

Checkpoint Contents

Federal Library

Federal Editorial Materials

Federal Taxes Weekly Alert Newsletter

Preview Documents for the week of 05/27/2010 - Volume 56, No. 21

Articles

Supreme Court won't review First Circuit's *Textron* decision (05/27/2010)

Federal Taxes Weekly Alert,

Supreme Court won't review First Circuit's *Textron* decision

U.S. v. *Textron Inc. and Subsidiaries*, (CA 1 8/13/2009) [104 AFTR 2d ¶ 2009-5208](#) cert denied 05/24/2010

Last summer, in an en banc rehearing (i.e., by the full Court), the Court of Appeals for the First Circuit, in a 3-2 decision, held that a corporation's tax accrual workpapers aren't protected by the work product privilege. In a much anticipated decision, the Supreme Court has now declined to review this controversial decision of the First Circuit. This article reviews the controversy. It also carries practitioner commentary, from Douglas S. Stransky, Attorney at Law, Sullivan & Worcester LLP, One Post Office Square Boston, MA 02109, on the reasons *Textron* felt the Supreme Court should hear the case and what its failure to do so means for practitioners.



RIA observation: Before the en banc hearing was granted, a Third Circuit panel essentially upheld the district court's holding that the workpapers were protected. The panel decision was withdrawn after the full Court agreed to review the case.

Facts. *Textron, Inc.* and its subsidiaries (*Textron*) was a publicly traded conglomerate with approximately 190 subsidiaries, one of which was *Textron Financial Corporation (TFC)*, a company that provided commercial lending and financial services. In 2001 and 2002, *Textron* had six tax attorneys and a number of CPAs in its tax department but *TFC's* tax department consisted only of CPAs. Consequently, *TFC* relied on attorneys in *Textron's* tax department, private law firms, and outside accounting firms for additional assistance and advice regarding tax matters.

As a publicly traded corporation, *Textron* was required by federal securities law to have public financial statements certified by an independent auditor. To prepare the financial statements, it calculated reserves to be entered on the company books to account for contingent tax liabilities. These liabilities, which affected the portrayal of assets and earnings, included estimates of potential liability if IRS decided to challenge debatable positions taken in its return.

Textron's federal tax returns, long with those of other large corporations, were audited periodically, at which time IRS examined returns for the years that were part of the audit cycle. During the '98-2001 audit cycle, IRS learned, from examining *Textron's* 2001 return, that *TFC* had engaged in nine "sale-in, lease-out" (SILO) transactions involving telecommunications and rail equipment. IRS has classified such transactions as "listed transactions" because it considers them to be of a type engaged in for the purpose of tax avoidance (see [Weekly Alert ¶ 4 2/17/2005](#)). IRS issued more than 500 information document requests in connection with the '98-2001 audit cycle, and *Textron* complied with all of them, except for the ones seeking its "tax accrual workpapers." These workpapers included summary spreadsheets that listed items in the tax return which if identified and challenged by IRS, could result in additional taxes being assessed. The final spreadsheets listed each debatable item, including the dollar amount subject to possible dispute and a percentage estimate of IRS's chances of success. The spreadsheets reflecting these calculations might also have been supported by backup e-mails or notes.


Textron refused to produce its tax accrual workpapers, asserting that they were privileged and that the summons was issued for an improper purpose. Subsequently, pursuant to [Code Sec. 7402\(b\)](#) and [Code Sec. 7604](#), IRS filed a petition in district court to enforce the summons.



RIA observation: As the First Circuit noted, historically, IRS hasn't automatically requested

tax accrual workpapers from taxpayers. In the wake of *Enron* and other corporate scandals, IRS began seeking companies' tax accrual workpapers only where it concluded that they had engaged in certain listed transactions that were the same or substantially similar to transactions that IRS had determined to be tax avoidance transactions. Under current IRS policy, if a taxpayer benefits from only a single listed transaction that was disclosed, IRS will only seek the workpapers for that transaction. But where the listed transaction wasn't disclosed or (as in *Textron's* case) the taxpayer benefits from multiple listed transactions, IRS will seek all of the workpapers for the tax year in question. See [Weekly Alert ¶ 3 06/20/2002](#).

District court decision. On Aug. 28, 2007, the district court held that *Textron's* tax accrual workpapers were protected by the work product privilege—which applies to materials prepared or gathered by an attorney in anticipation of litigation or preparation for trial—because they would not have been prepared “but for” the fact that *Textron* anticipated the possibility of litigation with IRS. The district court also found that the workpapers would have been protected by the attorney-client privilege and the [Code Sec. 7525](#) tax practitioner privilege but that these privileges were waived when *Textron* provided its workpapers to its independent auditor.

