



## Textron Workpapers Are Privileged Work Product

The first Circuit held that tax workpapers are protected by the work product doctrine, but remanded the case for a determination of whether the privilege was waived through disclosure to the outside auditor.

By Tom R. Wechter

Originally published in the *AICPA Tax Insider Newsletter*, February 12, 2009.

**February 2009**

One Atlantic Center, Suite 2300  
1201 West Peachtree Street  
**Atlanta, Georgia 30309**  
t 404.437.7000 f 404.437.7100

225 Franklin Street, Suite 2600  
**Boston, MA 02110**  
t 617.848.5750 f 617.848.5784

6600 Sears Tower  
233 South Wacker Drive  
**Chicago, IL 60606-6473**  
t 312.258.5500 f 312.258.5600

One Westminster Place  
**Lake Forest, IL 60045-1885**  
t 847.295.9200 f 847.295.7810

900 Third Avenue  
**New York, NY 10022**  
t 212.753.5000 f 212.753.5044

One Market  
Spear Street Tower  
Thirty-Second Floor  
**San Francisco, CA 94105**  
t 415.901.8700 f 415.901.8701

1666 K Street NW, Suite 300  
**Washington, DC 20006**  
t 202.778.6400 f 202.778.6460

[www.schiffhardin.com](http://www.schiffhardin.com)

On January 21, the First Circuit in *United States v. Textron Inc. and Subs.* (1st Cir. January 21, 2009) held that tax accrual workpapers are protected by the work-product privilege even if the workpapers are required by financial-reporting rules. However, the court remanded the case to the district court to determine if the workpapers of its outside auditor, Ernst & Young, which contained information from the Textron workpapers and were in Textron's possession were discoverable. If so, then Textron may have waived the privilege through its disclosure to Ernst & Young.

### Overview of the Textron Case

The IRS through a routine audit of Textron's corporate income tax liability for 1998 through 2001 had learned that one of its subsidiaries had entered into a number of sale-leaseback transactions during 2001. During the audit, the Internal Revenue Service (IRS) designated SILOs as listed transactions and contended that Textron's lease transactions were substantially similar. As a result, the IRS requested Textron's workpapers for 2001 to evaluate the abusive nature of the lease transactions. Textron refused to comply, claiming the work-product privilege, the attorney-client privilege and the Section 7525 tax-practitioner-client privilege. In the lower court proceedings, the district court held that the workpapers were protected by the work-product privilege and that disclosure to a non-adversary independent auditor did not waive the work-product privilege.

### Court's Definition of Litigation

After reciting that the work-product privilege protects documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative" — Fed. R. Civ. P. 26(b)(3)(A) — the court turned to defining "litigation." Drawing on the definition of litigation found in the Restatement (Third) of the Law Governing Lawyers §87 cmt. h (2000), the court held that audit disputes with the IRS are litigation, since they are adversarial proceedings before an administrative agency. The court was careful to delineate the filing of tax returns or participating in audits as not in themselves adversarial. The court found that although the processing of good faith disputes regarding the application of the tax law may not be adversarial, the disputes themselves are essentially adversarial and will become the subject of litigation unless resolved.

The court's determination of what constitutes litigation has been criticized by commentators on the basis that the audit process denies both parties the right to cross-examine or dispute the other party's presentation or materials before a neutral trier of facts. The court also ignores that the purpose of an IRS audit "is not to prepare for or conduct

litigation, but to assess the amount of tax liability through administrative channels" (*United States v. Baggot*, 463 U.S. 476, 480 (1983)). The court's finding that all tax-audit disputes are litigation, runs counter to the fact that many tax audit dispute resolution mechanisms are available with the IRS before litigation of the dispute in an adversarial setting.

