

# Protecting Client Tax Accrual Workpapers Under the Doctrine of Work Product Privilege

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On January 21, 2009, in the closely watched case of United States v. Textron, the First Circuit Court of Appeals upheld the 2007 federal district court ruling that Textron's tax accrual workpapers were protected work product, preventing disclosure to the IRS pursuant to an administrative summons. See United States v. Textron, 507 F. Supp. 2d 138 (D.R.I. 2007) *aff'd in part, vacated in part*, United States v. Textron, Dkt. No. 07-2631, slip. op. (1st Cir. January

21, 2009). Despite this significant taxpayer victory, however, the appeals court remanded the issue of waiver of the privilege back to the trial court. The waiver issue focuses on whether the privilege was waived when the tax accrual workpapers were shared with Textron's independent auditors which may open a door for the IRS to get what it is seeking.

In light of the Textron decisions, attorneys and CPAs serving clients of any size, should revisit the manner by which they and their clients handle the creation, management and production of tax accrual workpapers and other supporting documentation of positions taken or expected to be taken in a tax return. Those particularly at risk of compromising the work product privilege are those practitioners who provide all of a client's financial services - general accounting, tax preparation, tax advice and planning. By recognizing whether the scope of an engagement can result in the production of documents which are privileged at the outset, as well as subsequently and consistently treating these documents as privileged work product, CPAs and tax practitioners can reduce the risk that these workpapers become subject to IRS review.

## The Court's Work Product Analysis

In 2001, Textron, a conglomerate which makes, among other things, Cessna Aircraft and Bell Helicopters, engaged in a number of leasing transactions which produced various tax benefits. During a subsequent IRS audit, the IRS issued more than five hundred Information Document Requests ("IDRs"). Textron complied with all of the IDRs except those that requested its tax accrual workpapers. The IRS responded by serving Textron with an administrative summons, demanding the workpapers. In refusing to disclose these documents, Textron repeatedly asserted that the information was privileged. In asking the courts to compel production of the workpapers, the IRS argued that records were not privileged because the outside attorneys and CPAs involved with the records were not providing advice but, rather, were performing an accounting function by reconciling the company's tax records and financial statements.

Textron's tax accrual workpapers consisted of spreadsheets for the current and previous tax years listing items that Textron's in-house tax counsel anticipated could be challenged by the IRS. The workpapers were prepared by Textron's in-house CPAs and tax attorneys as well as attorneys from private law firms and CPAs from outside accounting firms. The evidence presented by Textron established that the workpapers contained their attorney's

evaluations of the litigation hazards of each item, as well as back-up documentation including notes, short memos, and e-mails from other in-house attorneys and accountants.

The court analyzed each of the possible privileges that could apply. First, the court ruled that the attorney-client privilege applied because the tax accrual workpapers consisted 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 [potential] litigation."

Second, the court found that the tax practitioner-client privilege of Section 7525 of the Internal Revenue Code applied to the workpapers that reflected advice received from in-house accountants because Textron's accountants participated in "advising Textron regarding its tax liability with respect to matters on which the law is uncertain or which require estimating the hazards of litigation percentages."

The court found that both of these privileges had been waived, however, when Textron provided its workpapers to its independent auditor, Ernst & Young ("E&Y"), notwithstanding the fact that E&Y agreed to keep the workpapers confidential.

Finally, the court addressed the work product privilege. Applying a broad "because of" test, the court concluded that the workpapers satisfied the "in anticipation of litigation" requirement of the work product privilege because "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 reserves would not have been prepared 'but for' the fact that Textron anticipated the possibility of litigation with the IRS." The court further noted that "even if the workpapers were needed to satisfy E&Y that Textron's tax reserves complied with GAAP, that would not alter the fact that the workpapers were prepared 'because of' anticipated litigation with the IRS."

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## Protecting Client Tax Accrual Workpapers

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Unlike the attorney-client and tax practitioner-client privileges, however, the court held that the work product privilege was not similarly waived because E&Y was not a potential adversary or acting on behalf of a potential adversary. Furthermore, the court noted that the E&Y auditors had professional obligations of confidentiality and had expressly agreed to its client, Textron, its intent to treat the tax accrual workpapers as confidential and to not disclose the information in the tax accrual workpapers.

The appeals court upheld the lower-court in all respects except it ordered the lower court to re-assess the issue of whether Textron had waived the work product privilege when it gave the workpapers to E&Y and whether Textron should now be forced to turn over the related workpapers prepared by E&Y which could reveal the content of the privileged Textron tax accrual workpapers.

### **What Should New Hampshire CPAs, Accountants and Attorneys Take Away from the Textron Cases?**

Regardless of whether you are in public or private practice or providing services in-house, tax practitioners need to be cognizant of whether their workpapers can be subject to IRS review. The determination generally hinges upon what kind of services are being provided. The more a particular engagement reflects an accounting function, such as reconciling tax records and financial statements or tax return preparation, the less likely a privilege will be extended. Workpapers which reflect tax advice, planning, risk assessment or statutory interpretation are afforded the greatest amount of protection from compelled disclosure. Accounting professionals who provide virtually all financial services to its clients, which is prevalent among small to medium sized businesses, are those professionals who have the heaviest burden of compartmentalizing their workpapers. In order to minimize the risk of disclosing your client's most sensitive tax documents, records relating to a review and compilation, for example, must be separated from those workpapers relating to tax advice and tax planning.

Tax practitioners need to proceed cautiously when relying on Textron. When performing client services, consider the following points:

#### **1 Distinguish between "tax advice" and "tax preparation".**

In addition to Textron, there is a great deal of case law which provide distinctions which determine whether a privilege protects a particular workpaper and whether such protection extends to the work of accountants and CPAs. For most accounting and tax preparation work, there are no privileges available. Thus, sensitive tax accrual workpapers and work product evaluating tax positions need to be carefully produced, treated and held in a different regard than other workpapers in order to fall under a protection.

#### **2 Anticipate litigation as early as possible.**

Workpapers can be prepared in anticipation of litigation long before there is any actual threat of litigation. When assessing tax issues, it is important to recognize issues which can result in a tax controversy as early as possible. It is equally important to identify

which privilege will apply to your client's workpapers so you are aware of what possible actions and communications could possibly result in a waiver of the privilege.

#### **3 Workpapers & client representation should be a team effort.**

Textron's workpapers were prepared by lawyers and accountants subject to the attorney-client, tax practitioner-client and work product privileges. Consider establishing a working relationship with a tax attorney, particularly for higher risk tax transactions. The court drew a clear distinction between tax accrual workpapers prepared by a taxpayer with the assistance of counsel and workpapers prepared by an outside auditor. As Textron suggests, the Attorney-CPA team provides greater protection of your client's most sensitive tax assessments.

#### **4 Incorporate a non-disclosure agreement or include non-disclosure provisions in an engagement letter.**

Despite not being enough to uphold the attorney-client or tax practitioner-client privilege, the written agreement between E&Y and Textron which described with specificity the nature of the relationship between the parties and an understanding concerning the nondisclosure of confidential workpapers was cited by the lower court as a factor supporting the assertion that the work product privilege had not been waived.

Compelled disclosure of our clients' most sensitive tax workpapers is an issue that is not going away any time soon. The issue of compelling E&Y to disclose its workpapers remains undecided and if the political climate continues to push for more corporate transparency and pressure mounts for the IRS to adopt more aggressive practices, then tax practitioners will need to continue taking proactive steps to ensure that doctrines like work product privilege adequately protect client tax accrual workpapers.

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