Practice

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Textron and Work Product Immunity: A Misguided Decision

In its recent *en banc* decision concerning a summons issued for the work papers prepared by tax advisors, the First Circuit in *Textron, Inc.*[1] stated: "Every lawyer who tries cases knows the touch and feel of materials prepared for a current or possible (*i.e.*, 'in anticipation of') law suit." While addressing the issue with broad generalities regarding litigation, the court betrayed an ignorance of how tax controversy matters unfold. Using this "I know it when I see it definition," the court rendered a decision that risks undermining the protections of the work product immunity.

The IRS Issued the Summons in *Textron* as an Exception to Its "Policy of Restraint"

The IRS has a long-standing "policy of restraint," which states that the IRS will seek tax accrual work papers only in "unusual circumstances."[2] In setting out this "policy of restraint," the Internal Revenue Manual defines "tax accrual work papers" as "those audit work papers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities … and to footnotes disclosing those tax reserves on audited financial statements."[3] Although the IRS starts with the premise that the preparation of tax accrual work papers is in the ordinary case viewed as an accounting function, and such work papers are in general not protected from disclosure,[4] the IRS takes the position such materials may include "information on whether there was reliance on outside legal advice" and "an assessment of the taxpayer's position and potential for sustention."[5]

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The Internal Revenue Manual defines "unusual circumstances" as:

A. A specific issue has been identified by the examiner for which there exists a need for additional facts;
B. The examiner has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue; and
C. The examiner has sought a supplementary analysis (not necessarily contained in the work papers) of facts relating to the identified issue and the examiner has performed a reconciliation of the taxpayer's Schedule M-1 or M-3 as it pertains to the identified issue.[6]

Examiners are instructed to seek tax accrual work papers only when "factual data cannot be obtained from the taxpayer's records or from available third parties, and then only as a collateral source for factual data." They are further instructed to limit such requests "to the portion of the work papers that is material and relevant to the examination."[7]

In Announcement 2002-63, the IRS set out an exception to its policy of restraint with regard to "listed transactions" or so-called abusive tax shelters. The IRS will routinely request the portion of tax accrual work papers that relates to the listed transaction in examinations involving returns filed after July 1, 2002, that claim tax benefits of a listed transaction or a substantially similar transaction and disclose the transaction as such on the return. When a listed transaction is not disclosed on the return, the IRS will routinely request the complete tax accrual work papers. When there are multiple listed transactions disclosed on the return, the IRS will exercise its discretion in determining whether to seek the complete tax accrual work papers.[8]

The IRS has acted very strategically in setting out this policy and its exceptions. Implicit in the "policy of restraint" is a recognition that tax accrual work papers will often present issues of whether an attorney has given privileged legal advice or acted in anticipation of litigation. When the IRS elects to label a transaction a "listed transaction," the IRS is not making a determination that has any binding legal effect. Rather, to label something a "listed transaction" is, in and of itself, the equivalent of the IRS setting out its litigation position concerning tax return positions taken in connection with such transactions. Moreover, IRS officials have candidly described the decision of moving away from the "policy of restraint" to demand tax accrual work papers in audits involving "listed transactions" as a prophylactic, intended to discourage companies from engaging in listed transactions, or in transactions that may become listed transactions, by creating the risk that they will be required to turn over their tax accrual work papers.[9]

The First Circuit Discounted Textron's Showing Regarding Work Product

The First Circuit in *Textron* acknowledged that the IRS issued a summons for Textron's work papers because the company's tax returns reported listed transactions. The documents at issue in *Textron* were not limited to the listed transactions, however.

The spreadsheets and underlying work papers at issue identified tax return positions that were open to challenge by the IRS, and analyzed the company's potential exposure and its chances of prevailing on those issues. As a publicly traded corporation, Textron prepared public financial statements, which included reserves for contingent tax liabilities; the financial statements were certified by the accounting firm that served as Textron's independent auditor.[10] The accounting firm had reviewed the work papers at issue to determine whether the reserve for contingent tax liabilities was adequate and reasonable.[11]

Both the district court and the First Circuit found that the disclosure to the accounting firm waived the attorney-client privilege, and accordingly both decisions focused on the work product immunity.[12] The district court ruled in favor of Textron, and the decision of the panel in the First Circuit found that the documents were protected work product, but remanded on the issue of whether disclosure to the accounting firm constituted a waiver. The First Circuit *en banc,* however, concluded that the documents were not attorney work product in the first instance.

