

TEXTRON: THE DEBATE CONTINUES AS TO WHETHER AUDITOR TRANSPARENCY WAIVES THE WORK PRODUCT PRIVILEGE

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BACKGROUND

In the tax community, one of the most widely-discussed issues is whether tax accrual workpapers are protected from disclosure to tax authorities by the work product privilege and, if so, whether this privilege is waived by disclosure of the workpapers to a corporation's financial statement auditors. This issue is an outgrowth of the tax shelter era that gained national attention after the Enron bankruptcy in 2001 and the enactment of the Sarbanes-Oxley Act in 2002. These events resulted in demands for increased transparency by both outside auditors and tax authorities.

The IRS, for example, historically requested tax accrual workpapers only in "unusual" circumstances.² In 2002, the IRS changed its policy of restraint and carved out an exception for corporations that engaged in a tax shelter or, more specifically, a "listed transaction."³ Depending on whether the listed transaction was properly disclosed and on how many listed transactions were completed, the IRS now requests some or all of the tax accrual workpapers

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² I.R.M. 4.10.20.3.1(1) (July 12, 2004). The requisite unusual circumstances exist if (i) a specific factual issue has been identified by the IRS and additional factual information is needed; (ii) the IRS sought this factual data from the taxpayer and third parties; and (iii) the IRS sought a supplementary analysis of facts and performed a reconciliation of the Schedule M-1 or M-3 as it relates to that issue. I.R.M. 4.10.20.3.1(2) (July 12, 2004). Even where these circumstances exist, however, the IRS' request for tax accrual workpapers should be limited to the portion of the workpapers that is "material and relevant" to the tax audit. *Id.*

³ I.R.M. 4.10.20.3 *et seq.* (July 12, 2004); *see also* Treas. Reg. § 1.6011-4 (2007).

during the audit of a corporate tax return.⁴ The IRS' change in policy was an unwelcomed event because these workpapers can provide a roadmap to the "soft spots" in the return.

Taxpayers became even more concerned about disclosure of tax accrual workpapers in 2006 when FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, ("FIN-48"), which provides a tax position cannot be recognized in the financial statements unless it is more likely than not that the position will be sustained upon an examination by the tax authority based on the technical merits.⁵ Some believe that FIN-48 makes the privilege argument moot, but there is nothing new about a tax litigation risk assessment. FIN-48 has simply mandated a specific methodology by which tax positions are recognized and measured, which necessarily encompasses the taxpayer's litigation risk assessment. Today, it is not uncommon for tax accrual workpapers (or FIN-48 workpapers)⁶ to include an inventory of uncertain tax positions, a litigation risk assessment for each uncertain tax position, and a matrix of the probabilities of success on the merits. To avoid a qualified audit opinion on the integrity of the financial statements, these workpapers are disclosed to the outside auditors as part of their review and, frequently, the auditors retain a copy of these workpapers.

When tax authorities also request these workpapers, taxpayers may resist disclosure based on the attorney-client privilege, the Section 7525 federal practitioner privilege,⁷ or the

⁴ See I.R.M. 4.10.20.3.2.3 (Jan. 15, 2005). If the listed transaction was properly disclosed, the IRS can request the tax accrual workpapers relating only to that transaction for the year under audit, but can request the same workpapers for other years if relevant to the current audit. I.R.M. 4.10.20.3.2.3(1) (Jan. 15, 2005). On the other hand, if the listed transaction was not properly disclosed, the IRS can request all tax accrual workpapers for the year under audit as well as the workpapers for other years if relevant to the current audit. I.R.M. 4.10.20.3.2.3(2) (Jan. 15, 2005). The IRS also can request all tax accrual workpapers for the year if either (i) the taxpayer claimed tax benefits from multiple listed transactions even if they were properly disclosed or (ii) the taxpayer had a single listed transaction that was properly disclosed and also had reported financial irregularities. I.R.M. 4.10.20.3.2.3(3) (Jan. 15, 2005).

⁵ FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109, at ¶¶ 5-7 (Financial Accounting Standards Board 2006). For purposes of FIN-48, this examination is assumed to occur with the tax authority having full knowledge of all relevant information. *Id.*

⁶ In March 2007, the IRS' Office of Chief Counsel announced its position that FIN-48 workpapers are tax accrual workpapers and are subject to the IRS' current policy for requesting tax-related workpapers. I.R.S. Chief Counsel Attorney Mem. 2007-2 (Mar. 22, 2007).

