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UPDATE 1-U.S. Supreme Court upholds IRS power in tax case

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* Decision lets lower-court ruling stand

* Lower court set new test for IRS document bid (Recasts; adds byline, context, attorney comments)

By Kim Dixon

WASHINGTON, May 24 (Reuters) - The U.S. Supreme Court let stand an appeals court decision upholding the power of tax authorities to demand legal work papers from corporations.

The lower court ruled in favor of an Internal Revenue Service bid for legal papers from corporate jet maker Textron Inc <TXT.N>. The company, which argued that the papers should be privileged, appealed to the Supreme Court.

Companies argued that the lower-court ruling has the potential to give the IRS unfettered access to legal advice given to the companies. They also worried that the ruling could be applied in cases beyond taxes, such as product safety cases.

Textron withheld documents from the IRS, including a spreadsheet compiled by its lawyers listing items of potential dispute with the agency and the company's odds of prevailing in the dispute.

The U.S. Court of Appeals for the First Circuit, in its ruling against Textron, set a new test, under which every party in commercial litigation whose opponents file financial statements with contingent liabilities for litigation will be able to obtain documents detailing such exposure, according to Douglas Stransky, an attorney at Sullivan and Worchester in Boston who represents corporate clients.

"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," he said. "It's surprising that the Supreme Court did not recognize this."

Related to the issue, the IRS has proposed mandating that companies estimate and list maximum federal tax liability associated with "uncertain" tax positions -- those that companies believe could be challenged by tax authorities. (Reporting by Kim Dixon, editing by Gerald E. McCormick and John Wallace)

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