Specifically, the work papers included a list of tax return positions that the company's tax advisors had identified as susceptible to challenge by the IRS, the amount of the potential liability, and an estimate, stated as a percentage, of the likelihood that the IRS would prevail were it to challenge the company's position on that issue, as well as back-up documents for these spreadsheets.[13] The published financial statements did not identify the specific tax items that the company believed might be open to

contention, but only set out a total reserve figure for contingent tax liabilities.[14]

The district court found that, while the work papers at issue in *Textron* served the purpose of aiding in the calculation of the reserve for contingent tax liabilities, "there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding."[15] As a large, publicly traded company, Textron routinely has its tax returns audited by the IRS. The First Circuit, however, ignored the implications of the likelihood that Textron would find itself in litigation with the IRS, stating that while Textron "sometimes … litigated disputed tax issues in federal court," Textron "usually settled disputes with the IRS through negotiation or concession or at worst through the formal administrative process."[16]

> The *Textron* decision risks both the sharp practices and the chill to sound legal advice that the work product immunity was intended to safeguard against.

The First Circuit emphasized a fact that is not open to dispute: The work papers were prepared in connection with Textron's analysis of its contingent tax reserves. The court downplayed, however, the clear interaction between setting up a contingency tax reserve and analyzing a litigation position. As Textron's director of tax reporting testified: "The purpose primarily was to determine whether Textron was adequately reserved *with respect to any disputes or litigations* that would happen in the future."[17] The court dismissed the import of testimony from Textron's vice president of taxes that the work papers "would guide us in making litigation and settlement decisions later in the process."[18]

The First Circuit Held That the Work Papers Were Not Attorney Work Product

The First Circuit identified the issue before it as whether work product can include "a document which is not in any way prepared 'for' litigation but relates to a subject that might or might not occasion litigation."[19] With this starting point, the First Circuit rendered a decision that portends a dangerous narrowing of the definition of work product.

The First Circuit started its discussion with the Supreme Court's decision in *Hickman v. Taylor,* establishing the work product immunity, and quoted the *Hickman* Court's examples of protected materials: "This work is reflected, of course, in interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways—aptly though roughly termed … as the 'work product of the lawyer.'"[20] The court next turned to the language of Rule 26(b)(3) of the Federal Rules of Civil Procedure, which codifies the work product immunity as protecting "documents and other tangible things that are prepared in anticipation of litigation or for trial by another party or its representative … ."[21] The First Circuit determined that the language "'prepared in anticipation of litigation or for trial' did not, in the reference to anticipation, mean preparation for some purpose other than litigation: it meant only that the work might be done *for* litigation but *in advance of* its institution."[22] Closing its circular reasoning to describe what such materials might be, the First Circuit said, in conclusory terms, "They are the very materials catalogued in *Hickman v. Taylor* and the English precedent with which the decision began."[23]

The First Circuit ignored that the *Hickman* decision does not purport to "catalogue" materials that may be work product. To the contrary, in the very language quoted in *Textron*, the Supreme Court stated that work product may be embodied in "countless other tangible and intangible ways."[24] The First Circuit also blithely stated that "[a]ny experienced litigator would describe the tax accrual work papers as tax documents and not as case preparation material."[25] The court clearly did not consider that litigators experienced in tax matters might have a different view. The court also wholly failed to recognize that the role of an attorney in advising a client is not solely to ready a matter for litigation, but also to guide the client through the best course, whether it be litigation or resolution, when a dispute is presented. Despite the First Circuit's attempt to dismiss the evidence, the record established that the Textron work papers served this purpose.

The First Circuit Gave Undue Deference to the IRS's Claims

It is easy to see why the IRS would want Textron's tax accrual work papers, which list and scope out odds

concerning contentious tax return positions. The First Circuit, in making a point that stands as a remarkable nonsequitor to the legal issues before it, stated that "Textron apparently thinks that it is 'unfair' for the government to have access to its spreadsheets, but tax collection is not a game."[26] In this statement, the First Circuit demonstrates that it has missed two key points. First, fairness is at the very heart of the work product immunity. It is the basic underpinning of the Supreme Court's decision in *Hickman v. Taylor* that it is fundamentally unfair for one party to gain access to the mental processes of an adversary. Second, it is the IRS that has turned this into a game, by setting out a sound policy and then undercutting it in limited cases to advance its own litigation position.

The court emphasizes the importance of tax collection by the IRS, but ignores that taxpayers have the right to take positions that the IRS may dispute. In fact, because it may be a court, and not the IRS, that will ultimately decide whether the positions taken on Textron's returns are correct, the need to maintain the work product protection for the analysis done by its advisors is all the more obvious.

The Majority Opinion in *Textron* Ignored Precedent

The majority opinion is based on a fundamental error in failing to recognize that quantifying the potential tax liability was done by Textron's tax advisors for litigation purposes. Any business will need its attorneys to analyze the strengths and risks of its position in anticipation of litigation, and the courts have long recognized that the work product immunity protects such analysis. As discussed in the well-reasoned dissent, the *Textron* decision is out of step with recent cases upholding the protection of work product in the tax area, including *P.J. Roxworthy* in the Fifth Circuit and *M. Adlman* in the Second Circuit.

