



## FIN 48 and Tax Accrual Workpapers

How companies can protect the disclosure of their tax accrual workpapers.

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With the increased pressure by the Internal Revenue Service (IRS) and Congress to disclose tax accrual work papers and the expansion of FIN 48 (FASB Interpretation 48: *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109*) to non-public companies, how do companies protect their tax accrual workpapers? There may be some hope in *United States v. Textron, Inc.* (1st Cir. No. 07-2632) that FIN 48 workpapers are protected by the work-product privilege. As we go to press, the government is preparing to file its motion for a rehearing or a hearing en banc of the Textron case.

### **FIN 48 Determinations and Workpapers**

Since the publication of FIN 48, privilege protection for FIN 48 workpapers has become of utmost importance. All public companies that are subject to GAAP for all tax years after December 2006, and all nonpublic companies — including not-for-profits — subject to U.S. Generally Accepted Accounting Principles (GAAP) for all taxable years after December 2008 (see FASB 48-3), must comply with FIN 48 in providing reserves for uncertain tax positions. FIN 48 workpapers are, in fact, considered by the IRS as tax accrual workpapers. (AM 2007-0012, Chief Counsel Memorandum). Although the IRS has generally followed a policy of restraint in requesting tax accrual workpapers, Internal Revenue Manual, Section 4.10.20 — the IRS has announced that it may request tax accrual workpapers of taxpayers that have engaged in listed transactions. Announcement 2002-63, 2002-2 CB 72. Further, the IRS has stated that FIN 48 disclosures "should be considered by examiners and agents when conducting risk assessments." Memorandum for Executive Managers and Examiners-Large and Midsized Business Division (May 2007, LMSB-04-0507-044).

The determinations under FIN 48 are a two-step process. First, it must be determined whether the tax position will more likely than not be sustained upon examination by the IRS, assuming that the IRS has complete knowledge of the transaction. Second, if the tax position meets the more likely than not measure, then the uncertain tax position must be measured to compute the reserve. In making these determinations, FIN 48 requires that "[it] shall be presumed that the tax position will be examined by the relevant tax authority that has full knowledge of all of the relevant information."

### **The First Circuit Decision in Textron**

Textron demonstrates the road map to successfully resisting production of tax accrual workpapers. During an examination of Textron's 1998 to 2002 tax years, the IRS discovered that one of Textron's subsidiaries had engaged in a number of sale-in lease-out transactions. During the audit, the IRS in Notice 2005-13, 2005-9 IRB 630

determined that such lease transactions were "listed transactions" and requested all of Textron's tax accrual workpapers, which consisted of spreadsheets, drafts of spreadsheets and backup materials that contained lists of contentious items, the dollar amounts reserved for each of them and the estimates of the chances of prevailing in litigation. When Textron refused to produce the workpapers in accordance with an administrative summons, the United States brought suit to enforce the IRS summons.

The First Circuit, in mid-January, upheld the District Court's opinion that tax accrual workpapers are protected by the work-product privilege; but, remanded the case to the District Court to determine whether Textron had waived the privilege by disclosing the tax accrual workpapers to its independent auditors.

### **Work-Product Privilege**

The work-product privilege protects documents and tangible items 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). The privilege is not absolute and materials will be discoverable where it is demonstrated that there is a substantial need for the materials and the party seeking discovery cannot without undue hardship obtain substantially equivalent materials by other means. In addition, documents that are prepared in the ordinary course of business or that would have been prepared in essentially similar form irrespective of the litigation do not fall within the protection of the privilege. The Court held that audit disputes with the IRS are litigation since they are inherently challenged. Applying the "because of " test of the First Circuit and a majority of the other circuits, the tax accrual workpapers were found to have been prepared because of the risk of disputes and litigation with the IRS and would not have been created in similar form but for the threat of litigation. In the case of documents that serve a dual purpose, the Court held that where one purpose was to summarize litigation hazards, it was enough to protect the documents under the work-product privilege, even though the documents also served another purpose, i.e. satisfying a regulatory requirement.

The Court affirmed that the disclosure of the Textron's tax accrual workpapers to its outside auditors did not constitute a waiver of the work-product privilege. The IRS had sought the independent auditor's workpapers from Textron, which claimed that it did not have the power or the right to obtain such workpapers from its outside auditor. Textron's outside auditors had referred to Textron's tax accrual workpapers in compiling its own workpapers. The case was remanded as to whether Textron had the right to the workpapers. Consequently, the issue was framed as to whether Textron had disclosed its tax accrual workpapers to a conduit from

whom the IRS could obtain discovery of the workpapers, and therefore, waived the work-product privilege.

### **Helpful Hints to Protect Tax Accrual and FIN 48 Workpapers**

If your company wishes to retain a work-product protection for its workpapers they should ensure that all such documents are kept under lock and key with a log of those accessing the papers and the purpose. All persons to whom the documents are disclosed should agree to maintain the confidentiality of the documents and not to include the documents in any other document. Each document should bear appropriate legends of the confidential and the work product nature of the materials.

FIN 48 workpapers should be segregated into separate file folders depending upon whether the materials are protected. One file folder should be comprised of the inventory of each tax position that may be subject to a tax dispute. It is likely that the list is not protected since it would contain no mental impressions, conclusions or opinions that are the key to the work-product protection. Another file folder should contain the matrix of tax reserves, including the percentage amount and the dollar amounts of the tax reserves for each tax issue. The taxpayer would certainly be at an unfair disadvantage in any settlement negotiations with the IRS, if this document was discoverable, and therefore, it should be protected under the work-product privilege. The last file folder should contain the legal analysis of each disputed tax issue listed, including strategies for each dispute, the strength and weakness of the taxpayer's position and the mental impressions of the taxpayer's advisers, which historically have been afforded work-product protection.

### **Conclusion**

By segregating the FIN 48 workpapers into separate files, your company can control and track the distribution of the work-product protected confidential materials and avoid inadvertently handing over any document to the IRS that might be otherwise protected or waiving the privilege by distributing the document to a conduit from whom the IRS could obtain discovery.

## About the Author

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