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THE FIRST CIRCUIT AFFIRMS *TEXTRON* AND PROVIDES SOME GUIDANCE REGARDING PROTECTIONS FOR TAX ACCRUAL WORKPAPERS IN LIGHT OF FIN 48

Executive Summary

Tax accrual workpapers provide substantiation for a taxpayer's financial statement reserves. These documents are very sensitive because they identify a company's own measure of issues on a tax return where the tax laws are unclear. It is typical for tax accrual workpapers to be prepared by a company's own in-house tax counsel or accountants, and the issues on the return will be identified by their likelihood of success, if the IRS were to litigate the issue. Because tax accrual workpapers are so sensitive, the government's pursuit of tax accrual workpapers has been a long-standing controversy between taxpayers and the IRS.

In June 2006, the Financial Accounting Standards Board implemented FIN 48, which revised the rules governing how companies account for their uncertain tax positions. This pronouncement fundamentally changed the accounting rules for tax positions by imposing a more-likely-than-not recognition standard on uncertain tax positions. The effective date for FIN 48 has been delayed (see below), however, many companies will soon be required to account for all positions on a tax return which do not have a more-likely-than-not likelihood of succeeding on the merits.

The IRS's ability to discover tax accrual workpapers has been the subject of recent decisions from several Federal District Courts. On January 21, 2009, the First Circuit Court of Appeals affirmed the District Court's ruling that a taxpayer's tax accrual workpapers are protected work product in *United States v. Textron, Inc.*¹ The holding in *Textron* is inextricably related to the production of FIN 48 tax accrual workpapers and schedules when the IRS requests them in an audit.

Background of Textron — Lower Court Proceeding

In the lower court proceeding, the IRS initiated litigation in the U.S. District Court of Rhode Island to enforce a summons demanding that Textron produce its tax accrual workpapers. (Textron is a publicly-traded company and, as such, is on a multi-year audit cycle). The IRS requested those workpapers because Textron had engaged in several so-called "SILO transactions," which the IRS has categorized as "listed transactions." Per the IRS's own "policy of restraint," the IRS normally will not request a company's tax accrual workpapers unless the company has engaged in a listed transaction or a transaction which the IRS dubs "the same as, or substantially similar to" an abusive tax avoidance transaction.

Textron's tax accrual workpapers consisted of spreadsheets and memoranda in which the company's tax lawyers:

1. Identified tax return items for which the tax law was unclear and thus might be challenged by the IRS.
2. Evaluated the likelihood of success in percentage terms.
3. Recommended dollar amounts that should be reserved for such items in the company's financial statements.

Textron's workpapers also included back-up memoranda, which its tax counsel prepared to evaluate the legal arguments for and against Textron's position.

¹ *United States v. Textron, Inc.*, 103 AFTR 2d 2009-xxxx (1st Cir. 2009).

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During the course of its financial audit, Textron disclosed the tax accrual workpapers to its outside auditor so it could evaluate the adequacy of the tax reserve on the financial statements. The outside auditor was not given a copy of the tax accrual workpapers prepared by Textron's internal counsel, but the auditor was allowed to see the workpapers in order for the outside auditor to prepare its own workpapers, to determine whether Textron was adequately reserved for potential disputes with the IRS.

The U.S. District Court for Rhode Island sustained the right for Textron to not disclose to the IRS its "tax accrual workpapers" when those documents were prepared by or at the direction of tax counsel. Textron had argued that the tax accrual workpapers were privileged under the (1) attorney-client privilege, (2) the tax-accountant privilege, and (3) the work product doctrine. The District Court ultimately found that Textron's tax accrual workpapers were privileged work product. Perhaps the most significant aspect of the decision is the District Court's holding that Textron could protect the confidentiality of such workpapers, even though that analysis had been shared with the company's outside auditor. The government appealed the decision to the First Circuit Court of Appeals.

First Circuit Court of Appeals' Holding

There were three issues presented for appeal: (1) whether the work-product doctrine protects Textron's workpapers; (2) whether any such work-product protection was waived through disclosure of the workpapers to Textron's outside auditor; and (3) whether the District Court erred in not considering the IRS's request for the outside auditor's own workpapers.

With respect to the first issue, the work product doctrine protects material prepared by a party or the party's representative in anticipation of litigation or preparation for trial. The IRS argued that the preparation of tax returns is not an adversarial process but a self-reporting regime. Moreover, the IRS argued that Textron's tax accrual workpapers could not have been prepared in "anticipation of litigation" because the workpapers were prepared for Textron to comply with its securities obligations, and therefore, the tax accrual workpapers were prepared to satisfy Textron's "regulatory requirements." The First Circuit Court of Appeals disagreed, flatly rejecting the IRS's contention that the mere presence of a regulatory purpose defeats the work-product doctrine on the grounds that "dual purpose documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose." Of incredible importance was the fact that Textron had a history of disputes and litigation with the IRS, and it was reasonable, the First Circuit noted, that litigation with the IRS was likely in the future. Thus, the First Circuit Court of Appeals found the workpapers to be protected work-product, even though the workpapers served dual purposes: financial reporting and anticipating litigation.

