THE APPLICATION OF THE ATTORNEY-CLIENT PRIVILEGE TO TAX ACCRUAL WORKPAPERS: THE REAL LEGACY OF *UNITED STATES V. TEXTRON*

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I. INTRODUCTION

In August 2007, the United States District Court for the District of Rhode Island ("District of Rhode Island") issued a much anticipated opinion in *United States v. Textron Inc.*[1] The case involved an unsuccessful attempt by the Internal Revenue Service ("I.R.S.") to enforce a summons requesting the corporation's tax accrual workpapers.[2] The opinion has garnered a great deal of attention as a significant taxpayer victory in asserting the work product doctrine to protect tax accrual workpapers.[3] By contrast, the court's analysis on the application of the attorney-client privilege has largely been overlooked because the taxpayer did not prevail on that theory.[4] However, as explained in this article, it is likely that the court's privilege analysis ultimately will prove to be the most influential part of the opinion—and the most beneficial to taxpayers.

Section II of this article provides background on the sensitivities with respect to tax accrual workpapers, and the state of the law prior to *Textron*. Section III describes and provides analysis of the District of Rhode Island's *Textron* opinion. Section IV summarizes the author's conclusions.

II. BACKGROUND

A. *Understanding the Sensitivities Associated With Tax Accrual Workpapers*

Among other things, Generally Accepted Accounting Principles ("GAAP") require a corporation to provide a financial accounting reserve for contingent tax liabilities and uncertain tax benefits ("tax reserve").[5] Corporations have many incentives to comply with such GAAP requirements.[6] For example, federal

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1. United States v. Textron Inc., 507 F. Supp. 2d 138 (D.R.I. 2007).

2. *Id.* at 141-42.

3. *See, e.g.*, Susan Simmonds & Sam Young, *Government Loses 'Test Case' on Tax Accrual Workpapers*, 2007 TNT 170-1, 116 TAX NOTES 815-17 (Aug. 31, 2007), *available at* http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2007+TNT+170-1.

4. *See Textron*, 507 F. Supp. 2d at 152 (explaining Textron had waived the attorney-client privilege).

5. *See* FINANCIAL ACCOUNTING STANDARDS BOARD ("FASB"), STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES 5-6, 8 (Mar. 1975), *available at* http://www.fasb.org/pdf/fas5.pdf.

6. *See, e.g.*, Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*,. 51 DUKE L.J. 1397, 1421 (2002) (citing Messod D. Beneish, *Detecting GAAP Violation: Implications for Assessing Earnings Management Among Firms with Extreme Financial Performance*, 16 J. ACCT. & PUB. POL'Y 271, 274 (1997)) (stating that most who violate the GAAP suffer from losses in the

securities laws require publicly traded corporations to have their financial books audited by independent public accountants to determine if they are in accord with GAAP standards.[7] Many stock exchanges and lending institutions also require audit certification of GAAP compliance.[8]

In order to prepare a tax reserve, a corporation's tax return positions must be reviewed to determine the likelihood that some may not be sustained after an I.R.S. audit.[9] The term "tax accrual work papers" is one of several names used to describe the documentation supporting the amount of the tax reserve.[10] The composite amount of a publicly traded corporation's tax reserve is made publicly available.[11] However, the components of that composite amount (i.e., the specific tax return positions determined to be vulnerable) are generally not publicly disclosed.[12] Indeed, the components are typically considered to be extremely sensitive, as they are essentially a listing of the "soft spots" of a taxpayer's return and could potentially serve as a "roadmap" for the I.R.S. on audit.[13] For this reason, taxpayers generally would prefer to not have to disclose their tax accrual workpapers to the I.R.S.

B. *Prior Case Law and the I.R.S. Policy of Restraint*

Prior to *Textron*, there were two leading cases in which the I.R.S. issued a summons for a taxpayer's tax accrual workpapers.[14] In 1982, the Fifth Circuit in *United States v. El*

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stock market before the violation, giving an incentive to correctly manage reported earnings).

7. Securities and Exchange Act of 1934, ch. 404, § 12, 48 Stat. 892 (1934) (codified as amended at 15 U.S.C. § 78l (2006); *see, e.g.*, Rebecca Anne Ferrell, *Internal Revenue Service Accessibility to Auditors' Tax Accrual Workpapers*, 72 GEO. L.J. 1211, 1211 (1984); Katherine Pryor Burgeson, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468, 468-69 (1982) (citing 15 U.S.C. §§ 77a-77bbbb, 78a-78kk).

8. *See, e.g.*, Scott L. Kline, United States v. Arthur Young*: Judicial Death Knell for Auditors' Privilege and Suggested Congressional Resurrection*, 71 CORNELL L. REV. 694 (Mar. 1986); United States v. El Paso Co., 682 F.2d 530, 534 n.3 (5th Cir. 1982).

9. *See* Cristi A. Gleason & Lillian F. Mills, IS THE TAX EXPENSE ESTIMATE IMPROVED OR BIASED IN THE PRESENCE OF USING THE SAME TAX AND AUDIT FIRM? (2006), http://www.irs.gov/pub/irs-soi/06gleason.pdf.

10. *El Paso*, 682 F.2d at 533.

11. *See, e.g.*, FASB, FASB INTERPRETATION NO. 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, FINANCIAL ACCOUNTING SERIES 6-7 (June 2006), *available at* http://www.fasb.org/pdf/fin%2048.pdf. (requiring composite tabular disclosures for unrecognized tax benefits for years beginning after December 15, 2006).

