prepared for use in litigation." Under the majority's ruling, *any* estimation of liability that may be used in a business context will be fair game for the government and private litigants alike. This cannot be what the Supreme Court meant in *Hickman v. Taylor*.

There was no compelling reason for the majority to upset longstanding and well-reasoned precedent simply to help the IRS discover what it already knew — that Textron had engaged in several

sale-leaseback transactions. Nor is there evidence that the IRS was in fact disadvantaged in identifying other allegedly improper deductions. The IRS and federal government already have numerous effective tools and methods to flesh out and discover so-called abusive tax shelters. For example, Congress has issued numerous statutes and the IRS has issued numerous regulations relating to the disclosure of reportable and listed transactions that harshly penalize non-disclosure.<sup>15</sup> Generally, if a taxpayer engages in a reportable transaction, the taxpayer and the material advisers must disclose the transaction to the IRS on specialized forms or risk stiff penalties. These regulations are written so broadly that they even "catch" numerous legitimate, non-abusive transactions, for example, certain typical transactions that trigger losses in excess of \$10 million (in the case of a large corporation).<sup>16</sup> Despite the IRS's assertions that it needed Textron's workpapers to assist in the discovery of tax shelters, its true motive was likely to find out how Textron was handicapping its tax positions. Arguably, such information unfairly assists the IRS in ascertaining Textron's settlement pressure point.

That said, the appeals court's decision in *Textron* is a two-way street. The ruling may also be employed by taxpayers to seek out and obtain the IRS's own estimation of its hazards of litigation and legal theories prior to litigation. As the majority explained, "Unprivileged IRS information is equally subject to discovery." Indeed, to the court, IRS documents created during an audit are not protected work product, despite containing attorneys' mental impressions and legal theories, because an IRS audit is not litigation.<sup>17</sup> For example, the IRS routinely redacts its own estimation of litigation hazards when it issues coordinated issue papers. Under the majority's ruling, those percentages are now fair game for taxpayers to request.


The First Circuit's test is unhelpful and unusable. To the majority, it was apparently obvious that Textron's workpapers were not work product. But how are lower courts supposed to employ a "you know it when you see it" standard? As Judge Torruella noted in his dissent, "Lower courts deserve more guidance than a simple reassurance that a bare majority of the *en banc* court knows work product when it sees it."

The most disturbing aspect of the majority's opinion is its bald assumption that the sale-leasebacks in which Textron engaged and for which Textron claimed tax benefits were abusive SILO tax shelters. In fact, no court, including the First Circuit, has ruled on the merits of the deductions claimed by Textron. In attempting to justify its position, the court stated, "Virtually all discovery against a party *aims* at securing information that may assist an opponent in uncovering the truth."<sup>18</sup> But here, the only "truth" the IRS was attempting to discover is what Textron's lawyers and accountants believed were the company's hazards of litigating a case with the IRS.

The First Circuit's *en banc* decision is a knee-jerk reaction to the proliferation of so-called tax shelters by corporate America. The majority's opinion in *Textron* mucks up an already complicated and fact-driven analysis, layering on top a new test, that despite statements to the contrary, requires a cause-and-effect like connection between the preparation of "work product" and the actuality of litigation.

## Now What?

Whether or not taxpayers are subject to the decisions of the First Circuit, disclosure of tax accrual workpapers is a real possibility. Taxpayers should prepare and operate under the assumption that the IRS will seek (and obtain) tax accrual workpapers.