### Were the Workpapers Prepared in Anticipation of Litigation?

The court tried to determine whether the workpapers were created "in anticipation of litigation." Applying the "because of" test of the First Circuit (see *Maine v. United States Dep't of the Interior*, 298 F.3d 60 (1st Cir. 2002)), the workpapers were found to have been prepared because of the "risk of disputes and litigation [with the IRS], which gave rise to compute and report tax reserves." The "because of" standard does not consider whether litigation was the primary or secondary purpose for its preparation. Rather it considers whether in light of the facts, the document can fairly be said to have been prepared with existing or potential litigation in mind. In the case of dual-purpose documents, the court held that where one purpose of the documents was to summarize litigation hazards, this was enough to protect the documents under the work-product privilege, even though the documents also served the purpose of satisfying a regulatory requirement. The court agreed with the district court that the driving force behind the preparation of the workpapers was the need to reserve money in anticipation of disputes with the IRS. Where a dual purpose document is prepared with a view towards litigation, the document is protected under the work product doctrine even though there is also a business purpose for its creation.

The dissenting opinion expressed dissatisfaction with the court's holding that the workpapers were prepared in anticipation of litigation. The dissenting Circuit Judge argued that the majority misread the controlling precedent, which " ... holds that it is not the *subject matter* discussed in the materials that controls, but whether the materials are prepared 'in the ordinary course of business' or were otherwise independently required, which are both the case with the tax accrual workpapers mandated by accounting requirements." See *Maine v. United States Dep't of the Interior*, 298 F.3d 60 (1st Cir. 2002). Consequently, under the dissenting opinion Textron's workpapers would not have been considered to have been prepared in anticipation of litigation, but were prepared in the ordinary course of business.

### Were the Textron Workpapers Disclosed to an Adversarial Party?

The court remanded the case to the district court to determine whether a disclosure to an adverse party was made by Textron. Under the work product doctrine, only a disclosure to an adverse party or to a conduit to a potential adverse party constitutes a waiver of the privilege. The court found that there was neither an actual nor potential adversarial relationship between Textron and Ernst & Young that would constitute a waiver of the work-product privilege. However, Ernst & Young could become a conduit, if it was required to produce the Textron workpaper information to the SEC or in response to a valid subpoena. The accounting firm did not retain a copy of Textron's workpapers, but used them and the information contained in them, together with its own analysis, in preparing its assessment of Textron's reserve for tax liabilities. The court remanded to the district court to determine whether Ernst & Young's workpapers could be discovered, and if so, whether the disclosure of the Ernst & Young's workpapers substantially increased the risk that the contents of Textron's workpapers would be disclosed to the government. If so, the disclosure to Ernst & Young would constitute a waiver of the work product protection.

It should be pointed out that if Ernst & Young's workpapers were discoverable from Textron, it could redact its workpaper material and claim the work-product privilege.

#### **Next Step-Hearing En Banc or Petition to the Supreme Court**

What is the next step? The government can seek a review *en banc*. There were only two circuit judges and one district court judge sitting on the panel. Each of the circuit judges took a different view of the "because of" test. Alternatively, the government can petition the Supreme Court for review because of the administrative importance and the conflict between the circuits in the "in anticipation of litigation" test, *e.g.* "because of" versus the "primary motivating purpose".

## About the Author

**Thomas R. Wechter** concentrates his practice in tax planning for individuals, corporations, and venture capital and private equity firms. He focuses on complex transactions involving acquisitions, dispositions, spin-offs, and new venture investments.

## About Schiff Hardin LLP

**Schiff Hardin LLP** is a general practice law firm representing clients across the United States and around the world. We have nearly 400 attorneys in offices located in Atlanta, Boston, Chicago, Lake Forest, New York, San Francisco and Washington

*This publication has been prepared for the general information of clients and friends of the firm. It is not intended to provide legal advice with respect to any specific matter. Under rules applicable to the professional conduct of attorneys in various jurisdictions, it may be considered advertising material.*

For more information visit our Web site at [www.schiffhardin.com](http://www.schiffhardin.com).

© 2009 Schiff Hardin LLP