12. *See El Paso*, 682 F.2d at 535.

13. *Id.* at 534, 545.

14. United States v. Arthur Young, 465 U.S. 805 (1984); United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982).

Paso Company sustained a lower court's decision to enforce the summons of the taxpayer's internally prepared tax accrual workpapers.[15] Based on the specific facts at issue, the court rejected the taxpayer's assertion of attorney-client privilege for two reasons.[16] First, the court held the privilege was "waived" when the tax accrual workpapers were provided to the taxpayer's independent auditors.[17] Further, the court reprimanded El Paso for making only a "blanket assertion" of privilege and failing to prove which documents were prepared by its tax attorneys as opposed to its tax accountants.[18] In a separate portion of the opinion, the Fifth Circuit also rejected El Paso's assertion of the work product doctrine because the tax accrual workpapers failed the Circuit's narrow "primary purpose" interpretation of the doctrine's "anticipation of litigation" requirement.[19]

Two years later, the Supreme Court issued its opinion in *United States v. Arthur Young & Company.*[20] In the course of a routine federal income tax audit of Amerada Hess Corporation, the I.R.S. discovered the taxpayer had made certain questionable payments.[21] The I.R.S. then instituted a criminal investigation and issued a summons to the taxpayer's independent auditor, Arthur Young & Company, to turn over the tax accrual workpapers prepared in the course of its audit of Amerada Hess.[22] Because the tax accrual workpapers in question were not prepared by lawyers of Amerada Hess Corporation (either in-house or outside counsel), the attorney-client privilege was never at issue.[23] Instead, the accounting firm was left to defend against the summons by making policy arguments and arguing for the creation of a new auditor-client privilege.[24] Writing for a unanimous Court, Justice Burger stated there was no discernible

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15. *El Paso*, 682 F.2d at 545.
16. *Id.* at 540.
17. *Id.* at 541.
18. *Id.*
19. *Id.* at 542-43. The work product doctrine states that:

> Work product consist[ing] of tangible material or its intangible equivalent . . . , or opinion work consist[ing] of the opinions or mental impressions of a lawyer . . . prepared by a lawyer for [current or pending] litigation . . . is immune from discovery or other compelled disclosure to the extent stated in §§ 88 (ordinary work product) and 89 (opinion work product) when the immunity is invoked as described in § 90.

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 87 (2000).

20. United States v. Arthur Young, 465 U.S. 805 (1984).
21. *Id.* at 808-09.
22. *Id.* at 808.
23. *Id.* at 809.
24. United States v. Arthur Young, 496 F.Supp. 1152, 1156 (S.D.N.Y. 1980).

congressional intent for creating such a new privilege; the Court permitted the summons to be enforced.[25]

Recognizing that a decline in auditor-client candor could threaten the financial reporting system and the financial markets, the I.R.S. historically has exercised self-restraint in requesting tax accrual workpapers.[26] After the district court issued its opinion in favor of the I.R.S. in *Arthur Young*,[27] for example, the Internal Revenue Manual was modified to sharply limit a field agent's authority to request tax accrual workpapers.[28] Tax accrual workpapers are outside the ambit of standard examination techniques[29] and are not to be requested absent unusual circumstances, such as when an examiner has not been able to obtain the necessary facts from the taxpayer.[30] Further, when an examiner does request workpapers, the examiner is limited to requesting the portion of the workpapers considered to be material and relevant to the issue under scrutiny, and the examiner must obtain written approval from the chief of examination.[31]

In 2002, the I.R.S. loosened its policy of self-restraint.[32] To the extent a taxpayer engaged in one properly disclosed Listed Transaction, Announcement 2002-63 permitted the Service to request tax accrual workpapers pertaining to that Listed Transaction.[33] However, to the extent a taxpayer failed to disclose a Listed Transaction or engaged in multiple Listed Transactions, Announcement 2002-63 permitted the Service to request *all* tax accrual workpapers.[34] Because of the sensitivity of tax accrual workpapers, this loosening of the I.R.S. policy of self-restraint created a controversy that continues among taxpayer advocates.[35]

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25. *Arthur Young*, 465 U.S. at 821.

26. *See, e.g.*, Cannon F. Allen, *Aftermath of* United States v. Arthur Young*: Surveying the Damage Done to the Accountant-Client Relationship*, 6 VA. TAX REV. 753, 776-77 (1987).

27. *Arthur Young*, 496 F. Supp. at 1160.

28. Allen, *supra* note 26, at 778-80; *see also* Robin L. Greenhouse & Michael Kelleher, Textron *Protects Tax Accrual Workpapers from IRS Summons*, 2007 TNT 200-29, 117 TAX NOTES 255-58 (Oct. 16, 2007).

29. Allen, *supra* note 26, at 779 (citing I.R.S. Manual § 4024.4).

30. Greenhouse & Kelleher, *supra* note 28, at 255 (citing I.R.S. Manual § 40234.3).

31. *Id.*

32. I.R.S. Announcement 2002-63 (July 8, 2002).

33. *See id.*

34. *See id.*

35. *See, e.g.*, Norman R. Nelson & Donna J. Fisher, *Banking Associations Take Issue with Tax Accrual Workpaper Policy*, 2005 TNT 168-16 (July 29, 2005); *Transcript of Tax Analysts Tax Accrual Workpaper Conference Available*, 2004 TNT 142-44 (July 23, 2004).

