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Abstract:

Neil D. Kimmelfield and William C.P. Hsu look at how FIN 48 might affect the Textron ruling and the work product doctrine.

Summary:

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Body

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On August 28, 2007, the U.S. District Court for the District of Rhode Island ruled in United States v. Textron Inc., C.A. No. 06-198, T, 100 AFTR 2d 2007-5848, Doc 2007-20046, 2007 TNT 169-1 (D.R.I. 2007), that some of Textron's internal tax accrual workpapers were protected from discovery under the work product doctrine because the papers were "prepared in anticipation of litigation" and the protection had not been waived by disclosure of the workpapers to auditors. Importantly, the workpapers at issue in Textron were prepared years before the Financial Accounting Standards Board issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." Assuming other courts agree with the Textron decision, it remains to be seen whether FIN 48 will affect the determination that tax accrual workpapers are prepared in anticipation of litigation.

In our opinion, there is reason to be concerned that FIN 48 will be viewed as undermining that determination in some cases. Accordingly, companies wishing to obtain work product protection for particular analytical documents connected to their income tax risk assessments should take steps to differentiate those documents from their normal FIN 48 workpapers.

Background

A company's tax accrual workpapers are documents prepared in connection with the company's determination of its financial statement reserve for current, deferred, and contingent tax liabilities. The workpapers may be prepared by the company's employees or by outside tax accountants and attorneys. The papers often include audit trails, risk assessments, and tax opinions and memoranda.

Section 7602 of the Internal Revenue Code empowers the IRS to "examine any books, papers, records, or other data which may be relevant to" determining a taxpayer's tax liability. Although the IRS has generally exercised restraint in requesting tax accrual workpapers, in Ann. 2002-63, Doc 2002-14466, 2002 TNT 117-12, the IRS announced that it may request tax accrual workpapers of taxpayers that have engaged in listed transactions. The Supreme Court has held that the IRS's summons power under section 7602 is limited by evidentiary privileges such as the attorney-client privilege and the work product doctrine. Upjohn Co. v. United States, 449 U.S. 383 (1981). However, the Supreme Court also has held that tax workpapers prepared by a company's independent auditors are not protected from disclosure. United States v. Arthur Young & Co., 465 U.S. 805 (1984). Moreover, although a tax opinion or memorandum prepared by a company's inside or outside counsel may be protected by the attorney-client privilege under some circumstances, many tax practitioners believe that that privilege is lost when the opinion is disclosed to the company's auditors. In one of the rulings in Textron, the Rhode Island district court confirmed that belief.

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The Textron Decision

In June 2005, the IRS issued a summons for all of Textron's 2001 and 2002 tax accrual workpapers because one of Textron's subsidiaries had engaged in a type of transaction that the IRS later designated as a listed transaction.
The requested documents included materials, prepared by or for attorneys, that assessed the risk that Textron would prevail in litigation regarding its tax return positions. Textron challenged the summons on several grounds, one of which was that the documents were protected by the work product doctrine, and the government filed an enforcement action in the district court.

The crucial question for the court was whether Textron's tax accrual workpapers were prepared in anticipation of litigation. Textron argued that it satisfied this requirement on the grounds that "its workpapers were prepared because it anticipated the possibility of litigation with the IRS regarding various items on its return." The IRS argued that "the workpapers were prepared in the ordinary course of business and in order to satisfy the requirements of the securities laws that financial statements filed by publicly traded companies comply with GAAP [generally accepted accounting principles] (which mandate the creation of reserves to meet contingent liabilities)."

The district court agreed with the taxpayer, stating:

It is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared at all "but for" the fact that Textron anticipated the possibility of litigation with the IRS. If Textron had not anticipated a dispute with the IRS, there would have been no reason for it to establish any reserve or to prepare the workpapers used to calculate the reserve. Thus, while it may be accurate to say that the workpapers helped Textron determine what amount should be reserved to cover any potential tax liabilities and that the workpapers were useful in obtaining a "clean" opinion from [Textron's auditors] regarding the adequacy of the reserve amount, 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.

Nor can there be any doubt that Textron's belief in the likelihood of litigation with the IRS was well-founded. As already noted, the matters identified in the workpapers dealt with issues on which the law was unclear. Moreover, in seven of Textron's eight previous audit cycles, "unagreed" issues had been appealed to the IRS Appeals Board, and three of those issues were litigated in federal court.

The district court also held that Textron had not waived the protection of the work product doctrine by disclosing its workpapers to its outside auditors, because Textron took steps to ensure that the auditors would maintain the confidentiality of the documents. As noted above, protection under the work product doctrine is waived by disclosure only when the disclosure is inconsistent with an intent to keep the materials from the company's adversaries.
Impact of the Textron Decision

The Textron decision suggests that all tax reserve analysis is prepared in anticipation of litigation because the analysis would not be needed but for the possibility of disputes with the taxing authorities. While this interpretation of the “anticipation of litigation” requirement has merit, it is not yet known whether other courts will agree with it. Moreover, it is important to remember that the workpapers at issue in Textron were prepared in 2001 and 2002, before the adoption of FIN 48. To determine the true impact of the Textron decision, companies must consider how the Textron analysis applies under the FIN 48 regime.

Under FIN 48, a company's determination of its income tax reserve may not take audit risk into account. FIN 48 mandates: "It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information" (FIN 48, para. 7.a). It follows that a company must determine its tax exposure and document its determination to the extent required by its auditors, regardless of whether it expects that the IRS or any other taxing authority will challenge, or even examine, its tax positions. For this reason, courts may conclude that FIN 48 generally undermines Textron's determination that tax accrual workpapers would not be prepared but for the possibility of disputes.

The work product doctrine, however, is applied separately to each document. Thus, even if courts conclude that, under FIN 48, tax accrual workpapers generally are not prepared in anticipation of litigation, it is still possible that particular documents included within the workpapers will have work product protection. If, for example, the level of detail in a company's memorandum of law regarding a tax position exceeds what the company normally prepares to document its FIN 48 analysis, there is no reason to think that the memorandum cannot be treated as prepared in anticipation of litigation simply because some documentation for the position would have been prepared as part of the company's standard FIN 48 compliance procedures.

Thus, it appears that, even under FIN 48, courts that agree with the Textron analysis may find that many documents analyzing a company's potential tax liabilities were prepared in anticipation of litigation. A company wishing to obtain work product protection for a document should therefore ensure that all persons to whom the document is disclosed, including outside auditors, agree to maintain the confidentiality of the document, and the company should consider ways of differentiating the document from documents it normally prepares as part of its FIN 48 compliance procedures.

Even if those steps are taken, however, companies should not assume for now that any tax opinions or other tax accrual workpapers will be protected from the IRS's summons power by the work product doctrine. It is not yet known whether courts other than the Rhode Island district court will agree that tax accrual workpapers prepared because of the possibility of disputes with taxing authorities are prepared in anticipation of litigation.

FOOTNOTE

/1/ It should be noted that the favorable "but for" analysis employed by the district court in Textron does not apply in jurisdictions that use a "primary purpose" test, under which dual-purpose documents are considered to be prepared in anticipation of litigation only if "the primary motivating purpose behind the creation of a document was to aid in possible future litigation." See United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982).

END OF FOOTNOTE

References

Subject Area:

Compliance;
Individual income taxation;
Tax system administration issues