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Textron, Work Product and Corporate Deals

By Robert W. Wood • Wood & Porter • San Francisco

Most concerns about prying IRS eyes these days are focused on IRS access to Swiss bank account information. But that focus may be myopic if it means you haven't yet considered how the tax world may change in light of the First Circuit's recent decision in *Textron, Inc.*, CA-1, 2009-1 USTC ¶50,167, 553 F3d 87 (2009). In this environment of enhanced transparency, it may seem odd to suggest that there are good reasons for IRS access to certain documents to be limited.

Of course, there's no doubt that U.S. tax law requires taxpayers to report their worldwide income for tax purposes. But turning over workpapers and other documents may not be so clear-cut. In fact, there has recently been a push for more disclosure that has nothing to do with Swiss bank accounts.

Perhaps because this issue seems unrelated to the foreign account disclosure issues (which it is) and seems unimportant (which it isn't), the larger disclosure issue is being widely overlooked.

New Assault

The issue is work product protection from the IRS. It is something that litigators (as well as many other lawyers) understand instinctively. Increasingly, tax advisors understand it too. Broadly stated, the work product doctrine says that an individual or company need not turn over documents that were created in anticipation of litigation. [*See Hickman v. Taylor,* SCt, 329 US 495, 510 (1947).] It has wide application, and certainly isn't limited to tax litigation.

However, just how *does* work product protection apply to taxes? And how is the IRS mounting an assault against it? Traditionally, tax lawyers understand that documents that will be used in the event of tax litigation and that relate to the strength or weakness of a tax position are covered by the work product privilege.

ALSO IN THIS ISSUE

Frequently, as part of vetting a particular tax argument, one will discuss what tax arguments the IRS could make that might foil a claimed tax position. Understandably, no one would want to hand the IRS a roadmap of arguments to make against them. If you are a good tax lawyer, the IRS might not have considered some or all of these arguments on its own. You don't want to do the IRS's work for it.

Thus, the work product privilege has been a central precept of tax planning for generations. Of course, work product protection is different from attorney-client privilege. The latter still protects communications between clients and their lawyers, whether or not dealing with anticipated litigation.

But in the rough and tumble of business, many companies will show the tax discussions and figures to their outside accountants too. That will waive the attorney-client privilege unless the company has gone to the effort to ensure that the accountants are retained not by the client directly, but rather by the law firm representing the company. The idea of the latter is to import attorney-client privilege to these accountant communications.

That often makes sense where tax litigation is imminent, but it can be cumbersome, and probably doesn't make sense in many garden-variety situations.

IRS Access Pass

The First Circuit Court of Appeals in *Textron, Inc.* [CA-1, 2009-2 USTC ¶50,574] has ruled that the IRS can get access to such documents that are not protected by attorney-client privilege. Some say this case eviscerates work product protection in the tax area, and may threaten to extend beyond taxes and IRS collections to many other areas. The case has been widely watched and remains controversial for good reason.

Textron is a defense contractor with a complicated tax return and complicated tax issues. Textron prepared memos and calculations dealing with the extent to which its calculation of its tax liabilities would pass muster in an IRS audit. As it turned out, the IRS did audit and tried to get access to all these documents.

Textron refused to disclose them, and the matter landed in federal court. Textron argued that the work product doctrine applied, so these documents did not have to be turned over to the IRS. After all, Textron's lawyers believed the IRS might challenge the tax deductions leading to litigation.

To Textron, that brought the questioned documents and spreadsheets into the purview of traditional work product protection. The District Court held that the documents were protected from disclosure to the IRS under the work product doctrine. [*See Textron Inc.*, DC-RI, 2007-2 USTC ¶50,605, 507 FSupp2d 138 (2007).] The First Circuit affirmed [*see Textron, Inc.*, 553 F3d 87, *supra*], but then hearing the case *en banc*, the First Circuit reversed. The court declined to shield the documents from IRS eyes *via* the work product doctrine. The court found that the documents were not prepared *specifically* for use in litigation.

Universal Impact?

This issue of specific intent to use something in litigation may explain the decision. Yet there are

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also strong policy overtones. The First Circuit actually said that "tax collection is not a game" and that "[u]nderpaying taxes threatens the essential public interest in revenue collection." [*See en banc* opinion, at 2728.]

For now, the *Textron* decision is binding only in federal courts within the First Circuit. Yet this decision is expected to be trumpeted by the IRS, and to be looked to for guidance throughout the country. How work product fights will be resolved throughout the United States is not yet clear.

Whatever happens, the *Textron* case is terribly important. It is also terribly frightening. After all, it means that even though notes and documents you prepare for *other* types of litigation should be protected under the work product doctrine, notes and documents in tax cases may not be. That is counterintuitive, and just seems wrong.

The key—at least if you listen to the First Circuit Court of Appeals and to IRS lawyers—may be both temporal and conditional. Textron's problem was that it was calculating it strengths and weaknesses from a tax viewpoint, at the time it was preparing and filing its returns. Moreover, Textron did not know for sure that it would face scrutiny on these issues. If you read IRS audit statistics, you might think any discussion of an audit is speculative.

Of course with some big companies, an audit is a certainty. That can make the temporal element less important. If there is no question you will have a dispute, can't it be said that you are preparing the documents for the specific purpose of litigation?

Secret Scramble

It isn't hyperbole to suggest that the IRS has won an enormous victory in *Textron*. In our incredibly complicated tax system (which is by far the most complicated tax system in the world), companies and individuals alike can and do—and frankly *should*—plan ahead for which tax issues on their returns are solid and which are not. There are almost infinite shades of grey, and even the opinions of well-qualified professionals can and do differ.

In such an environment, it seems abhorrent to suggest that if you plan ahead in this way you will be penalized. It seems like a game of "gotcha." There is a disincentive to plan if you must turn over to the IRS the fruits of your planning. True, very careful taxpayers may be able to contradict the effect of *Textron*'s assault on the work product doctrine by expanding the cloak of attorney-client privilege.

If you solely deal with your tax lawyer and not your accountant, *Textron* should not apply. Alternatively, if you have your tax lawyer as the point of all communication, that may import attorney-client privilege for all such communications. Of course, that may be terribly cumbersome. Here are a few items that may help you to skirt the unhappy result in *Textron:*

- Keep any legal opinions on tax matters, as well as tax authorities memoranda, in a separate file.
- If you maintain tax accrual work papers, limit them to numerical analyses. Keep the tax memos in a legal file, preferably with counsel.
- Start thinking of tax documents as tax returns and spreadsheets, more numbers rather than words. If you can, try to organize yourself so the legal issues associated with taxes are kept in a legal file.
- Keep legal opinions and tax analysis memos under the province of the general counsel's office. They may relate to finances, but they are legal.
- Whenever possible, have tax work done by outside tax counsel rather than by outside accountants.
- If you are in-house counsel, try to keep legal opinions and tax memoranda in an entirely separate file from accounting and financial statement records.

For many taxpayers who cannot take these steps, and perhaps even for those who can, the *Textron* case represents a serious assault on privacy in the tax world. It may help if all of your notes and documents themselves are prominently legended at the time they are created with "Work Product" protections. It may also help if you show, or are able to show, that you are preparing these documents for the *specific* use of anticipated litigation.

Curiously, if the work product doctrine is actually called into question, your fears about litigation will have proven true. Talk about a self-fulfilling prophesy. Yet as it turned out for Textron, and perhaps for other taxpayers, the black cloud of potential disclosure of key strategic documents is troubling indeed.