United States v. Textron Inc.: First Circuit Rejects Work Product Protection for Tax Accrual Workpapers

On August 13, 2009, the United States Court of Appeals for the First Circuit issued its 3-2 en banc decision in United States v. Textron Inc.[1] holding that tax accrual workpapers prepared by lawyers and other in-house personnel at Textron to support tax reserves reflected in its audited financial statements were not protected by the work product doctrine from required production in response to an Internal Revenue Service ("IRS") summons. The Court's ruling may have broad implications not limited to tax-related workpapers.

I. Background and Procedural History

Federal securities laws require publicly traded corporations to have public financial statements certified by an independent auditor. Such financial statements include reserves for contingent tax liabilities, and other contingent liabilities. The financial statements normally do not identify the specific exposures to which the reserves relate. In determining the amounts of such reserves, officers and employees of the corporation create workpapers that identify particular issues and vulnerabilities, quantify the amounts of the potential exposures, and estimate the potential claimants' percentage likelihoods of success in making any claims based on such issues and vulnerabilities. Before certifying the corporation's financial statements, the independent auditor generally will require access to the tax accrual workpapers and other workpapers to facilitate its review of the adequacy and reasonableness of the corporation's reserves.[2]

With respect to tax accrual workpapers created by the auditor itself, rather than by employees of the corporation, the Supreme Court established 25 years ago in United States v. Arthur Young & Co.[3] that no privilege protected them from disclosure to the IRS. In the portion of the opinion that rejected work product immunity under Hickman v. Taylor,[4] the Supreme Court relied on the fact that the independent auditor had a "public watchdog" function rather than a role as "confidential advisor" or "loyal representative."[5] For that reason, the Arthur Young decision did not resolve the issue presented in Textron.

The IRS has maintained a policy of requesting tax accrual workpapers only in unusual circumstances, but will make such requests if the taxpayer has claimed tax benefits arising out of "listed transactions" that the IRS regards as abusive tax avoidance transactions.[6] A Textron subsidiary had engaged in nine sale-in, lease-out ("SILO") transactions that were listed transactions.[7] As a result, the IRS requested, and then issued an administrative summons for, Textron's tax accrual workpapers. Textron refused to provide them to the IRS.

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1 No. 07-2631 (1st Cir. Aug. 13, 2009) (hereinafter "Slip Opinion").

2 By providing this access, the corporation waives any attorney-client privilege that might otherwise protect portions of the workpapers.

3 465 U.S. 805 (1984).

4 329 U.S. 495 (1947).

5 465 U.S. at 817-18.

6 IRS Announcement 2002-63, 2002-2 C.B. 72.

7 Slip Opinion at 5-6.

The IRS filed a summons enforcement action in the United States District Court for the District of Rhode Island, which heard evidence and held that the tax accrual workpapers were protected under the work product doctrine.[8] That decision was initially affirmed by a divided First Circuit panel.[9] The latter decision was later vacated when the government's motion for rehearing en banc was granted.[10]

II. First Circuit's Decision

In the three-judge majority opinion by Judge Boudin, the First Circuit held that "the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements" and that the privilege does not apply to tax accrual workpapers.[11] The majority stated that it was applying Maine v. United States Dep't of Interior,[12] which it explicitly reaffirmed.[13] Maine was a Freedom of Information Act case in which the State of Maine had sought documents related to the decision to list Atlantic salmon in Maine as in danger of extinction. In embracing the "because of the prospect of litigation" standard rather than the primary purpose standard for determining applicability of work product protection,[14] the First Circuit in Maine had quoted at length from United States v. Adlman,[15] in which the Second Circuit had held that a detailed memorandum assessing the likely result of potential federal tax litigation can be entitled to work product protection even if its primary purpose is to assist in the making of a business decision. The portion of Maine (and Adlman) quoted by the First Circuit in Textron, however, was to the effect that documents prepared in the ordinary course of business or that would have been created in essentially the same form without regard to litigation are not entitled to work product protection.[16]

As acknowledged by Judge Boudin's opinion, the work product principle is embodied in Rule 26(b)(3) of the Federal Rules of Civil Procedure, where the language protects documents "prepared in anticipation of litigation or for trial."[17] The majority construed this concededly governing phrase as if it requires preparation for use in litigation (rather than merely in anticipation of litigation) before work product protection applies.[18] As would normally be true, there was little evidence in Textron that the tax accrual workpapers were prepared for use in tax litigation.

In a vigorous 28-page dissent, Judge Torruela (joined by Judge Lipez) argued that the "because of the prospect of litigation" test adopted by the First Circuit in Maine supported affirmance in Textron, and that the majority ignored this in asserting that it was applying Maine without referring to the "because of" test.[19] The

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8 United States v. Textron Inc., 507 F. Supp. 2d 138 (D.R.I. 2007).

9 Originally published at 553 F.3d 87 (1st Cir. 2009) (withdrawn).

10 560 F.3d 513 (1st Cir. 2009).

11 Slip Opinion at 11, 24.

12 298 F.3d 60 (1st Cir. 2002)

13 Slip Opinion at 11.

14 298 F.3d at 67-68.

15 134 F.3d 1194 (2d Cir. 1998).

16 298 F.3d at 70; Slip Opinion at 21.

17 Slip Opinion at 9, 13.

18 Id. at 13-14, 18.

19 Id. at 26-31.

dissent argued further that the majority ignored other circuit court precedents, contravened principles underlying the work-product doctrine, brushed aside the text of Rule 26(b)(3), and misrepresented the findings of the District Court.[20]

III. Significance of the Decision

If it is not overturned, this decision will assist the IRS in its battle against tax avoidance transactions that it regards as abusive. Not only will it facilitate collection of additional taxes (not limited to tax shelter issues) from the taxpayers that are forced to produce their tax accrual workpapers to the IRS, but also it will reinforce a strong disincentive for taxpapers to engage in listed transactions (including transactions that are "similar to" the transactions identified by the IRS) because the IRS does not seek tax accrual workpapers from taxpayers that do not engage in such transactions.

On the other hand, the Court's reasoning is not limited to tax-related work-papers.[21] As aptly put by the dissent, "In straining to craft a rule favorable to the IRS as a matter of tax law, the majority has thrown the law of work-product protection into disarray."[22]

The First Circuit's new "for use in litigation" test makes future development of the law in this area more uncertain, and various categories of documents not prepared for use in litigation may be found not entitled to work product protection even if they are prepared in anticipation of litigation or, in the previous judicial rephrasing of Rule 26(b)(3), because of the prospect of litigation. Particularly where such documents serve the public interest by facilitating accurate corporate financial statements, it may reflect sounder policy to protect confidential internal assessments of potential litigation exposures from discovery or other forced disclosure to potential litigation adversaries. Developments in this area of law bear watching.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email L. Howard Adams at 212.701.3162 or hadams@cahill.com; or Charles A. Gilman at 212.701.3403 or cgilman@cahill.com.

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20 Id. at 26.

21 In response to Textron's assertion that it is unfair for the government to have access to its identification of tax issues and estimates of the IRS likelihood of success, the Court did point out that there is an essential public interest in revenue collection, but this did not appear to play a significant role in its reasoning. Id. at 23-24.

22 Id. at 53.