KIRKLAND **ALERT**

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First Circuit *En Banc* Panel to Decide if Tax Accrual Workpapers are Protected Attorney Work Product

Can the IRS compel a taxpayer to produce its own internal analyses — prepared by counsel — of questionable tax positions and the likelihood of success in litigation with the IRS? That issue was addressed during the highly anticipated *en banc* rehearing in *United States v. Textron*, which took place on June 2, 2009 before the United States Court of Appeals First Circuit. While the *en banc* decision has not yet been issued, the ruling could have far-reaching consequences in tax and other disputes. Indeed, at oral argument, counsel for the IRS asserted: "Whatever test this Court applies will apply outside the tax realm. We recognize that."

The specific issue in *Textron* concerns the scope of attorney work product protection over tax accrual workpapers, which provide support for a taxpayer's financial statement reserves. These workpapers are especially sensitive because they often contain an analysis, prepared by counsel, of the taxpayer's exposure to certain tax positions that may be challenged by the IRS. The government's primary argument on appeal is that the workpapers are not work product because they were prepared in the ordinary course of business to support Textron's public financial statements, not to assist in litigation. The IRS further argues that any work product protections were waived when Textron disclosed the workpapers to its independent public accountants. Given the breadth of the government's argument (as counsel for the IRS conceded), a ruling in the case could extend to other legal analyses that are created to assist with SEC reporting obligations or otherwise provided to auditors.

This client alert provides background on the *Textron* case and discusses the recent oral arguments during the *en banc* rehearing. While it is difficult to predict the outcome, the vigorous questioning both sides faced during argument underscores the importance of the issues on appeal.

District Court Decision

Textron, Inc. is a publicly traded company, and like other large companies, Textron undergoes periodic audits of its federal tax returns. During the audit of Textron's 1998-2001 returns, the IRS issued an administrative summons to Textron for "all Tax Accrual Workpapers" for the 2001 tax year.[1] Typically, tax accrual workpapers are prepared by corporate counsel and accountants. The documents provide the necessary support for the tax reserves and ensure that a company is reserved adequately in the event of potential tax disputes or litigation. In this case, Textron's tax accrual workpapers consisted of spreadsheets and memoranda in which the company's tax lawyers identified tax return items for which the tax laws were unclear and, therefore, may be challenged by the IRS. The workpapers also evaluated Textron's chances of prevailing in litigation, in percentage terms, and recommended the dollar amounts that should be reserved to reflect the possibility that Textron might not prevail in litigation.

Invoking the attorney work product doctrine, Textron claimed that the tax accrual workpapers were prepared in "anticipation of litigation" and, therefore, protected from discovery. The company pointed to "hazards of litigation percentages" contained in the tax accrual workpapers as well as past litigation with the IRS to show that it reasonably anticipated litigation with respect to some of the tax positions considered in the workpapers. Indeed,

Textron argued that if it had not anticipated litigation with the IRS, there would have been no reason to establish any reserve or prepare the workpapers used to calculate the reserve.

The IRS argued that the attorney work product doctrine does not apply because the primary purpose for the creation of tax accrual workpapers is to support a taxpayer's tax reserves during independent audits required under federal securities regulations, not to aid in potential litigation. Thus, according to the IRS, the documents would have been created in substantially similar form whether or not the defendant anticipated litigation. The IRS further argued that Textron waived work product protections by providing the workpapers to its independent public accountants.

The District Court found that "there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding." Thus, the court held that Textron's workpapers were prepared "because of" anticipated litigation and were protected work product. Even if created for a "dual purpose" — namely, for anticipated litigation *and* for financial reporting purposes — the tax accrual workpapers were still protected from discovery.

The court further rejected the IRS's waiver argument, reasoning that the work product privilege is waived only where disclosure is made to an adversary or where disclosure "substantially increases the opportunity for potential adversaries to obtain information." The District Court held that disclosure of tax accrual workpapers to independent auditors does not substantially increase the IRS's opportunity to obtain the information contained in those documents. The Court found that an independent auditor is neither itself a potential adversary nor is it a conduit to a potential adversary, such as the IRS.

Original Panel Decision on Appeal

The case was appealed to the First Circuit, and on January 21, 2009, the panel majority upheld the District Court's determination that the tax accrual workpapers were prepared because of litigation and therefore protected. The majority rejected the IRS's contention that the mere presence of a business or regulatory purpose defeats work-product protection. However, the panel majority remanded the case for further consideration of the whether Textron waived work product protections by providing the tax accrual workpapers to the auditors.

In analyzing the waiver issue, the panel majority held that an independent auditor is not in an adversarial position and is unlikely to disclose workpapers to the IRS, or any other potential adversary. However, the auditors may have used Textron's workpapers to prepare their own assessments of the company's tax reserves. Relying on the Supreme Court decision in *United States v. Arthur Young*,[2] the panel majority concluded that the auditor's workpapers may have included tax reserve information that could be discoverable. Because the District Court did not make any factual findings regarding the content of the auditor's workpapers or the extent to which disclosure of those papers would reveal Textron's work product, the panel majority concluded that a remand was necessary.

The dissent by Circuit Judge Boudin concluded that tax accrual workpapers do not qualify for work product protection because they are prepared for reasons independent of the need to prepare for or conduct litigation. Under the First Circuit's decision in *Maine v. United States Dept't. of the Interior,* work product protection does not extend to "documents that are prepared in the ordinary course of business or would have been created in the same form irrespective of litigation."[3] The Court in *Maine,* the dissent noted, concluded that this caveat applies even if litigation is contemplated or the documents aid in the preparation of litigation. Thus, in Judge Boudin's view, Textron's tax accrual workpapers were not protected work product under *Maine* and that the panel majority's holding contradicted that precedent. Perhaps anticipating the petition for rehearing *en banc*, Judge Boudin noted: "it is important for us to adhere to the existing rules of the road. . . . An *en banc* court could change the rule; a panel majority cannot."

