

How the Attorney Work Product Doctrine Can Protect Tax Accrual Workpapers from IRS Summons

Editor's Note: As we were going to press (March 25), the First Circuit vacated its decision in Textron and scheduled an en banc hearing for June 2. Nevertheless, the practical advice set forth in this article remains valid and important.

Robert T. Duffy
Kilpatrick Stockton LLP
Charlotte, North Carolina

In this IRS summons case, the Court of Appeals for the First Circuit, one judge dissenting, ruled that Textron's tax accrual workpapers are attorney work product and are protected against forced disclosure to the IRS.

The appeals court, however, remanded the case to the district court to consider whether Textron must produce the tax accrual workpapers that Ernst & Young ("E & Y") prepared and still holds. The remand potentially threatens the protection against disclosure of the very Textron tax accrual workpapers that the First Circuit's opinion protects for now.

What the Court of Appeals Held

The First Circuit held that because "the function of the documents" – of the tax accrual workpapers that Textron prepared - "was to analyze litigation for the purpose of creating and auditing a reserve fund," it follows that Textron prepared those workpapers "because of" the prospect of litigation. It is irrelevant that Textron also prepared the workpapers to comply with financial reporting obligations because a "dual-purpose" document may be work product. Hence, the workpapers are work product.

The appeals court also held that Textron did not waive work product protection by disclosing its tax accrual workpapers to E & Y, because E & Y was not an actual or potential adversary of Textron. (That disclosure waived the attorney-client privilege, however, and so this case is about work product only.)

Remanded to the District Court

The First Circuit remanded the case to the district court to consider whether Textron must produce the tax accrual workpapers that E & Y prepared and still holds. To avoid a duty to produce the E & Y workpapers to the IRS, Textron must show that it lacks "control" over those papers. Such "control" exists only if E & Y must turn over its workpapers to Textron upon demand.

In a roundabout way, the remand also threatens the protection of the tax accrual workpapers that Textron prepared and the First Circuit protects for now. If the district court rules that Textron controls the E & Y workpapers and must produce them, then the district court also

must ascertain whether the E & Y workpapers reveal Textron's own tax accrual analysis. If so, then, when Textron disclosed its tax accrual workpapers to E & Y, Textron possibly waived work product protection for them.

What Next for Textron?

The question is whether this case first goes down to the district court on remand, or it first goes up to the Supreme Court for review. The IRS might well successfully press the Solicitor General to authorize the United States to petition the Supreme Court to review one or more of the First Circuit's holdings. The United States likely will frame the question for review as whether the First Circuit erred in ruling that the work product doctrine protects Textron's tax accrual workpapers. Less likely, the United States might also ask the Court to review the question whether a financial auditor is a potential adversary (so that disclosing the tax accrual workpapers to E& Y waived work product protection).

If the United States does petition the Supreme Court, then because of the administrative importance of the issue and the conflict between the First Circuit's opinion and the Fifth Circuit's opinion in *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982) (declining to protect tax accrual workpapers as work product), the Supreme Court's granting of the petition becomes a real prospect.

Welcome as this opinion is to taxpayers, it is too soon to rack up certain victory for Textron. Historically, in IRS summons cases, the Supreme Court has more often favored the United States. This litigation over Textron's tax accrual workpapers is not over.

Implementing the Lessons of Textron

While Textron involves an IRS summons, perhaps an equally important application of this case would prevent examinations of work product by state taxing authorities. The IRS has a long-standing "policy of restraint" limiting the examination of tax accrual workpapers unless the taxpayer has engaged in one or more of the maligned "listed transactions." However, the vast majority of state taxing authorities have no such announced policy. Moreover, states are becoming more aggressive as they perceive the erosion of their corporate tax base by sophisticated multi-state strategies.

To sustain the defense of the work product doctrine (and of the attorney client privilege, where appropriate) to the compelled disclosure of confidential tax information, plan ahead. That is, before even preparing that information, make the effort to bring it within the scope of the work product doctrine. Arguments for protecting documents that are thought-up only after they are prepared typically fail.

Conclusion

In summary, Textron's defense against the IRS summons benefited from the following favorable facts, which are worth emulating:

- Use tax lawyers to create the work product. To be sure, “work product” need not be attorney work product, so long as it is prepared in anticipation of litigation or for trial. However, it is much easier to show that tax accrual work papers are work product when a tax attorney, or a person working for the tax attorney, prepares it.
- As in Textron, have the tax lawyers review proposed transactions and, well prior to preparing tax accrual workpapers, identify the risky tax issues, write the memoranda of law and fact, and assess the prospects for success in litigation.
- Document the requirement that the auditor, to whom the tax accrual workpapers are disclosed, must keep them confidential.
- Although the auditor must review the taxpayer’s tax accrual workpapers, do not allow the auditor to retain a copy.
- Do not disclose the tax accrual workpapers to any other third parties.
- Privileged communications and work product aside, cooperate with the IRS by furnishing all other requested information.
- Keep business and transactional records out of the tax accrual workpapers, which ideally should consist only of tax counsel’s memoranda regarding the litigation hazards of doubtful tax positions.