Tax Accrual Workpapers May Be Privileged

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The fine line between tax accounting work and tax legal work is often blurry. The preparation of a tax return may involve both number crunching and legal analysis. Most accountants would consider the preparation of tax accrual workpapers as accounting work.

After all, tax accrual workpapers involve the calculation and the recording of a journal entry for potential tax liabilities on the company's books. What could be more fundamental to accounting than the preparation of a journal entry?

Thus, the preparation of tax accrual workpapers is often left to the tax accountants, who presumably know more about FAS 109 and FIN 48 than most tax attorneys. However, a recent District Court case, *Textron, Inc.*, DC-RI, 2007-2 USTC ¶50,605 (Aug. 29, 2007), demonstrates the importance of involving tax attorneys in a company's preparation of tax accrual workpapers. The involvement of tax attorneys in the preparation of tax accrual workpapers may protect the workpapers from being disclosed to the IRS later during an audit.

History Lesson

Many M&A TAX REPORT readers may not even remember Arthur Young, the other Arthur-named accounting firm. Yet, in 1984, the U.S. Supreme Court in *Arthur Young, Inc.*, SCt, 465 US 805 (1984), upheld the rights of the IRS to obtain tax accrual workpapers prepared by the taxpayer's independent auditors. That was a big deal at the time. Notably, the source of that invigorated authority was the IRS' broad summons authority. The Supremes specifically rejected Arthur Young's position that the workpapers were not relevant to the IRS audit.

Arthur Young was an important case. Yet, on the heels of that victory, the IRS reaffirmed its policy of restraint in Announcement 84-46. Just what is "restraint"? That policy contemplated that the IRS would not seek tax accrual workpapers absent unusual circumstances. The main unusual circumstance was simply when the examiner has not been able to obtain the necessary facts from the taxpayer.

In such a case, to put an additional control on the circumstance, the IRS examiner was

supposed to obtain written approval from the chief of examination. Even then, the request is to be limited to the portion of the workpapers believed to be material and relevant to the examination. Just how all this worked in practice was debatable, and to some extent, could still be debated today.

In any event, in 2002, the IRS announced that it was modifying its mantra of restraint. In Announcement 2002-63, the IRS said that the IRS examiner must request the taxpayer's tax accrual workpapers for any listed transaction claimed on a return. OK, that suggests there's a higher standard when a listed transaction is involved (sound familiar?). Plus, if a taxpayer claimed two or more of these listed baddies on a return, the examiner then could have a field day. In such a case, the examiner *must* request the tax accrual workpapers for *all* items reported on the return. Not exactly restraint, one might argue. It is with this background that the *Textron* case looms large.

Key Papers

In *Textron*, the IRS issued summons for the taxpayer's tax accrual workpapers in connection with its audit of the taxpayer's 2001 tax return. The taxpayer's in-house tax attorneys and CPAs had prepared the tax accrual workpapers. The workpapers consisted solely of a spreadsheet containing:

(a) a list of items on the taxpayer's tax returns, which, in the opinion of the taxpayer's in-house tax attorneys, involved issues on which the tax laws were unclear;

(b) estimates by the taxpayer's in-house tax attorneys expressing, in percentage terms, their judgments regarding the taxpayer's chances of prevailing in any litigation over those issues; and

(c) the dollar amounts reserved to reflect the possibility that the taxpayer might not prevail in such litigation.

The taxpayer's independent auditors had examined the tax accrual workpapers for purposes of issuing an unqualified opinion on the taxpayer's financial statements. Notably, the tax accrual workpapers did not include any documents pertaining to the underlying transactions in question.

Look-See?

In holding that the taxpayer did not have to turn over its tax accrual workpapers to the IRS, the court ruled that the tax accrual workpapers were protected under the attorney-client privilege, the tax practitioner privilege under Code Sec. 7525, and the work-product privilege. That sounds like a three-pronged victory.

However, the court also held that the taxpayer's disclosure to its independent auditors waived both the attorney-client privilege and the tax practitioner privilege. Ouch. Nonetheless, the court ruled that such disclosure did not waive the work-product privilege (in large part, because the auditors were not viewed as potential adverse parties, and because the auditors signed confidentiality agreements).

In determining whether the tax accrual workpapers were protected as work product, the court considered the question of whether the tax accrual workpapers were prepared "in anticipation of litigation." Noting a split in the Circuits as to the standard to apply in determining whether a document was prepared "in anticipation of litigation," the court applied the "because of" test as articulated in *M. Adlman,* CA-2, 98-1 USTC ¶50,230, 134 F3d 1194 (1998), and concluded that the tax accrual workpapers were protected as work product.

Caution Ahead?

Textron is a significant victory for taxpayers. Nonetheless, corporations should proceed with caution. Other taxpayers may encounter different results in attempting to protect tax accrual workpapers (or other documents) from disclosure to the IRS.

Indeed, two standards exist for determining whether a document is prepared "in anticipation of litigation." Some courts have applied the "principal purpose" standard, while other courts may conclude differently on the question of whether certain tax accrual workpapers are work product.

Furthermore, the work product privilege is a qualified (rather than an absolute) privilege. If the IRS can show a "substantial need" for the protected documents and an inability to otherwise obtain the information contained therein without

"undue hardship," the taxpayer may be required to disclose tax accrual workpapers even though they are protected under the work product privilege. [*See* Fed. R. Civ. P. 26(b)(3).]

Line-Item Advice

Textron offers some valuable lessons for corporate tax departments to employ in the preparation of tax accrual workpapers:

- Corporations should consider creating a procedure whereby tax attorneys review questionable tax positions during the process of preparing tax accrual workpapers.
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- Corporations should require their independent auditors to sign confidentiality agreements.
- The tax accrual workpapers should not be disclosed to the corporations' external tax preparers (such disclosure might waive the work product privilege).
- The tax accrual workpapers should be kept in a separate file from the documents pertaining to the underlying transactions for which there is questionable tax treatment.

Last Word

Like it or not, companies are implementing processes for compliance with FIN 48's new recognition, measurement and disclosure requirements. In this context, the *Textron* case gives companies strategies for creating steps in their FIN 48 compliance process to protect their FIN 48 workpapers as work product.

Plainly, *Textron* does not guarantee that such steps will protect the companies' FIN 48 workpapers under the work product privilege. Equally plainly, taking these steps can help give companies a fighting chance.