En Banc Rehearing

The panel decision was later vacated in March of 2009 when a majority of the five Judges on the First Circuit voted to hear the case *en banc*. Arguably, the granting of the motion for rehearing *en banc* could be interpreted as an indication that most of the judges on the court (at least three of the five) disagreed with the panel decision.[4] However, the spirited questioning during the June 2, 2009 *en banc* rehearing provided few clues as to which way the court will ultimately rule. In fact, the questioning was so active that the parties had no time to address the waiver issue.

Not surprisingly, the judge who wrote the original panel majority decision, Judge Torruella, continued to be supportive of Textron's position. Posing the first questions from the Court, the judge challenged the introductory statement by the IRS that it was not asking the Court to depart from its prior precedent. Indeed, Judge Torruella suggested that the IRS was arguing for a "fundamental change in the rule" and that the IRS itself had advocated the opposite position in trying to protect its own attorney work product from discovery in a prior case. Joined by Judge Lipez, Judge Torruella challenged the IRS position that the documents would have been prepared irrespective of litigation, stressing the District Court's factual finding that the workpapers "would not have been prepared in this form except for the fact they were contemplating litigation."

As the questioning progressed, the agency made its position clear — any document "required to be done for SEC purposes," regardless of its content, is created "in the ordinary course of business" and not protected by the work product privilege. According to the IRS, the First Circuit decision in *Maine* does not protect such documents even if the content reflects a lawyer's mental impressions regarding anticipated litigation.

There appeared to be some support for this position on the Court. For example, much of Chief Judge Lynch's questioning focused on the fact that the FASB standards on tax and other litigation reserves "require[], among other things, an assessment of the degree of probability of an unfavorable outcome." The Chief Judge further suggested that Textron's dilemma is not a common one in practice because lawyers can — and in her estimation typically do — draft documents that must be disclosed to comply with government regulations carefully, so as not to reveal sensitive legal opinions, theories or strategies. During the questioning of Textron's counsel, the Chief Judge went so far as to suggest that Textron's choice to use lawyers rather than accountants to complete the tax accrual workpapers was motivated by a desire to invoke the work product privilege to shield the documents from discovery and "manipulate the system."

While there appeared to be some sympathy for the argument that tax accrual workpapers are created "in the ordinary course of business," the judges also expressed concerned with the breadth of the IRS's position. Judge Lipez for one suggested that denying work product protection for tax accrual workpapers may not be in the spirit of the privilege because the "content reflects the mental impressions, the tactical considerations, the legal analysis, which the work product doctrine is designed to protect." Other judges expressed marked concern that adopting the IRS position would have undesirable consequences far beyond the tax arena. In particular, with regards to litigation reserves, Judge Howard seemed concerned that documents generated for financial reporting purposes, but which summarize pending litigation, might be opened up to discovery. Accordingly, counsel for the IRS was pressed whether there was a "limiting principle" to the agency's position. Counsel ultimately conceded that there was no such limiting principle noting: "if it is required by the SEC rules, then necessarily it cannot be protected by the work product privilege."

It was surprisingly unclear how Judge Boudin, who dissented from the original panel majority decision, might decide this case. As previously noted, the judge suggested in his dissent that an *en banc* court could change what he viewed as the controlling precedent, which may indicate a willingness to reconsider his position. Throughout the arguments Judge Boudin seemed troubled by the IRS's blanket position that documents prepared because of the possibility of litigation but also for a business or regulatory purpose were not protected. During the IRS's rebuttal argument, Judge Boudin posed the final question: "Counsel, I'm not sure I understand how . . . you

reconcile the government's position with the dual-purpose acknowledgement in *Maine*?" The question essentially was not answered.

A corporate client's right to unfettered and confidential legal advice is critical in today's challenging environment. In the post-Sarbanes-Oxley world, companies must rely on counsel for a wide array of decisions. Yet if the broad position of the IRS is accepted, internal legal analyses or other work product turned over to independent auditors could be opened up to discovery by any potential adversary. Whether based on the definition of work product or waiver, such a decision in *Textron* could have far reaching consequences both inside the tax arena and beyond. Ultimately, any decision that weakens a corporate counsel's work product protections could undermine the financial reporting process and frustrate a company's ability to seek legal counsel.

Kirkland & Ellis LLP

Kirkland & Ellis LLP is well positioned to assist clients in handling IRS disputes and other government investigations or inquiries. We offer significant expertise in counseling individuals and companies in a wide range of tax and regulatory inquiries. Our firm includes several former federal prosecutors and enforcement attorneys with the U.S. Department of Justice, the U.S. Securities and Exchange Commission, and other governmental agencies. And the Firm's expertise is distributed across all of its offices, including Los Angeles, Chicago, New York, and Washington D.C. We are interested in discussing with you in greater depth the issues discussed above. We welcome the opportunity to provide strategic counseling services relating to these critical issues.

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1 The IRS's current policy is to request tax accrual workpapers only when the taxpayer has engaged in a listed transaction or when there are "unusual circumstances" necessitating review of the workpapers. IRS Announcement 2002-63, 2002-2 C.B. 72; Internal Revenue Manual § 4.10.20.3.

2 465 U.S. 805 (1984).

3 298 F.3d 60, 70 (1st Cir. 2002) (internal quotation marks omitted).

4 The Circuit Court judges on the original panel decision were Judge Torruella, who wrote for the majority, and Judge Boudin writing the dissent. The other judge on the panel majority was a district court judge sitting by designation.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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