

Evaluating *United States v. Textron* And the Privilege Doctrine

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In *United States v. Textron*,¹ the United States District Court for the District of Rhode Island considered the issues of attorney-client privilege and work product doctrines as they relate to tax accrual workpapers. Tax accrual workpapers are taxpayer-prepared schedules and documents supporting the financial statement disclosure. In *Textron* the workpapers were disclosed to the company's independent auditor as part of the auditor's review. Historically, the IRS exercised restraint and would request accrual workpapers from taxpayers only in limited circumstances. However, recent legislative and other pressures are forcing corporations to compile more-detailed workpapers. Also, firms are experiencing internal pressure due to the accounting requirements of the Financial Accounting Standards Board Interpretation No. 48. The IRS has classified FIN 48 workpapers as tax accrual workpapers and will treat them the same as other tax accrual workpapers until more information about their nature is obtained. *Textron* was a test case in which the IRS had requested all of the taxpayer's tax accrual workpapers rather than just the workpapers related to a disputed transaction.

The court's decision discussed both the attorney-client privilege and the work product doctrine. The court held that while the attorney-client privilege did apply to tax accrual workpapers, the privilege was waived when the documents were disclosed to the taxpayer's independent auditors. However, in a more controversial holding, the court concluded that the work product doctrine protected the documents because they were "prepared in anticipation of litigation" under the court's definition of that requirement. Further, work product protection was not waived when the documents were disclosed to the independent auditor, since the auditor's interests were not adverse to the taxpayer's interests. While some have

attacked this holding as improperly expanding the scope of the work product doctrine, the holding is consistent with the policy behind the work product doctrine. By protecting the taxpayer's tax accrual workpapers, the court promoted adversarial fairness, the foundation of the work product doctrine.

The Facts

During the audit, the Service discovered that Textron Financial Corporation, one of Textron Inc.'s numerous subsidiaries, had engaged in several sale-in, lease-out transactions. Following the IRS's policy for those transactions, the Service requested all of Textron's tax accrual workpapers for the years in question. The workpapers comprised spreadsheets of potential tax liabilities and analysis of the chance of prevailing on those issues. The court noted that the tax accrual workpapers did not include documents that contained factual information regarding the disputed transactions. As a large corporation, Textron was audited by the IRS regularly and had frequently challenged the Service's postaudit conclusions. In seven of its past eight audit cycles, dating back to 1980, Textron had appealed the determinations reflected in the revenue agent's report. Three of the disputes were not resolved at Appeals and proceeded to litigation. To comply with auditing requirements, the workpapers were given to Textron's independent auditors under the explicit understating that they were to remain confidential.

The Decision

The court analyzed whether the attorney-client privilege or the work product doctrine protected these documents from disclosure to the IRS. While the court initially held that the workpapers were covered by the attorney-client privilege, that privilege was waived when the documents were disclosed to Textron's auditors.² The court's decision in this regard was consistent with a long line of decisions concluding that privilege is automatically waived on disclosure to a third party.

The court's discussion of the work product doctrine was more complex. Under the work product doctrine, documents prepared "in anticipation of litigation" are not discoverable absent a substantial need for the materials and an inability to obtain substantially equivalent materials. Circuit courts are split in interpreting the phrase "in anticipation of litigation."³ The district court applied the broader "because of" standard adopted by the First Circuit, under which documents are protected so

²*Id.* at 152.

³*Compare United States v. Roxworthy*, 457 F.3d 590, 593, Doc 2006-15129, 2006 TNT 155-7 (6th Cir. 2006), with *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981).

¹*United States v. Textron, Inc.*, 507 F. Supp.2d 138 (2007), Doc 2007-20046, 2007 TNT 169-1 (D. R.I. Aug. 28, 2007).

long as they are created in reasonable anticipation of litigation, regardless of the primary purpose for which the document was created.⁴

In applying the “because of” standard to the facts, the court held that Textron’s tax accrual workpapers were protected by the work product doctrine. While the IRS argued that the documents were created in the ordinary course of business and therefore were not protected, the court concluded that the documents would not have been prepared “but for” the prospect of litigation and therefore fell within the scope of the doctrine. The court noted that “if Textron had not anticipated a dispute with the IRS, there would have been no reason . . . to prepare the workpapers used to calculate the reserve. . . . There would have been no need to create a reserve in the first place.”⁵ Textron’s history of tax litigation and administrative appeals also gave the corporation sufficient support for their belief in the prospect of litigation. Contrary to the conclusion reached in *United States v. El Paso Co.*,⁶ in which the court applied the stricter “primary purpose” standard and found that tax accrual workpapers were not prepared in anticipation of litigation, the *Textron* court concluded that the work product doctrine may apply even though the documents were created for financial reporting purposes.⁷