In addition, Announcement 2002-63 also noted that the Supreme Court's opinion in *Arthur Young* "confirmed" the Service's right to obtain tax accrual workpapers pursuant to its summons authority.[36] Moreover, the Announcement stated that the attorney-client privilege was inapplicable and could not prevent the Service from obtaining tax accrual workpapers.[37] For this purpose, the Internal Revenue Manual specifically defines "tax accrual workpapers" to include workpapers "whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor."[38] Interestingly, the Announcement makes no mention of attorney-prepared workpapers.[39]

III. THE DISTRICT OF RHODE ISLAND'S *TEXTRON* OPINION

Section III-A of this article provides a factual and procedural overview of the *Textron* case. Section III-B analyzes the District of Rhode Island's reasoning on the work product doctrine and identifies potential weaknesses on appeal. Section III-C examines the court's privilege analysis and explains the potential lasting benefit the case may provide to other taxpayers.

A. *Overview of the Case*

During the federal income tax audit of Textron's returns for tax years 1998-2001, the I.R.S. learned that the taxpayer had engaged in nine "Listed Transactions."[40] Consequently, the I.R.S. issued an information document request ("IDR") seeking Textron's tax accrual workpapers.[41] After Textron refused to comply, the I.R.S. filed a petition in the District of Rhode Island to enforce a summons seeking the tax accrual workpapers.[42] In defense, Textron argued that the summons was not issued for a

36. I.R.S. Announcement 2002-63 (July 8, 2002).
37. *Id.*
38. *See* I.R.S. Manual § 4.10.20 (Jan. 15, 2005).
39. I.R.S. Announcement 2002-63 (July 8, 2002).
40. United States v. Textron Inc., 507 F. Supp. 2d 138, 142 (D.R.I. 2007).
41. *Id.*
42. *Id.*

legitimate purpose[43] and asserted the attorney-client privilege,[44] the I.R.C. § 7525 privilege,[45] and the work product doctrine.[46]

Past cases had already established extremely broad parameters for the I.R.S. when issuing summonses.[47] As a result, it was not surprising that the court quickly dismissed Textron's argument that the summons was not issued for a legitimate purpose.[48]

Because of the specific facts at hand, it was also probably not a surprise that the taxpayer's attorney-client privilege and § 7525 privilege arguments were unsuccessful. Prior to asserting those privileges in the summons case at hand, Textron already provided the tax accrual workpapers to its independent auditors.[49] However, it is well-established in the case law that independent auditors do not enjoy confidential relationships with their clients;[50] for purposes of the attorney-client privilege (and the derivative § 7525 privilege), independent auditors are considered third parties.[51] Thus, it was difficult to avoid the conclusion that confidentiality had been breached when Textron provided its tax accrual workpapers to its independent auditor.[52]

B. *The Weakness of* Textron's *Work Product Analysis*

Ultimately, the District of Rhode Island refused to enforce the summons because it held that Textron's tax accrual

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43. *Id.*

44. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 68 (2000) (defining the attorney-client privilege as protecting a communication made between privileged persons in confidence and for the purpose of obtaining or providing legal assistance for the client).

45. I.R.C. § 7525 (2004) (identifying the confidentiality protections for communications between a taxpayer and attorney, as well as between a taxpayer and tax practitioner).

46. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 87 (2000) (defining work product doctrine as material prepared by a lawyer for litigation or in reasonable anticipation of future litigation).

47. *See, e.g.*, United States v. Powell, 379 U.S. 48, 57 (1964) (holding the Commissioner "need not meet any standard of probable cause" to enforce a summons); *see also, e.g.*, United States v. Gertner, 65 F.3d 963 (1st Cir. 1995) (explaining that the court will give wide latitude to the Commissioner's summons decisions, and those decisions need only be done in good faith and in compliance with the law).

48. *Textron*, 507 F. Supp. 2d at 144-45.

49. *Id.* at 143.

50. *See* Strategic Capital Res., Inc. v. Citrin Cooperman & Co., 213 F. App'x 842, 843 (11th Cir. 2007); *see also* Indep. Petrochem. Corp. v. Aetna Cas. & Sur. Co., 117 F.R.D. 292, 295 (D.D.C. 1987).

51. *See* S.E.C. v. Brady, 238 F.R.D. 429, 439 (N.D. Tex. 2006); *see also In re* Pfizer Inc. Sec. Litig., 1993 WL 561125 (S.D.N.Y. Dec. 23, 1993).

52. *See Textron*, 507 F. Supp. 2d at 151-52.

workpapers were protected by the work product doctrine.[53] The court rejected the I.R.S.'s assertion that the tax accrual workpapers were prepared in the ordinary course of business.[54] The court also rejected the I.R.S.'s reliance on the Fifth Circuit's holding in *El Paso* that the work product doctrine did not protect tax accrual workpapers.[55] The court observed that *El Paso* had applied the minority view that the work product doctrine was only applicable when the "primary purpose" for creating a document was the anticipated litigation;[56] the First Circuit, however, had previously adopted the majority "because of" test.[57] The District of Rhode Island examined the facts and held that Textron satisfied the "because of" test.[58] Further, noting the differing waiver standards applicable to the attorney-client privilege and the work product doctrine, the court adopted the majority view that disclosure of information to an independent auditor does not waive work product protection.[59]

The court's application of the "because of" test is likely to attract scrutiny on appeal and by future courts that consider following the approach of *Textron*. The court reasoned:

> [I]t is clear that [the tax accrual workpapers] 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 . . . 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.[60]

Thus, the court's "because of" standard was equivalent to a "but for" standard.[61] However, such a "but for" standard does not appear to be in accord with the narrower purpose of the work

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53. *Id.* at 154-55.
54. *Id.* at 150.
55. *Id.*
56. *Id.*
57. *Id.* at 150-51.
58. *Id.* at 150.
59. *Id.* at 152-53.
60. *Id.* at 150 (omission in original).
61. *See id.*

product doctrine, which the court had explained earlier in the opinion:

> The work product privilege applies to materials prepared or gathered by an attorney in anticipation of litigation or preparation for trial. The purpose of the privilege is "to preserve a zone of privacy in which a lawyer can *prepare and develop legal theories and strategy* 'with an eye toward litigation' free from unnecessary intrusion by his adversaries," . . . "to prevent a litigant from taking a free ride on the research and thinking of his opponent's lawyer and to avoid the resulting deterrent to a lawyer's committing his thoughts to paper."[62]

Thus, the stated purpose of the work product doctrine is to enable a litigant to prepare for "litigation" without an adversary benefiting from his work product.[63]

Various courts have understood the doctrine similarly, and have echoed the same purpose.[64] For example, in the leading case of *Hickman v. Taylor*, the Supreme Court expressed the purpose of the doctrine as providing the attorney with privacy "free from unnecessary intrusion by opposing parties" to facilitate "[p]roper preparation of a client's case" and to permit the attorney to "prepare his legal theories and plan his strategy without undue and needless interference."[65] Similarly, the Fourth Circuit has characterized work product as "an 'anti-freeloader' rule designed to prohibit one adverse party from riding to court on the enterprise of the other."[66] Further, the District Court for the District of Columbia has described the work product doctrine as "designed to balance the need of the adversary system to promote an attorney's preparation against society's general interest in revealing all facts relevant to the resolution of a dispute."[67]

In these cases, the wording of the purpose of the work product doctrine strongly suggests that the doctrine extends to

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62. *Id.* at 148 (emphasis added) (citations omitted).

63. *Id.*

64. *See* NLRB v. Sears, Roebuck & Co., 421 U.S. 132 (1975); Hickman v. Taylor, 329 U.S. 495, 511 (1947); United States v. Adlman, 134 F.3d 1194, 1196 (2nd Cir. 1998); Nat'l Union Fire Ins. v. Murray Sheet Metal Co., 967 F.2d 980, 985 (4th Cir. 1992); United States v. M & T Mortgage Corp., 238 F.R.D. 3, 6 (D.D.C. 2006).

65. *Hickman*, 329 U.S. at 511.

66. *Nat'l Union Fire Ins.*, 967 F.2d at 985.

67. *M & T Mortgage Corp.*, 238 F.R.D. at 6.

materials that are prepared for potential use by an attorney in prosecuting the client's interests in the anticipated litigation or dispute.[68] However, a "but for" standard casts a much wider net to include materials that are not necessarily useful in such litigation.[69] Indeed, it is doubtful that tax accrual workpapers, which typically just identify and quantify vulnerable return positions,[70] would be useful in the litigation anticipated with respect to those positions.

In *Textron*, the District of Rhode Island found the "but for" requirement was satisfied because the tax accrual workpapers were prepared simply because the taxpayer anticipated the I.R.S. would challenge the return positions described therein.[71] The court's analysis completely ignored whether or not the tax accrual workpapers in question might be used by Textron when it fought the anticipated I.R.S. challenges, at I.R.S. appeals, or in federal court.[72]

The District of Rhode Island based its "but for" analysis on the Second Circuit's application of the "because of" test in *United States v. Adlman*, which involved the I.R.S.'s attempted summons of a memorandum prepared by an accounting firm.[73] The memorandum analyzed in detail a proposed merger, which would produce a large tax loss that the I.R.S. was likely to challenge.[74] The memorandum proposed possible legal theories or strategies for the taxpayer to adopt in response to the anticipated litigation, recommended preferred methods of structuring the transaction, and made predictions about the likely outcome of litigation.[75] The purpose of the memorandum was to inform the taxpayer's business decision as to whether or not to proceed with the proposed merger; the decision to merge turned on the accounting firm's assessment of the likely outcome of the anticipated litigation.[76]

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68. *See Adlman*, 134 F.3d at 1196 (stating that the work product doctrine is intended to preserve a zone of privacy in which a lawyer can prepare and develop legal theories and strategy) (citing *Hickman*, 329 U.S. at 511); *Sears, Roebuck & Co.*, 421 U.S. at 132 (discussing the preparation in anticipation of litigation requirement).

69. *Cf.* Ricardo Colón, *Caution: Disclosures of Attorney Work Product to Independent Auditors May Waive the Privilege*, 52 LOY. L. REV. 115, 125 (2006) (comparing the "primary purpose" approach to the broader "because of" test).

70. *See* United States v. El Paso Co., 682 F.2d 530, 545 (5th Cir. 1982).

71. United States v. Textron Inc., 507 F. Supp. 2d 138, 150 (D.R.I. 2007).

72. *See id.*

73. *See Adlman*, 134 F.3d at 1199.

74. *See id.* at 1195.

75. *See id.* at 1195.