The district court in *Textron* noted that there are two tests for determining whether a document was prepared in anticipation of litigation. Under the "primary purpose" test, the document will be protected provided that the primary purpose in its creation was to aid in future litigation. Under the alternative "because of" test, the document will be protected provided that it was prepared or created because of potential litigation. In sum, documents prepared for more than one purpose are more likely to find protection under the work product immunity in those jurisdictions that apply the "because of" test than in those courts that look to the "primary purpose test." As the dissent noted in the *en banc* opinion, the First Circuit wholly ignored the "because of" test that had stood as precedent in the First and other Circuits.[27]

As the dissent noted, the issues raised in the *Textron* case squarely require consideration of "whether the work product doctrine applies where a dual purpose exists for preparing the legal analysis, that is, where the dual purpose of anticipating litigation and a business purpose co-exist."[28] The dissent cited to the Second Circuit decision in *Adlman,* which expressly held that a requirement that the materials be prepared "primarily or exclusively to assist in litigation" was inconsistent with the text of Rule 26(b)(3) and the policies underlying work product protection. Thus the *Adlman* court concluded, as did the district court in *Textron,* that the work product immunity protects materials prepared "because of" litigation, and not just those materials prepared "for use" in litigation.[29] The Sixth Circuit's decision in *Roxworthy* followed the holding in *Adlman* to conclude that tax accrual work papers of the kind at issue in *Textron* were protected work product.[30]

In analyzing the work papers at issue in *Textron*, the dissent stated that "Textron's litigation hazard percentages contain exactly the sort of mental impressions about the case that *Hickman* sought to protect."[31] Next, the dissent noted, denying work product protection risked a chilling effect on candid legal advice in litigation, and may make attorneys hesitant to record their impressions of the risks of litigation. The dissent further found that this concern was heightened by the lack of protection accorded by the majority to the supporting materials that accompanied the work papers.[32]

Conclusion

The *Textron* decision risks both the sharp practices and the chill to sound legal advice that the work product immunity was intended to safeguard against. The battle in *Textron* has endured through several decisions, and should not rest with the First Circuit's flawed reasoning.

Endnotes

1 *Textron, Inc.*, CA-1, 2009-2 USTC ¶50,574.
2 IRM §4.10.20.3(2). Notably, the words "policy of restraint" often appear in quotation marks even in IRS statements on issues regarding tax accrual work papers.
3 IRM §4.10.20.2(1).
4 *See Arthur Young & Co.*, SCt, 84-1 USTC ¶9305, 465 US 805.
5 IRM §4.10.20.2(2)(A).
6 IRM §4.10.20.3.1(2).
7 IRM §4.10.20.3.1(1).
8 Announcement 2002-63, 2002-2 CB 72; *see*

Endnotes

IRM §4.10.20.3.2(1).

[9] *E.g.,* Comments of IRS Chief Counsel Donald Korb, 66th Institute on Federal Taxation, New York University School of Continuing and Professional Studies, New York, NY, October 21, 2007.

[10] *Textron, Inc., supra* note 1.

[11] *Id.*

[12] *Textron, Inc.,* DC-RI, 2007-2 USTC ¶50,605, 507 FSupp2d 138, *aff'd,* CA-1, 2009-1 USTC ¶50,167, 553 F3d 87, *rev'd,* CA-1, 2009-2 USTC ¶50,574. The district court also determined that the statutory tax practitioner privilege set out in Code Sec. 2525 was also waived by the disclosure.

[13] *Textron, Inc., supra* note 1.

[14] *Id.*

[15] *Textron, Inc., supra* note 12, 507 FSupp2d, at 150.

[16] *Textron, Inc., supra* note 1.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Textron, Inc., supra* note 1, *quoting, Hickman v. Taylor,* 329 US 485, at 511 (1947).

[21] *Textron, Inc., supra* note 1, *quoting,* F.R. Civ. P. Rule 26(b)(3).

[22] *Textron, Inc., supra* note 1.

[23] *Id.*

[24] *Hickman, supra* note 20, 329 US, at 511.

[25] *Textron, Inc., supra* note 1.

[26] *Id.*

[27] *Textron, Inc., supra* note 1; *see M. Adlman,* CA-2, 98-1 USTC ¶50,230, 134 F3d 1194, at 1202; *P.J. Roxworthy,* CA-6, 2006-2 USTC ¶50,458, 457 F3d 590.

[28] *Textron, Inc., supra* note 1.

[29] *Adlman, supra* note 27, 134 F3d, at 1202.

[30] *Roxworthy, supra* note 27, 457 F3d, at 593–94.

[31] *Textron, Inc., supra* note 1.

[32] *Id.*