After determining that the work product doctrine was applicable, the court continued to discuss whether that protection was waived on disclosure of the tax accrual workpapers to Textron’s independent auditor. Unlike the policy behind the attorney-client privilege, under which waiver is nearly automatic on disclosure, the policy behind the work product doctrine states that only disclosures “that are inconsistent with keeping the information from an adversary constitute a waiver of the work product privilege.”⁸ Citing many cases reaching the same conclusion, the court found that work product protection was not waived on disclosure to an independent auditor because the disclosure did not “substantially increase the IRS’s opportunity to obtain the information contained in them.”⁹

While work product protection may be overcome by a showing that there is substantial need for the documents and an inability to otherwise obtain the documents, the court held that such a showing was not made by the IRS. The documents had little connection to the determination of Textron’s tax liability because “the determination of any tax owed by Textron must be based on *factual* information, none of which is contained in the workpapers and all of which is readily available to the IRS through the issuance of IDRs [information document requests] and by other means.”¹⁰ The court refused to disclose the documents to the IRS and noted that forced

disclosure of tax accrual workpapers “would put Textron at an unfair disadvantage in any dispute that might arise with the IRS.”¹¹

Analysis

The *Textron* decision is important for a number of reasons. First, the substantive decisions concerning the attorney-client privilege and work product doctrine continue to shape an unsettled area of law. Second, the court’s policy discussion provides further support for the position that tax accrual workpapers should be protected from forced disclosure to the IRS.

The decision’s substantive holding continues to support a line of cases declining to protect previously disclosed tax accrual workpapers under the attorney-client privilege. While the IRS continues to argue that tax accrual workpapers do not constitute legal work and are therefore not within the scope of the attorney-client privilege, this argument again proved unsuccessful. The court also adopted a strict adherence to the waiver doctrine and did not protect the tax accrual workpapers under the attorney-client privilege because the documents were disclosed to an independent auditor. The vast majority of courts considering the issue have reached the same conclusion. This case demonstrates again that such an argument would struggle to find sympathy in federal court.

The court’s holdings regarding the work product doctrine are more significant. The court concluded that the tax accrual workpapers were prepared in anticipation of litigation, even though they were also prepared to meet financial reporting obligations. The court was sympathetic to the taxpayer’s case and used a well-reasoned opinion to provide strong support for the argument that the work product doctrine supports the protection of tax accrual workpapers. The decision became one of many recent decisions that run counter to the holding in *United States v. El Paso Co.*¹²

The most unsettled area of law concerns whether disclosure to an independent accounting firm waives

¹¹*Id.*

¹²As mentioned above, in *El Paso Co.*, the Fifth Circuit applied the stricter primary purpose interpretation of the work product doctrine, under which a document is prepared in anticipation of litigation only if “the primary motivating purpose behind the creation of a document was to aid in possible future litigation.” *El Paso Co.*, 682 F.2d at 542. The facts in *Textron* support a scenario in which tax accrual workpapers might be protected even under the stricter primary purpose test used in *El Paso Co.* In the evidentiary hearing, Textron’s vice president of taxes stated that, in the absence of financial reporting obligations, tax accrual workpapers still would be generated because they “would guide [Textron] in making litigation and settlement decisions later in the process.” Transcript of Proceedings (Evidentiary Hearing) held on June 26, 2007, at 68, *United States v. Textron, Inc.*, No. 06-198 (D. R.I. Aug. 28, 2007). While the court did not discuss this testimony in its decision, if accepted, such a statement would provide support for work product protection under the more stringent standard because the primary motivating purpose behind the creation of a document may have been to aid in future litigation, thereby meeting the primary purpose test as outlined in *El Paso Co.*

⁴*Textron* 570 F. Supp.2d at 150.

⁵*Id.*

⁶*United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982).

⁷*Textron* F. Supp.2d at 151.

⁸*Id.* at 152.

⁹*Id.* at 153.

¹⁰*Id.* at 155 (emphasis in original).

work product protection. *Textron* follows other recent cases in concluding that such a disclosure does not constitute a waiver because the independent auditor's interests are not adverse to the corporation's.¹³ As in other cases, the court found it significant that independent auditors have professional obligations to maintain the confidentiality of auditing materials. Further, the court found it noteworthy that the documents were disclosed to the independent auditor with the understanding that the documents were privileged. Both elements will likely continue to play an important role in any future court's analysis of the issue.