76. *See id.*

The Second Circuit's work product analysis in *Adlman* rejected the Fifth Circuit's "primary purpose" test,[77] and adopted the more widely accepted "because of" test.[78] The Second Circuit reasoned that the wording of the work product doctrine in Federal Rule of Civil Procedure 26(b)(3),[79] as well as the underlying purpose of the doctrine, were incompatible with the narrower "primary purpose" standard.[80] *Adlman* indicated the proper test was whether the document can fairly be said to have been prepared "because of" the prospect of litigation, which turns on whether the document would have been prepared irrespective of the expected litigation.[81]

At first blush, this arguably loose wording in *Adlman* appears to support *Textron*'s "but for" analysis. However, when digging a little deeper, it is not clear the "because of" standard is necessarily as broad as the District of Rhode Island's "but for" analysis would suggest.[82] Unlike the tax accrual workpapers in *Textron*, which merely listed and quantified return position vulnerabilities,[83] the detailed accounting firm memorandum in *Adlman* suggested and analyzed various "legal theories or strategies" that the taxpayer might have used to defend against a subsequent I.R.S. challenge of the contemplated tax loss.[84] Further, it is significant to note that other courts applying the "because of" test have done so in a more restrictive manner than the *Textron* court and have insinuated the doctrine is only applicable to documents that will be useful in the anticipated litigation.[85] The District Court for the District of Columbia has explicitly stated that the "because of" test requires that "a

77. *Id.* at 1203.

78. *Id.*

79. FED. R. CIV. P. 26(b)(3).

80. *Adlman*, 134 F.3d at 1198.

81. *Id.* at 1202.

82. *See* Ataxingmatter, http://ataxingmatter.blogs.com/tax/2007/08/textron-inc-tax.html (Aug. 30, 2007) (positing that because "[d]eterminations of the merits of an uncertain tax position require the CPA or attorney or taxpayer to consider the possibility of success on the merits before a court," the District of Rhode Island's analysis must be too broad because it would cover all tax-related workpapers).

83. United States v. Textron Inc., 507 F. Supp. 2d 138, 142-43 (D.R.I. 2007).

84. *Adlman*, 134 F.3d at 1195.

85. For example, the Ninth Circuit sustained a party's work product claims with respect to dual purpose documents because they were prepared by an environmental consultant, in part with a "litigation purpose" to help the lead attorney "advise and defend" the client against anticipated litigation with the Environmental Protection Agency. *In re* Grand Jury Subpoena, 357 F.3d 900, 909-10 (9th Cir. 2003). Similarly, the Eighth Circuit has determined the "because of" test was not satisfied when the documents' creators were not involved in "giving legal advice or in mapping litigation strategy in any individual case," and the documents did not "enhance[] the defense of any particular lawsuit." Simon v. G.D. Searle & Co., 816 F.2d 397, 401 (8th Cir. 1987).

document must have been created for use at trial or because a lawyer or party reasonably anticipated that specific litigation would occur *and prepared the document to advance the party's interest in the successful resolution of that litigation.*"[86]

In light of these points, it is unclear whether the District of Rhode Island's "but for" analysis will ultimately stand. The government quickly filed an appeal challenging the court's decision.[87] Predictably, taxpayer advocates have proclaimed *Textron*'s work product analysis as "well-reasoned,"[88] "correctly decided,"[89] and making "eminent sense."[90] However, Chief Counsel Donald Korb has stated publicly that he believes the taxpayer victory in *Textron* will be "short-lived"[91] and, thus, the case has not "undermin[ed] the I.R.S. policy of seeking tax accrual workpapers when appropriate."[92] Other commentators are also skeptical the District of Rhode Island's holding will survive appeal.[93] Columnist Lee Sheppard, for example, has criticized *Textron*, claiming the court's "logic strains credulity" and its analysis "read[s] the ordinary course of business exception out of the rule." [94]

C. Textron's *Privilege Analysis*

Although the government is appealing the *Textron* court's holding with respect to work product doctrine,[95] it is unlikely the court's holding on attorney-client privilege will be affected.

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86. Banks v. Office of the Senate Sergeant-at-Arms, 228 F.R.D. 24, 26 (D.D.C. 2005) (emphasis added).

87. Rob Hanson, Cory Tull, & Henry Singleton, *IRS Enforcement, and the Policy of Restraint*, 117 TAX NOTES 601, 603 (Nov. 5, 2007).

88. Greenhouse & Kelleher, *supra* note 27, at 7.

89. Simmonds & Young, *supra* note 3, at 4 (attributing this statement to Robin Greenhouse of McDermott, Will & Emery).

90. *Id.* (attributing this statement to Phil Karter of Chamberlain, Hrdlicka, White, Williams & Martin).

91. Jeremiah Coder, *Korb Again Condemns Idea of Codifying Economic Substance*, 2007 TNT 209-6, 117 TAX NOTES 578-80, (Oct. 29, 2007).

92. Simmonds & Young, *supra* note 3, at 1; Neil D. Kimmelfield & William C. P. Hsu, Textron, *the Work Product Doctrine, and the Impact of FIN 48*, 2007 TNT 228-28, 117 TAX NOTES 871-72, (Nov. 26, 2007) (questioning whether other courts will agree with *Textron*'s "but for" analysis).

