Ruling Is a Frightening Step Back for Taxpayers' Privacy Rights

By Robert W. Wood

A furor currently swirls around IRS access to Swiss bank account information, with resulting pressure on U.S. taxpayers who've been hiding income or assets to come clean. In this environment of enhanced transparency, it may seem odd to suggest that there are good reasons for the IRS's 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.

There's also no doubt that the IRS can and will push for full disclosure. Yet there remain circumstances in which taxpayers have a right of privacy — even from IRS eyes.

Unfortunately, it is far from clear the IRS agrees. In fact, there has recently been an assault on such privacy that has nothing to do with Swiss bank accounts. The larger privacy issue — work-product protection — is being widely overlooked.

It is something every litigator (and many other lawyers) should understand instinctively. 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,* 329 U.S. 495 (1947). It has wide application, and certainly isn't limited to tax litigation.

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.

Indeed, as part of vetting a particular tax position, one often will discuss arguments the IRS could assert that might foil a claimed tax position. Understandably, you would not want to hand the IRS a roadmap of arguments to make against you. 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 them.

Thus, the work product privilege has been a central precept of tax planning for generations. Note that 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.

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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 by the law firm representing the company. The idea 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.

The 1st Circuit Court of Appeals in *U.S. v. Textron, Inc.*, 2009 U.S. App. LEXIS 18103 (1st Cir. 2009), has ruled that the IRS can get access to such documents that are not protected by attorney-client privilege. Some say this eviscerates the work-product protection in the tax area, and may threaten to extend beyond taxes and IRS collections. The case has been widely watched and remains controversial — for good reason.

Textron is a defense contractor with a sophisticated tax return and comlpex tax issues. The company prepared memos and calculations dealing with the extent to which its tax positions 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, and the matter landed in federal court.

Textron argued that the work-product doctrine applied. 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 indeed protected under the work-product doctrine. The 1st Circuit affirmed, but upon hearing the case en banc, it reversed. The court declined to shield the documents from IRS eyes. The court found that the documents were not prepared *specifically* for use in litigation.

This issue of specific intent to use something in litigation may explain the decision. Yet there are also strong policy overtones. The 1st Circuit actuallyadmonished that "tax collection is not a game" and that "[u]nderpaying taxes threatens the essential public interest in revenue collection."

For now, the *Textron* decision is binding only in federal courts within the 1st Circuit. Yet the 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 U.S. 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 wrong.

The key — at least if you listen to the 1st Circuit and to IRS lawyers — may be both temporal and conditional. Textron's problem was that it was calculating its 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?

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 in the world), companies and individuals alike can, do and should plan ahead for which tax issues on their returns are solid and which are not. There are almost infinite shades of gray, and even the opinions of well-qualified professionals differ.

In such an environment, it is abhorrent to suggest that if you plan ahead in this way you will be penalized, with a kind-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 have teeth. Alternatively, if you have a 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.

For many taxpayers who cannot take these steps, 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.

Unless *Textron* is reversed by the Supreme Court or by legislation, taxpayer rights have been weakened significantly. While transparency in the tax system is generally good, the ruling in *Textron* is not.

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