

U.S. V. TEXTRON - THE FIRST CIRCUIT GRANTS THE IRS ACCESS TO THE PLAYBOOK

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Earlier this year, a three-judge panel of the United States Court of Appeals for the First Circuit gave tax attorneys and certified public accountants alike a momentary cause for celebration when it held that tax accrual work papers are protected from disclosure to the Internal Revenue Service ("IRS") under the work product doctrine. U.S. v. Textron, Inc., 555 F.3d 87 (1st Cir. 2009). This decisive taxpayer victory proved to be a fleeting one, however, as a mere two months later the First Circuit vacated the panel's opinion and stated that it would reconsider the matter en banc, or before the full court. U.S. v. Textron, Inc., 560 F.3d 513 (1st Cir. 2009). On August 13, 2009, after conducting an additional hearing, the full court issued its final opinion and held that the IRS was entitled to obtain copies of the documents in question. United States v. Textron, 577 F.3d 21 (1st Cir. 2009). In so holding, the First Circuit not only reversed the three-judge panel's earlier ruling, but also appeared to adopt a more restrictive view of the work product doctrine than has been applied in previous cases. Given that this new standard will now be applied in all federal courts in New Hampshire, Maine, Massachusetts, Puerto Rico and Rhode Island, companies and certified public accountants should revisit the manner in which they create and produce documents that may constitute tax accrual work papers and Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") supporting documentation.

Background

Textron is a conglomerate that manufactures, among other things, Cessna Aircrafts and Bell Helicopters. As a publicly-traded

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corporation, the company is required by law to generate annual public financial statements which have been independently verified by an outside auditor. Moreover, in these financial statements, Textron must incorporate a reserve for contingent tax liabilities in order to account for any potential tax liabilities that would arise if the IRS challenged debatable tax positions taken by the company in its returns. In calculating this reserve, Textron's tax department prepares "tax accrual work papers" that list the items that could result in additional taxes being assessed, the dollar amount of such liability, and a percentage estimate of the IRS' likelihood of success if it were to challenge the particular item. It is these tax accrual work papers that the independent auditor reviews in order to fulfill its duty to determine "the adequacy and reasonableness of the corporation's reserve account for contingent tax liabilities." U.S. v. Arthur Young & Co., 465 U.S. 805, 812 (1984).

The instant dispute revolved around Textron's audited public financial statement for 2001. In that year, one of Textron's subsidiaries had purchased several pieces of equipment from tax-exempt foreign utilities and then proceeded to lease the equipment back to the utility on the same day. While conducting a subsequent audit of Textron's tax returns for 1998 through 2001, the IRS became concerned that these arrangements were sale-in/lease-out ("SILO") deals, which are a form of transaction tax-exempt entities sometimes engage in as part of a plan to transfer depreciation and other deductions to a non-exempt entity. Because SILO's can be disregarded when the transacting parties' only motive is tax avoidance, the IRS demanded access to the tax accrual work papers prepared by Textron's tax department for the 2001 calendar year. When Textron refused, the IRS brought suit in the Rhode Island federal district court.

Litigation Ensues

At trial, Textron argued that the work papers were protected from disclosure by, among other things, the work product doctrine. As codified in the Federal Rules of Civil Procedure, that doctrine dictates that "a party may not [ordinarily] discover 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). Relying upon language from a prior First Circuit opinion, Textron asserted that the work papers were insulated from disclosure under the work product doctrine because they had been "prepared or obtained because of the prospect of litigation." Maine v. U.S., 298 F.3d 60, 68 (1st Cir. 2002) (quoting U.S. v. Adlman, 134 F.3d 1194, 1202 (2d Cir. 1998)) (emphasis in original).

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In addressing Textron's claim, the district court noted that the First Circuit had previously held that there can be no work product protection when the documents in question "are prepared in the ordinary course of business or . . . would have been created in essentially similar form irrespective of the litigation." U.S. v. Textron, 507 F. Supp. 2d 138, 150 (D.R.I. 2007). The district court concluded, however, that while the papers in question were undoubtedly prepared to obtain a favorable opinion letter from Textron's auditors regarding the company's reserves, there would have been no need for such reserves "if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding." Id. As a result, the court held that the documents had been prepared "because of" the prospect of litigation and, according to prior First Circuit case law, were therefore protected.

The First Circuit's Ruling

Although the three-judge panel of the First Circuit Court of Appeals initially agreed with the district court's reasoning, as noted above, a majority of the full court did not. Instead, the full court held that the work papers were not protected under the work product doctrine because, in essence, they had been prepared for a business purpose – namely, to convince Textron's auditors that the reserves for contingent tax liabilities contained in the company's financial statement were justified. Although purporting to apply prior precedent, in arriving at this conclusion the court departed from its prior rule which afforded work product protection to documents "prepared or obtained *because of* the prospect of litigation" and applied in its stead a much narrower test. Specifically, the First Circuit intimated that work product protection would only be afforded to those documents "prepared *for use* in possible litigation." Textron, 577 F.3d at 33 (J. Torruella, dissenting). In practical effect, this would appear to mean that, absent application of some other privilege (such as the attorney-client privilege), the IRS will generally be able to obtain access to documents prepared by accountants or legal counsel which analyze a clients' potential tax exposure but would not ultimately be used in the actual litigation that is contemplated therein.

Conclusion

It remains to be seen how the district courts of Maine, New Hampshire, Massachusetts, Rhode Island and Puerto Rico will apply this new "prepared for use in" standard, particularly in light of the court's failure to adequately reconcile this test with seemingly contradictory First Circuit precedent. However, what can be



stated with certainty is that businesses and accountants must now proceed with greater caution in preparing tax accrual work papers and FIN 48 supporting documentation, respectively, as this material will be discoverable by the IRS in a much larger number of cases going forward. Accordingly, as taxpayers and accountants attempt to fulfill their legal and ethical disclosure requirements in a manner that will not grant the IRS access to their playbook, they would be wise to obtain advice from qualified tax counsel.

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