93. Hanson, Tull & Singleton, supra note 87 (noting the "long-term impact of the *Textron* decision remains unclear"); Dustin Stamper, *IRS Official Promises Ex Parte Guidance to Ease Independence Concerns*, 2007 TNT 213-3, 117 TAX NOTES 580-81, (Nov. 2, 2007) (citing Gerald Kafka as predicting the decision will not withstand scrutiny); Lee A. Sheppard, *News Analysis:* Textron *Case Expands Work Product Privilege*, 2007 TNT 176-6, 116 TAX NOTES 917-24, (Sept. 10, 2007) (questioning whether the work product holding will prevail on appeal).

94. Sheppard, *supra* note 93.

95. Hanson, Tull & Singleton, *supra* note 87, at 5.

Because the taxpayer did not ultimately prevail on its privilege theory,[96] there is no reason for the government to contest the privilege holding on appeal. Similarly, because Textron prevailed on its work product doctrine argument,[97] the taxpayer is also unlikely to appeal the privilege holding. Thus, the District of Rhode Island's privilege analysis will probably not be diminished regardless of the outcome on appeal. This situation may increase the long-term significance of that analysis.

In its *Textron* opinion, the District of Rhode Island summarized the parties' arguments with respect to the attorney-client privilege.[98] Textron asserted the privilege applied because the tax accrual workpapers had been prepared by its attorneys and reflected the attorneys' "legal conclusions;" these legal conclusions identified items on Textron's return that might be challenged by the I.R.S. and assessed the likelihood of Textron prevailing in any ensuing litigation.[99] The I.R.S. denied the privilege based on the theory that Textron's attorneys did not provide legal advice but instead performed an accounting function by reconciling the company's tax records and financial statements.[100]

The court noted the general rule that for purposes of attorney-client privilege, mere preparation of a tax return is unprivileged accounting work; however, legal advice may be privileged even when made in connection with the preparation of a return.[101] The *Textron* court quoted three cases to elaborate on this delineation.[102] In *United States v. Chevron Texaco Corporation,* the Northern District of California held that determining the tax consequences of a particular transaction is rooted in the law such that communications offering tax advice or tax planning are "legal" communications.[103] The Seventh Circuit in *United States v. Frederick* held that accounting work includes audit representation to verify the accuracy of a return, but lawyer work includes audit representation dealing with issues of statutory interpretation or case law raised in connection with the

96. United States v. Textron Inc., 507 F. Supp. 2d 138, 154 (D.R.I. 2007).

97. *Id.*

98. *Id.* at 146-47.

99. *Id.* at 143.

100. *Id.* at 147-48.

101. *Id.* at 146.

102. *Id.* at 146-47 (citing United States v. Frederick, 182 F.3d 496, 500 (7th Cir. 1999); United States v. El Paso Co., 682 F.2d 530, 539 (5th Cir. 1982); United States v. Chevron Texaco Corp., 241 F. Supp. 2d 1065, 1076 (N.D. Cal. 2002)).

103. *Chevron*, 241 F. Supp. 2d at 1076.

I.R.S. audit of the taxpayer's return.[104] In *United States v. El Paso Company,* the Fifth Circuit suggested that legal advice includes "a lawyer's analysis of the soft spots on a tax return and his judgment on the outcome of the litigation on it."[105]

The District of Rhode Island described Textron's tax accrual workpapers as "essentially consist[ing] of nothing more than counsel's opinions regarding items that might be challenged because they involve areas in which the law is uncertain and counsel's assessment regarding Textron's chances of prevailing in any ensuing litigation."[106] The court then held the workpapers were protected by attorney-client privilege.[107] The court distinguished *Arthur Young* as involving workpapers that were prepared by a corporation's independent auditor (who had an obligation to serve the public interest in preserving the integrity of the securities markets) and were not prepared by attorneys (whose function is to provide the taxpayer with legal advice).[108] Nevertheless, because of Textron's voluntary disclosure of its tax accrual workpapers to its auditor, the court ultimately held the attorney-client privilege did not protect the workpapers due to waiver.[109] Significantly, it appears that, *but for that disclosure*, the court would have denied enforcement of the I.R.S. summons due to application of the attorney-client privilege.

The *Textron* court's analysis with respect to attorney-client privilege appears much stronger than its analysis of the work product doctrine. Indeed, the court's privilege analysis is more in line with existing privilege case law.[110] The *Textron* opinion reflected the judiciary's on-going attempt to delineate between nonprivileged accounting work and privileged lawyer work.[111] In the past, courts were reluctant to apply the attorney-client privilege when attorneys performed services that did not involve

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104. *Frederick*, 182 F.3d at 500.

105. *El Paso*, 682 F.2d at 539.

106. *Textron*, 507 F. Supp. 2d at 146.

107. *Id.*

108. *Id. at* 147.

109. *Id. at* 151-52.

110. *Id.* at 146 (citing *In re* Keeper of Records (XYZ Corp.), 348 F.3d 16, 22 (1st Cir. 2003)) ("The attorney-client privilege must be narrowly construed because it comes with substantial costs and stands as an obstacle of sorts to the search for the truth." (citing United States v. Nixon, 418 U.S. 683, 709-10 (1974))).