1. Take special care and attention in creating your workpapers. Be careful how transactions and matters are described.
2. Label and treat your workpapers as privileged and confidential. Make sure they are marked and respected accordingly.
3. Involve more lawyers (especially litigators) in determining your exposure. Get the General Counsel's office involved from the beginning. The further the putatively protected document gets from being considered created in the ordinary course of your business, the better your chances will be to persuade a judge that the document should be protected work product.
4. Segregate your workpapers between those created in the ordinary course of business and those specifically related to imminent or potential litigation. Ideally, workpapers should consist only of counsel memorandum, opinions, and litigation hazards assessments, and not business or transactional analyses.
5. Own your workpapers. Do not allow your independent auditor (or anyone else) to keep a copy of your workpapers.
6. Have a written policy of confidentiality with respect to the workpapers that you show to your independent auditors.
7. Cooperate with the IRS by timely furnishing all non-privileged documents and information. A good rapport with your examination team may go a long way in steering you clear of court. 

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1. In Announcement 84-46, 1984-18 I.R.B. 18, the IRS announced that despite its victory in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), it would request tax accrual workpapers only in unusual

circumstances. In the wake of the proliferation of tax shelters, the IRS announced that it will routinely request tax accrual workpapers if the taxpayer has engaged in a "listed transaction." See Announcement 2002-63, 2002-2 C.B. 72; I.R.M. 4.10.20.3.2.3 (Jan. 15, 2005). If a taxpayer has not properly disclosed its participation in a listed transaction on its tax return or has claimed tax benefits from multiple listed transactions, the IRS has the discretion to request all tax accrual workpapers for all years under examination.

2. *United States v. Textron, Inc.*, 507 F.Supp.2d 138 (D.R.I. 2007). See also Jean A. Pawlow, Stephen M. Ryan, and Kevin Spencer, "Hands-Off My Tax Accrual Workpapers: *Textron*, FIN 48, and Related Issues," 59 Tax Executive 421 (Fall 2007).
3. See *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982).
4. See *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998).
5. 298 F.3d 60, 68 (1st Cir. 2002).
6. *United States v. Textron, Inc.*, 553 F.3d 87 (1st Cir. 2009). See also Jean A. Pawlow and Kevin Spencer, "Adrift in a Sea of Uncertainty: Tax Accrual Workpapers Are Work-Product . . . But Showing them to Your Auditor May Waive the Protection," 60 Tax Executive 33 (Jan.-Feb. 2009).
7. See also *Regions Financial Corp. v. United States*, 2008 U.S. Dist. LEXIS 41940, at \*27-28 (N.D. Ala. May 8, 2008); *Lawrence E. Jaffe Pension Plan v. Household International, Inc.*, 237 F.R.D. 176, 183 (N.D. Ill. 2006); *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 448 (S.D.N.Y. 2004), *aff'd and rev'd in part*, 500 F.3d 171 (2d Cir. 2007). But see *Medinol v. Boston Scientific Corp.*, 214 F.R.D. 113, 116-17 (S.D.N.Y. 2002).
8. See *Maine v. Department of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002).
9. Emphasis in original.
10. As one commentator pointed out, the four judges that did find that Textron's workpapers were protected work product had vast litigation experience: "The judges that would have upheld work product had amassed 114 years of judicial experience . . . 71 were spent in trial courts." See Ron Buch, "The Touch and Feel of Work Product," Tax Analysts (Aug. 31, 2009). These judges, apparently, did not know it when they saw it!
11. Emphasis in original.
12. Emphasis in original.
13. Emphasis in original.
14. In *Hickman*, 329 U.S. 495 (1947), the Supreme Court permitted attorney's notes to be withheld from the plaintiffs, holding that they were immune from discovery: "In performing his various duties . . . it is essential that a lawyer work with a certain degree of privacy, free from unnecessary intrusion by opposing parties and their counsel. Proper preparation of a client's case demands that he . . . prepare his legal theories and plan his strategy without undue burden and needless interference." *Id.* at 510-11.
15. See e.g., IRC §§ 6011, 6111, 6112, 6707, 6707A, and 6708.
16. See Treas. Reg. § 1.6011-4(b)(5).
17. See *Abel Inv. Co. v. United States*, 53 F.R.D. 485, 488 (D. Neb. 1971) (cited by the majority).
18. Emphasis in original.