 **RIA observation:** The [Code Sec. 7525](#) privilege protects a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered privileged if it were between a taxpayer and an attorney, but doesn't protect work product or communications simply for the preparation of a tax return.

First Circuit panel decision. On Jan. 21, 2009, the First Circuit, affirming the district court, held that *Textron's* tax accrual workpapers were protected by the work product privilege (see [Weekly Alert ¶ 9 01/29/2009](#)). However, it set aside the district court's ultimate determination that work-product protection wasn't waived, and sent the case back to the district court to reassess the question of whether disclosure of the auditors' workpapers would reveal the information contained in *Textron's* workpapers.

A few months after the panel decision was issued, the full Court agreed to hear the case and the panel decision was withdrawn.

First Circuit's en banc holding. On rehearing en banc, the three judges joining in the First Circuit's majority opinion concluded that *Textron's* workpapers, which were prepared to support financial filings and gain auditor approval, weren't protected by the work product privilege. That privilege was aimed at protecting work done for litigation, not in preparing financial statements. IRS's access served the legitimate and important function of detecting and disallowing abusive tax shelters.

The Court reasoned that the work product privilege is centrally aimed at protecting the litigation process, specifically, work done by counsel to help him in litigating a case. It's not a privilege designed to help a lawyer prepare corporate documents or other materials prepared in the ordinary course of business. There was no evidence that the papers were prepared for potential use in litigation or that they would in fact serve any useful purpose for *Textron* in conducting litigation if it arose. It was undisputed that the purpose of the workpapers was to make book entries, prepare financial statements and obtain a clean audit. *Textron's* motive 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 Court held that it's not enough to trigger work product protection that the subject matter of a document relates to a subject that might conceivably be litigated. Nor is it enough that the material is prepared by lawyers or represents legal thinking, since much corporate material prepared in law offices or reviewed by lawyers falls in this category. It is only work done in anticipation of or for trial that is protected.

The Court observed that *Textron* might be correct in its assessments that unless IRS might dispute an item in the return, no reserve would be necessary, and that some of the items resulting in a reserve might be litigated. The Court noted that the district court did not say that the workpapers were prepared *for use* in possible litigation—only that the reserves would cover liabilities that might be determined in litigation. If the district court had made such a statement, the Court concluded that such a finding would have been clearly erroneous.

Even if litigation was remote, *Textron* would still have had to prepare work papers to support its judgment. The main aim of audit workpapers was to estimate the amount potentially in dispute and the percentage chance of winning or losing. It was doubtful that these tax accrual workpapers would be useful in the litigation with respect to these positions. The Court determined that any experienced litigator would describe the tax accrual

workpapers as tax documents and not as case preparation materials.

Emphasizing that tax collection wasn't a game and that underpaying taxes threatened the essential public interest in revenue collection, the Court stated that if a blueprint to Textron's possible improper deductions could be found in Textron's files, it was properly available to the government unless privileged. The Court found that no work product privilege applied.

Supreme Court declines review. Attorney At Law Stransky noted that in the petition for review by the Supreme Court, "Textron set forth three reasons why the Supreme Court should hear the case. First, Textron argued that the en banc decision widened the existing split in the circuits over the scope of the work product privilege. Second, Textron asserted that the en banc decision was wrong as a matter of law. Finally, Textron's petition emphasized that the question presented is one of paramount importance to all attorneys and their clients and thus deserving of the Court's attention."

Stransky observed further that "[t]here were eleven amicus curiae briefs in support of Textron's petition, emphasizing the importance of this case. The briefs urged the Court to take the case and settle the split among the circuits on the scope of the work product doctrine, arguing that the standard articulated by the First Circuit undermined the doctrine and has a chilling effect on clients' use of counsel." According to Stransky, "[e]vidently, those briefs fell on deaf ears at the Supreme Court. Because the decision by the en banc court eviscerated the work product protection that shielded exactly the type of attorney analysis that was present in this case, attorneys and their clients now know that the Supreme Court will not in the words of the dissent in the First Circuit 'intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country.'"



RIA viewpoint: Stransky says that "'[t]he prepared for' test established by the First Circuit sets a troubling precedent that could hinder attorneys from preparing analyses that are of the greatest importance to their clients. Under this 'prepared for' test, every party (not only IRS or state tax authorities) in commercial litigation whose opponent files GAAP financial statements that report contingent liabilities for litigation exposure will be able to obtain in discovery the hazards of litigation analysis of its opponent's lawyers. The First Circuit's decision has eviscerated the work product protection that exists to protect exactly the type of attorney analysis that was present in this case. It's surprising that the Supreme Court did not recognize this, especially where there were so many briefs that highlighted the danger of having the First Circuit's decision stand."

References: For the work product privilege, see [FTC 2d/FIN ¶ T-1330](#); [United States Tax Reporter ¶ 76,024.07](#).