111. *Id. at* 146-47 ("[I]n the context of an IRS audit, by stating that where representation during an audit consists of 'merely verifying the accuracy of a return,' it is 'accounts' work'; but if the attorney participates in the audit 'to deal with issues of statutory interpretation or case law' that may have been raised in connection with examination of the taxpayer's return, 'the lawyer is doing lawyer's work and the attorney-client privilege may attach.'").

questions of law and legal judgment.[112] For example, privilege has been held inapplicable when an attorney was merely acting as a "scrivener" to copy numbers onto a return[113] or verifying the accuracy of numbers reported on a return.[114] Similarly, courts have held legal work is not involved when return preparation questions are easily answered by reference to the "instructions and informal publications" provided to the public by the I.R.S.[115] However, to the extent attorneys provide opinions and advice as to the repercussions and ambiguous boundaries of tax law, the privilege has been found to be applicable.[116] Indeed, the courts have been more willing to find legal work was performed (and, therefore, the privilege applicable) to the extent that legal gray areas are involved.[117]

The *Textron* court's approach to attorney-client privilege is also in accord with the leading cases involving summonses of tax

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112. *Cf.* United States v. Abrahams, 905 F.2d 1276, 1284 (9th Cir. 1990) (citing the established principle that "[a]lthough communications made *solely* for tax return preparation are not privileged, communications made to acquire legal advice about what to claim on tax returns may be privileged"); United States v. Schmidt, 360 F. Supp. 339, 347 (M.D. Pa. 1973) (stating that privilege was applicable to the extent that the lawyer performed an "exercise of legal judgment").

113. Canaday v. United States, 354 F.2d 849, 857 (8th Cir. 1966) (stating that the return preparer in question acted as a "scrivener").

114. *Id.*

115. United States v. Willis, 565 F. Supp. 1186, 1189-90 (S.D. Iowa 1983).

116. *Id.* at 1190 (describing privileged tax planning as involving advice as to tax consequences from contemplated events or transactions); *see, e.g.*, United States v. Liebman, 742 F.2d 807, 810 (3rd Cir. 1984); United States v. BDO Seidman, LLP, 2004 WL 1470034 at *2 (N.D. Ill. June 29, 2004); *In re* Sealed Case, 877 F.2d 976, 979 (D.C. Cir. 1989). *But see* United States v. Chevron Texaco Corp., 241 F. Supp. 2d 1065, 1072 (N.D. Cal. 2002) (reasoning that tax advice from an attorney was not sufficiently legal to warrant the application of the attorney-client privilege); United States v. Lake, 257 F. Supp. 35, 37 (E.D.N.C. 1966) (holding the taxpayer had waived all privilege protection and the attorney was free to divulge any legal advice he may have given the taxpayer).

117. *See, e.g.*, United States v. El Paso Co., 682 F.2d 530, 534 (5th Cir. 1982) (implying that pre-filing return characterization advice from a lawyer was within the scope of the attorney-client privilege; the court emphasized that the tax laws were "far from a model of clarity," a "sprawling tapestry of almost infinite complexity" that had "fostered a wealth of interpretations"); United States v. Judson, 322 F.2d 460, 468 (9th Cir. 1963) ("Few areas of the law draw so many individuals in contact with governmental powers as does federal taxation. Yet this branch is one of the thickest of the law's 'bramble bush.' The ramifications of tax law are often a stubborn challenge to the most expert legal practitioner. The very nature of the tax laws requires taxpayers to rely upon attorneys, and requires attorneys to rely, in turn, upon documentary indicia of their clients' financial affairs."); United States v. BDO Seidman, LLP, No. 02-C-4822, 2005 WL 742642, at *9 (N.D. Ill. Mar. 30, 2005) ("As this court noted [previously], . . . the tax code and underlying regulations is full of complexities and uncertainties. The question of whether the Interveners and BDO engaged in unlawful activity, or alternative [sic] properly complied with the tax code, is one of the ultimate questions for this litigation." (citation omitted)).

accrual workpapers.[118] For example, *Arthur Young* involved tax accrual workpapers prepared by a taxpayer's independent auditor, not by counsel.[119] Therefore, the attorney-client privilege was simply not at issue.[120] Although *Arthur Young* is not on point with the facts of *Textron*, the Supreme Court acknowledged that the traditional privileges did apply to I.R.S. summonses.[121]

In contrast to *Arthur Young*, the attorney-client privilege was at issue in *El Paso*,[122] and the *Textron* court's analysis was very similar to that of the Fifth Circuit.[123] The Fifth Circuit initially found privilege had been "waived" because the tax accrual workpapers were provided to El Paso's independent auditor.[124] It is black letter law that a waiver can only occur if privilege first attaches.[125] Thus, the Fifth Circuit implicitly held that privilege initially applied to the tax accrual workpapers.[126] That portion of the *El Paso* decision was identical to the District of Rhode Island's analysis in *Textron*.[127]

In addition to the waiver holding, the Fifth Circuit rejected El Paso's "blanket assertion" of privilege due to its failure to prove that the tax accrual workpapers had been prepared by El Paso's attorneys (and not its accountants).[128] By contrast, in *Textron*, it was undisputed that the taxpayer's lawyers had prepared the tax accrual workpapers in question.[129] Nonetheless, the District of Rhode Island focused on the similar question of whether the preparation of the tax accrual workpapers by Textron attorneys was lawyer work or accountant work for purposes of the attorney-client privilege.[130]

Although the taxpayer's assertions of attorney-client privilege failed in *El Paso*,[131] the Fifth Circuit implied that the taxpayer would have been successful if the tax accrual

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118. *See e.g.*, United States v. Arthur Young, 465 U.S. 805, 817-19 (1984); *El Paso*, 682 F.2d at 542.

119. *Arthur Young*, 465 U.S. at 805.

120. *See id.*

121. *Id.* at 816.

122. *El Paso*, 682 F.2d at 538-43.