With respect to the issue as to whether Textron had waived the work-product privilege by sharing the workpapers with its outside auditor, the First Circuit Court of Appeals found that disclosure to Textron's outside auditor did not necessarily waive the work-product doctrine because the outside auditor was not a potential adversary to Textron. While disclosure of protected work-product to an adversary forfeits the work-product protection, the potential for any dispute with Textron's outside auditor was remote.

However, Textron's outside auditor did not retain copies of Textron's own internally prepared tax accrual workpapers, but the auditor did incorporate Textron's analysis, together with the auditor's own expertise, to prepare the auditor's own assessment of Textron's reserve liability. Because the District Court did not consider in the lower court proceeding whether the outside auditor would be required to produce its own workpapers pursuant to the IRS summons, the First Circuit Court of Appeals remanded the case to the District Court to determine whether disclosure of the auditor's tax accrual workpapers was required by Textron.

FIN 48

In June, 2006, the Financial Accounting Standards Board (FASB) approved the final version of FIN 48 for generally accepted accounting principles with respect to certain tax positions. FIN 48 was originally effective for fiscal years beginning after December 15, 2006 for public companies and for fiscal years beginning on January 1, 2007 for non-publicly traded or privately held calendar year companies. Originally, the same 2006 effective date was to apply to all companies for financial accounting purposes. In November 2007, FASB agreed to delay the effective date of FIN 48 until tax years beginning on January 1, 2008 for private companies. Thereafter, FASB decided that an additional delay beyond the original deferral was necessary, probably in response to the outcry in the tax community regarding the potential negative impact FIN 48 would have on the IRS's ability to gain taxpayers' tax accrual workpapers. Thus, FIN 48's effective date has been further delayed for certain non-public enterprises until annual financial statements for fiscal years beginning after December 15, 2008. The public can expect further guidance regarding FIN 48's requirements for non-public companies in the first quarter of 2009.

FIN 48 applies to all entities that use the GAAP method for accounting purposes, including tax-exempt organizations and pass-through entities. FIN 48 imposes a higher GAAP standard than was previously required for reporting companies. Previously, financial statements needed to have a reasonable possibility, or remote possibility, to survive IRS review. FIN 48 dramatically changed the accounting rules for tax positions by imposing an income-recognition model, which requires each tax position to have a more-likely-than-not chance of being sustained on the merits before the tax benefits can be recognized. Once a position passes this threshold, companies must measure the expected tax benefits using a complicated cumulative-probability approach. Moreover, companies must book any interest and penalties associated with their uncertain tax positions on their tax accounting workpapers.

Under FIN 48, a company's financials should reflect the expected future tax consequences of its tax positions, assuming full knowledge of the position and related facts by the IRS and other tax authorities. FIN 48 further requires companies to increase disclosure of their tax positions on their financial statements, which includes disclosures of reclassifications of previous tax positions which did not meet the more-likely-than-not standard.

The implementation of the new accounting rules under FIN 48 created anxiety and fear in the tax practitioner community. Tax practitioners predicted that FIN 48 would influence companies' financial statements and expand companies' disclosures about tax matters. Of greater concern was the fear that FIN 48 would instill great power in the IRS to find companies' "soft-spots" on their returns in an audit, simply by aggressively pushing for tax accrual workpapers, as a matter of course.

Conclusion

The First Circuit Court of Appeals' holding in *Textron* is of significant importance in the ongoing debate regarding the IRS's pursuit of tax accrual workpapers, particularly on the cusp of the implementation of FIN 48. While it is clear that *Textron* supports a finding that tax accrual workpapers which are prepared by a taxpayer's in-house counsel are arguably protected work product, what remains uncertain is whether the outside auditor's workpapers are protected from IRS discovery. The First Circuit left this important part of the issue unanswered and remanded the matter back to the District Court for further inquiry. In the meantime, taxpayers will need to understand that tax accrual workpapers received from non-lawyer outside auditors may not be protected from IRS discovery in an audit. Tax accrual workpapers which are not prepared by legal counsel and which identify "soft spots" on a return could be discoverable by the IRS, should the IRS decide to pursue them. While the IRS has stated that it intends to honor its "policy of restraint" in not requesting tax accrual workpapers even while FIN 48 is in effect, taxpayers should proceed with caution and take extra measures to ensure that their tax accrual workpapers (and the underlying analysis which supports the workpapers) remain privileged.

Readers of this Alert should feel free to contact the author of this Alert to discuss the implications of this important case and its implications to tax litigation matters.

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