Tax Controversy Alert

Textron Did Not Seal the Fate of Work Product Protection Claims for Tax Accrual Workpapers

In *Textron,*[1] the First Circuit on rehearing decided that tax accrual workpapers are not protected against disclosure to the IRS by the work product doctrine. In the words of the dissent, the *Textron* majority abandoned the widely used "because of" test, which asks whether a document was prepared because of the prospect of litigation and, instead, imposed "a 'prepared for' test, asking if the documents were 'prepared for use in possible litigation.'"

After the *Textron* decision was issued and the Supreme Court denied certiorari, fears were expressed regarding the health of the work product doctrine, both as related to tax accrual workpapers and more generally. The *Textron* dissent called the result "a significant expansion of the IRS's power" and stated that "more important are the ramifications beyond this case and beyond even the case of tax accrual workpapers in general. One commentator agreed and lamented that under *Textron* the "whole adversarial system would be undermined."[2]

Well, perhaps not. While *Textron* is binding precedent in the First Circuit,[3] it is not elsewhere. For example, in *Salem Financial, Inc. v. United States,* 102 Fed. Cl. 793 (Ct. Fed. Cl. 2012) the Court of Federal Claims stated that "[i]t is an unsettled question whether tax reserves and associated workpapers are prepared in anticipation of litigation, such that they constitute protected work product." The court noted that the "Federal Circuit has not ruled directly on this issue, and there is no controlling Supreme Court precedent."

As recognized in *Salem Financial*, courts outside the First Circuit are free to reject *Textron.* In the Second Circuit, *United States v. Adlman,* 134 F.3d 1194 (2nd Cir. 1998), largely ignored by the *Textron* majority but lionized by the dissent, remains the law. In *Adlman,* the Second Circuit considered whether the work product doctrine protected "a litigation analysis prepared by a party or its representative in order to inform a business decision which turns on the party's assessment of the likely outcome of litigation expected to result from the transaction," which is an analysis similar to that performed in tax accrual workpapers. *Id.* at 1197. The court ruled that "work-product protection should not be denied to a document that analyzes expected litigation merely because it is prepared to assist in a business decision." *Id.* at 1199. The decision in *Regions*

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[1] *United States v. Textron,* 577 F.3d 21 (1st Cir. 2009) (en banc), *cert. denied,* 130 S. Ct. 3320 (2010).

[2] Michele M. Henkel, Textron Eviscerates the 60-Year-Old Work Product Privilege, 125 Tax Notes 237, 242 (2009).

[3] *Santander Holdings USA, Inc. & Subs. v. United States,* 110 AFTR 2d 2012-5443 (D. Mass. 2012) ("In this circuit it is settled that tax reserve workpapers are generally not entitled to work product protection . . ..")

Financial Corp. & Subs. v. United States, 2008 U.S. Dist. LEXIS 41940 (N.D. Ala. 2008), holding that the taxpayer's tax accrual workpapers were protected by the work product doctrine, also remains good law.

Adlman, in particular, was recognized as a leading case and cited favorably prior to the *Textron* decision. For example, in *United States v. Roxworthy*, 457 F.3d 590, 599 (6th Cir. 2006), the Sixth Circuit cited *Adlman* for the proposition that "a document can be created for both use in the ordinary course of business and in anticipation of litigation without losing its work-product privilege."[4] The court also stated that "here, the IRS would appear to obtain an unfair advantage by gaining access to KPMG's detailed legal analysis of the strengths and weaknesses of [the taxpayer's] . . . position. This factor weighs in favor of recognizing the documents as [work product] privileged." *Id.* at 595.

Subsequent to the *Textron* decision, courts have continued to express the same view, distancing themselves from the *Textron* majority. In *United States v. Deloitte, LLP*, 610 F.3d 129, 135 (D.C. Cir. 2010), the court held that a document prepared by a taxpayer's auditor was work product protected, despite the fact that it was prepared "as part of the routine audit process." The court found *Textron* "distinguishable" and then stated that "[m]oreover, [the] . . . dissenting opinion in *Textron* makes a strong argument that while the court said it was applying the 'because of' test, it actually asked whether the documents were 'prepared for use in possible litigation,' a much more exacting standard." *Id.* at 138. In *Salem Financial*, the court evidenced a similar anti-*Textron* inclination, citing the *Textron* dissent and stating that the "Court is sympathetic to the public policy considerations counseling toward application of the work product doctrine to tax reserve documents."

Recently, in *Wells Fargo & Co. v. United States*, No. 0:10-mc-00057 (D. Minn. 2013), the court also found that tax accrual workpapers contained work product protected information. It is true that the court rejected the taxpayer's claim that its mere identification of uncertain tax positions ("UTP's) and related factual information was work product protected, holding that this information was created in the ordinary course of business. On this issue, the court cited *Textron* when it observed that the "mere identification of which tax positions a company should analyze under FIN 48 is too far removed from any litigation to be protected by work product or considered created "because of" litigation."

Importantly, however, the *Wells Fargo* court did protect as work product "recognition and measurement analysis" reflected in the tax accrual work papers. This analysis included "settlement figures, the strengths and weaknesses of Wells Fargo's case, and assessments of

[4] Followed in *United States v. Eaton Corp., et al.*, 110 AFTR 2d 2012-5638 (N.D. Ohio 2012).

Wells Fargo's chances of prevailing in litigation." Citing and quoting *Deloitte*, the court ruled that "material developed in anticipation of litigation can be incorporated into a document produced during an audit without ceasing to be work product." And, echoing *Roxworthy* and *Salem Financial*, the court stated that "[a]llowing the IRS access to Wells Fargo's recognition and measurement analysis in the TAWs would provide a window into the legal thinking of Wells Fargo's attorneys on active litigation strategy, running counter to the purpose of the work product doctrine."

In sum, three observations can be made. First, the *Textron* dissent's contention that the *Textron* majority created a new standard that "ignores a tome of precedents from the circuit courts and contravenes much of the principles underlying the work-product doctrine" has rung true with other courts. Second, as a result, courts have declined to adopt the *Textron* majority's new "prepared for" standard, relying instead on the established, pre-*Textron* "because of" analysis. Third, courts have resisted the *Textron* majority's implicit call to allow the "essential public interest in revenue collection" to justify what the *Textron* dissent described as "a significant expansion of the IRS's power."

As a result of the *Textron* majority's decision, Textron was ordered to comply with the IRS's summons for its tax accrual workpapers. In the long run, however, it may be the *Textron* dissent that has the broader and more lasting impact, encouraging other courts to view the majority's new "prepared for" rule as, in the words of the dissent, "a dangerous aberration in the law of a well-established and important evidentiary doctrine."

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About the Author

A partner in Steptoe's Washington office, **J. Walker Johnson** formerly was a trial attorney in the Tax Division, US Department of Justice, where he litigated numerous tax cases. Since 1987 he has been an adjunct law professor in the LL.M. in Taxation program at Georgetown University Law Center, presenting the course Taxation of Financial Institutions and Products. At Steptoe, he has litigated numerous major tax cases, including cases such as New York Life (payment vs. deposit), American Electric Power (COLI policies), Textron (tax accrual workpapers), John Hancock (cross-border leveraged leasing), and others. He is recognized as a leading tax litigator by *Chambers* and *Legal 500*. Mr. Johnson can be reached at wjohnson@steptoe.com or + 1 202.429.6225.

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