

# Certiorari Denied in Textron: Is the Game Over?

The Supreme Court denied certiorari in Textron, leaving open the question whether in the First Circuit the work-product privilege protects tax-accrual workpapers.

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Despite numerous *amicus curiae* briefs urging the Supreme Court to grant certiorari and a split in the circuits, on May 24, 2010, certiorari unexpectedly was denied in *United States v. Textron, Inc.*, 577 F.3d 21 (1st. Cir., 2009), which held that Textron's tax accrual workpapers were not protected by the work-product privilege. Many tax practitioners and commentators have soundly criticized the majority opinion. To fully understand the import of *Textron*, the majority opinion must be analyzed in light of the facts and what it said and did not say.

### **Work-product Privilege**

The work-product privilege, as first articulated by the Supreme Court in *Hickman v. Taylor*, 329 U.S. (1947), was codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure to protect a document from discovery if it is "prepared in anticipation of litigation or for trial ..." To determine whether a document is protected, the purpose for the preparation of the document must be determined. The litigation content of a document does not answer the question as to the purpose for its creation.

The broader test adopted by most circuits, except the Fifth, is that a document is protected if it is "prepared because of the prospect of litigation." The Fifth Circuit adopted a narrower test that a document is protected if the "primary motivating purpose" in creating the document is to aid in possible future litigation. In anticipation of litigation means a real expectation of litigation, but not pending litigation. A general fear of being challenged will not satisfy the standard, but a real expectation of a specifically identified litigation is necessary.

### **Background**

The workpapers sought by the Internal Revenue Service (IRS) were Textron's own workpapers prepared by its own in-house accountants and lawyers consisting of spreadsheets and backup materials that contained uncertain tax positions and estimates of the chances of prevailing in litigation with the IRS with respect to these items. During the audit of Textron, certain transactions entered into by its financial intermediary subsidiary became listed transactions and the IRS sought Textron's workpapers with respect to the listed transactions. Later, the IRS sought all of Textron's workpapers.

### **District Court's Decision**

When Textron refused to turn over its workpapers, claiming work-product privilege, the IRS brought an enforcement action for the workpapers. Following the "because of" test, the court reasoned that "[t]here would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding." As a result, the district court held that the work-product privilege protected the workpapers, having been prepared in anticipation of litigation.

### **First Circuit *En Banc* Majority Decision**

A three-judge panel of the First Circuit originally affirmed the lower court's decision. On the IRS petition to hear the case *en banc*, the First Circuit withdrew the panel decision and heard the case *en banc*. The full-court majority, over a strong dissent, reversing the panel and the lower court, held that

Textron's workpapers were not protected by the work product doctrine because they were not prepared for litigation, but rather for financial reporting purposes and therefore were prepared in the ordinary course of business.

The majority stated very clearly that it was applying the "because of" test adopted in *Maine v. United States Dep't of Interior*, 298 F. 3d 60 (1st Cir., 2002) as the test in the First Circuit, but in applying the test the majority looked to see if the documents were "prepared for use" in litigation. The majority noted that even though the workpapers contained legal thinking, they were not protected as work product, because Textron did not prepare the workpapers for use in possible litigation, but instead to estimate its tax reserves and to obtain a clean opinion from its outside auditors.

Textron's workpapers were argued to be dual purpose documents, i.e. prepared for litigation with the IRS and to support tax reserves that reflected litigation risks. Under the "because of" test dual purpose documents have been held to be protected. However, the majority opinion found that there was no evidence supporting a litigation purpose for the workpapers and they were not protected because they were prepared in the ordinary course of business and would have been created regardless of the litigation. Obviously, the majority did not consider the Textron workpapers dual purpose documents since the evidence showed that the workpapers served only the single purpose of disclosure.

The majority opinion weighed the respective interests of the IRS and the work-product privilege and placed the interest of the IRS and the collection of revenue ahead of the protection of work product. The weighing of competing interests was the very analysis conducted by the Supreme Court in the *Arthur Young & Co.* case, which held that the IRS was entitled to the taxpayer's financial accountants' workpapers.

### **Dissent Opinion**

In a very critical opinion the dissent accused the majority of failing to follow the "because of" standard of the First Circuit and adopting a "prepared for use in potential litigation" standard. According to the dissent, the dual nature of the Textron's workpapers did not preclude the application of the "because of" standard and mandate the application of the "prepared for use in litigation" standard.

Further, the dissent accused the majority of using "simple generalizations" to avoid the *Maine* precedent and was critical of the majority's suggestion that it was respecting, rather than overruling *Maine*. The dissent concludes that under the Majority's unprecedented, narrower standard, the work-product privilege will not protect the workpapers.

### **Comments**

The majority has been criticized for adopting an absolute rule that workpapers to establish reserves for audited financial statements are not protected by the work-product privilege. Yet, the majority opinion never states that tax accrual workpapers are never protected by the work-product privilege or that workpapers to determine proper financial reserves cannot also be prepared in anticipation of

litigation. The majority emphasizes the facts surrounding the preparation of the workpapers that “[t]here is no evidence in this case that the workpapers were prepared for such [litigation] use or would in fact serve any useful purpose for Textron conducting litigation if it arose.” In analyzing whether the workpapers were prepared for litigation, the majority concluded that the workpapers did not have the touch and feel of materials prepared for litigation. Further, the majority emphasized that the “singular immediate purpose” of the workpapers was to establish reserves for audited financial statements to receive a clean audit opinion and there was no evidence to support a litigation purpose of the workpapers. If there was such evidence, the majority may have come out differently.

### **Conclusion**

Under the majority’s opinion evidence demonstrating the use in litigation for the document or litigation as the purpose for the preparation of the document, in addition to disclosure requirements, may bring a different result. Workpapers with a litigation touch and feel, but also prepared to estimate tax reserves for audited financial statements, may be protected as work product even under the First Circuit’s decision in *Textron*.

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