123. *Compare* United States v. Textron Inc., 507 F. Supp. 2d 138, 147 (D.R.I. 2007), *with El Paso*, 682 F.2d at 540-41.

124. *El Paso*, 682 F.2d at 540-41.

125. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 79 cmt.e (2000).

126. *El Paso*, 682 F.2d at 539.

127. *Compare El Paso*, 682 F.2d at 539, *with Textron*, 507 F. Supp. 2d at 146.

128. *El Paso*, 682 F.2d at 541.

129. *Textron*, 507 F. Supp. 2d at 147.

130. *Id.*

131. *See El Paso*, 682 F.2d at 540-41.

workpapers had been kept confidential (*i.e.*, not disclosed to the independent auditor) and if the taxpayer had proven that its attorneys had prepared them.[132] The *Textron* court went a step further in holding explicitly that the attorney-client privilege did attach initially to the tax accrual workpapers in question, but was lost subsequently due to a waiver of privilege.[133]

IV. CONCLUSION

In light of these points, there are several actions taxpayers may take to bolster their likelihood of successfully sustaining an assertion of privilege with respect to their tax accrual workpapers. First, it is critical that tax accrual workpapers be prepared exclusively by licensed attorneys with no more than minor, clerical duties being delegated to non-attorneys (*e.g.*, administrative assistants, paralegals).[134] Second, to help build the argument that the attorneys performed legal (and not accounting) work, it would be helpful to include legal references (*e.g.*, Code sections, regulations, cases, etc.) in the tax accrual workpapers that explain the legal ambiguity that prompted the attorney to include the item in the tax reserve.[135]

In order to prevent a subsequent waiver of privilege, it is important to avoid giving third parties access to the tax accrual workpapers.[136] This is especially important with respect to independent auditors.[137] However, in the post-Enron[138] age of Sarbanes-Oxley[139] and FIN 48,[140] it can be very difficult to avoid such disclosures without risking a qualified opinion. Nonetheless, taxpayers will likely avoid waiver by preparing separate summary documentation about the reserve, especially for the independent auditor.[141] Privilege never protects facts;

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132. *Id.*

133. *See Textron*, 507 F. Supp. 2d at 152.

134. *See id.* at 151. Alternatively, in order to claim the § 7525 privilege, persons qualifying as federally authorized tax practitioners could be involved with the preparation of the tax accrual workpapers. *Id.* at 147.

135. In general, attorney-client privilege applies when an attorney is dispensing legal advice related to taxes, but does not apply if the attorney is doing work normally done by an accountant. *Id.* at 146.

136. *See id.* at 151.

137. *See id.*

138. Michael L. Seigel, *Corporate America Fights Back: The Battle Over Waiver of the Attorney-Client Privilege*, 49 B.C. L. REV., 1, 2-3 (2008) (discussing Congress' reaction to the Enron scandal).

139. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

140. *See* FASB INTERPRETATION NO. 48, *supra* note 11.

141. *See Textron*, 507 F. Supp. 2d at 142 (giving examples of tax accrual papers and demonstrating that the category is broadly defined).

instead, it protects certain communications about facts.[142] Therefore, sharing factual information with third parties does not waive privilege even if a client has discussed that factual information with an attorney.[143] As long as a client avoids revealing the actual communications between an attorney and his/her client, waiver can be avoided.[144] Thus, a taxpayer can avoid waiver to the extent it withholds its actual tax accrual work papers but provides its independent auditor with specially prepared factual summaries of its tax reserve.[145] Such summaries should be viewed as the disclosure of non-privileged factual information as long as the taxpayer does not reveal the attorney's underlying legal analysis or other attorney-client communications.[146]

Although taxpayer advocates have viewed *Textron* as a significant taxpayer victory, the *Textron* court's work product doctrine holding is flawed and vulnerable on appeal.[147] By contrast, the court's holding with respect to attorney-client privilege is better supported,[148] and is less likely to be challenged on appeal.

Even if the taxpayer victory on work product doctrine proves to be short-lived, the court's privilege analysis may provide a long-term boost to taxpayers hoping to prevent enforcement of a summons of their tax accrual workpapers. To the extent such taxpayers structure their facts to withstand the type of analysis applied by the District of Rhode Island in *Textron*, they should be successful in arguing that attorney-client privilege applies to protect their tax accrual workpapers from summons.

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142. Upjohn Co. v. United States, 449 U.S. 383, 395-96 (1981) ("[T]he protection of the privilege extends only to *communications* and not to facts. A fact is one thing and a communication concerning that fact is an entirely different thing. The client cannot be compelled to answer the question, 'What did you say or write to the attorney?' but may not refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communication to his attorney." (quoting Philadelphia v. Westinghouse Elec. Corp., 205 F. Supp. 830, 831 (E.D. Pa. 1962))).

143. *Id.* at 396 ("Here the Government was free to question the employees who communicated with Thomas and outside counsel. Upjohn has provided the IRS with a list of such employees, and the IRS has already interviewed some 25 of them. While it would probably be more convenient for the Government to secure the results of petitioner's internal investigation by simply subpoenaing the questionnaires and notes taken by petitioner's attorneys, such considerations of convenience do not overcome the policies served by the attorney-client privilege.").

144. *Id.*

145. *See id.*

146. *See id.*

147. *See, e.g.*, Simmonds & Young, *supra* note 3, at 1.

148. *See* United States v. Textron Inc., 507 F. Supp. 2d 138, 152 (D.R.I. 2007).