Finally, the decision may provide support for the protection of related tax documents such as FIN 48 workpapers and tax opinions. As mentioned earlier, the IRS plans to treat FIN 48 workpapers as tax accrual workpapers. Similar reasoning may be used to argue that FIN 48 workpapers are also protected by the work product doctrine because they are created for analogous reasons and under similar circumstances. This decision will be important because the IRS has stated that FIN 48 disclosures "should be considered by examiners and others when conducting risk assessments."¹⁴ FIN 48 disclosures have already led to Senate investigations of at least 30 companies, and the IRS will likely follow suit, thereby bringing the issue of FIN 48 workpapers to the forefront.¹⁵ A tax opinion disclosed to an independent auditor may also find strengthened support for protection under *Textron*. Like that of tax accrual workpapers, the fate of disclosed tax opinions is uncertain. The reasoning of the opinion may be used to support a stronger argument concerning tax opinions, even under the primary purpose standard. Unlike tax accrual workpapers, tax opinions are not required by financial reporting obligations and are primarily used to analyze the legal consequences of a transaction. The argument for work product protection of tax opinions is even stronger than the argument for the protection of tax accrual workpapers.

Throughout the decision, the *Textron* court also had to balance the policies behind the work product doctrine against Congress's policy choice in favor of disclosure of all information relevant to a legitimate IRS inquiry for the purposes of tax investigations.¹⁶ The decision concluded

that the fairness of litigation policy supporting the work product doctrine prevailed. At several points in the decision, the court noted that the workpapers contained only legal material and therefore disclosure would not provide the IRS with any additional facts to conduct their investigation and would only unfairly disadvantage *Textron* in any future dispute with the Service. Importantly, the court noted that disclosure would be patently unfair, "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."¹⁷ *Textron's* disclosure of the documents to the independent auditor was required but did not increase the chance that the opposing party will obtain the information. Due to the obligations to maintain confidentiality and the circumstances in which the disclosure was made, the court concluded that such a disclosure cannot be equated with disclosure to an adverse party. Because independent auditing standards are universal, this same policy argument could support any taxpayer seeking to protect disclosed tax accrual workpapers or other protected documents disclosed to an independent auditor.

The decision is also consistent with the current political climate. By adopting a broad interpretation of the work product doctrine, the court not only protected the tax accrual workpapers from forced disclosure to the IRS, but also likely promoted communication between corporations and their independent auditors. If the documents were not protected under either the attorney-client privilege or the work product doctrine, communication with independent auditors would either be discouraged or the IRS would gain an unfair advantage. To the extent the IRS forces its position, the former result is more likely. In the wake of the Sarbanes-Oxley Act of 2002, there is a strong political pressure to promote full and frank communication between corporations and their independent auditors to avoid future accounting scandals. By providing confidentiality to those communications, the *Textron* decision further promotes that communication.

Conclusion

With the current pressures on independent auditors and in-house tax departments, the *Textron* decision will be used as guidance in interpreting the extent of privilege relating to previously disclosed tax documents. A strong body of precedent now supports the protection of disclosed tax accrual workpapers and related documents under the work product doctrine. Moreover, that protection is not waived when the documents are disclosed to an independent auditor, since the auditor does not have an adverse interest. Nevertheless, the issue is far from settled. Chief Counsel Donald Korb has indicated that the IRS is "not going to change anything as a result of this decision."¹⁸ In the face of an approaching deadline, the

¹³The court also distinguished *United States v. Massachusetts Institute of Technology (MIT)*, 129 F.3d 681, Doc 97-32547, 97 TNT 231-13 (1st Cir. 1997). In *MIT* the court held that documents disclosed to the Defense Contract Audit Agency were not protected by the work product doctrine. The *Textron* court found the factual pattern distinguishable because the audit agency in *MIT* had an obligation to the Department of Defense to determine the accuracy of charges and the authority to sue for overcharges. Therefore, the disclosure to the audit agency was a disclosure to a potential adversary.

¹⁴Memorandum for Executives, Managers, and Examiners — Large and Mid-Sized Business Division (May 10, 2007, LMSB-04-0507-044).

¹⁵Jesse Drucker, "How Accounting Rule Led to Probe," *The Wall Street Journal*, Sept. 11, 2007, p. A5.

¹⁶*Textron*, 2007 WL 2458325 at 144 (quoting *Arthur Young & Co.*, 465 U.S. at 816).

¹⁷*Textron* at 155.

¹⁸"Korb Says Government Unlikely to Yield on *Textron*," Practitioners Praise Court Ruling," *Daily Tax Report* (BNA), Aug. 31, 2007, p. K-1.

COMMENTARY / REPORTS IN BRIEF

IRS recently filed a notice of appeal.¹⁹ However, an IRS spokeswoman indicated that the notice was intended as a placeholder that will protect the government's right to appeal the decision.²⁰ In any case, the impact of the decision will be significant as courts continue to grapple with this issue.

¹⁹Notice of Appeal filed Oct. 22, 2007, *United States v. Textron, Inc.*, No. 06-198 (D. R.I. Aug. 28, 2007).

²⁰"Government Files Notice It Is Appealing *Textron* Work Product Privilege Ruling," *Daily Tax Report* (BNA), Sept. 24, 2007, p. K-1.