⁷ Unless otherwise noted, all "Section" references are to the Internal Revenue Code of 1986, as amended.

work product privilege.⁸ In response, the government contends the workpapers are prepared in the ordinary course of business or to comply with SEC requirements and, therefore, are not privileged work product. The government also contends that, even if privileged, all privilege is waived upon disclosure of the workpapers to the outside auditors. In touting its right to access these documents, the government continuously relies on (i) the Supreme Court decision in *United States v. Arthur Young*,⁹ which held there is no “accountant work product privilege” precluding the discovery of the auditors’ own workpapers prepared in the course of its financial statement review and (ii) the Fifth Circuit decision in *United States v. El Paso Co.*,¹⁰ which held the corporation’s tax pool analysis was not privileged work product because the primary motivation for preparing the analysis was financial reporting, not litigation.

Because of *Arthur Young* and *El Paso*, many have viewed the privileged nature of tax accrual workpapers with skepticism. This skepticism, however, is misplaced. *Arthur Young* is distinguishable because it involved the auditors’ workpapers, not the taxpayer’s own litigation risk assessment. *El Paso*, on the other hand, involved the taxpayer’s own tax pool analysis but it is a decision from the Fifth Circuit, which as discussed below is only Circuit that has adopted the strict primary motivation standard in determining whether a document was prepared “in anticipation of litigation.”

On January 21, 2009, the First Circuit issued an eagerly awaited decision in *United States v. Textron Inc.*,¹¹ which was the first Circuit Court of Appeals decision addressing the privileged nature of tax accrual workpapers since the Fifth Circuit’s 1982 decision in *El Paso*. As discussed below, a majority panel held that Textron’s tax accrual workpapers are privileged work

⁸ Because the attorney-client privilege and Section 7525 federal practitioner privilege are waived on disclosure to a third party, this publication focuses on the application of the work product privilege.

⁹ *United States v. Arthur Young*, 465 U.S. 805 (1984).

¹⁰ *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982).

¹¹ *United States v. Textron Inc.*, No. 07-2631, slip op. (1st Cir. Jan. 21, 2009), *withdrawn & reh’g en banc granted*, No. 07-2631, 2009 WL 775439 (1st Cir. Mar. 25, 2009).

product and that its outside auditors (E&Y) are not actual or potential adversaries.¹² The First Circuit, however, vacated the ultimate determination of whether the privilege was waived and remanded for assessment of (i) whether disclosure of E&Y's audit workpapers would reveal the Textron's confidential information (i.e., whether E&Y is a conduit to an adversary) and (ii) whether Textron has a legal right or ability to obtain E&Y's workpapers, which were also requested in the summons.¹³ One judge dissented, stating that the majority's finding of privileged work product is inconsistent with governing law.¹⁴ Both parties filed petitions for rehearing. Given the significance of the issue in *Textron*, it is not surprising that the First Circuit's decision was recently withdrawn and an *en banc* hearing has been scheduled for June 2, 2009.

Notwithstanding the withdrawal of the *Textron* decision, there is an emerging line of authority finding that the work product privilege is alive and well in the tax world, and taxpayers have a real hope of protecting tax-sensitive documents from tax authorities.¹⁵ As for *Textron*, there is a strong argument that the workpapers at issue are privileged work product and that the privilege was not waived upon their disclosure to E&Y because E&Y was not an actual adversary, a potential adversary, or a conduit to an adversary. Contrary to the dissent, the District Court's decision was correct and entirely consistent with relevant precedent. The question is whether the First Circuit will ultimately affirm.

¹² *Id.* at 41.

¹³ *Id.*

¹⁴ *Id.* at 42-49.

¹⁵ See, e.g., *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006) (KPMG memoranda that were completed after the transaction but before the tax return and that analyzed tax consequences of transactions involving the creation of captive insurance company and subsequent stock transfers were privileged work product); *Regions Fin. Corp. v. United States*, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,345, WL 2139008 (N.D. Ala 2008) (counsel and E&Y memoranda that were included in the tax accrual workpapers and that expressed opinions, evaluated legal theories, and analyzed possible IRS theories were privileged work product, and this privilege was not waived upon disclosure of the documents to the outside auditors); *Commissioner v. Comcast Corp.*, 901 N.E.2d 1185 (Mass. 2009) (Andersen memoranda addressing the alternative structures for a stock sale and the related litigation risks were privileged work product even though they were prepared to inform a business decision).

THE WORK PRODUCT DOCTRINE

The work product privilege was first recognized in *Hickman v. Taylor* where the Supreme Court established a zone of privacy for actions taken with an “eye toward litigation” so that counsel could work “without undue and needless interference” in “the historical and the necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients’ interests.”¹⁶ This work product privilege was codified in Fed. R. Civ. P. 26(b)(3), which provides that a document is protected from discovery if it is “prepared in anticipation of litigation or for trial by or for another party or by or for that other party’s representative.” In making this determination, the Circuit Courts of Appeal apply two different standards.¹⁷

Under the majority view, a document is protected work product if it is “prepared or obtained because of the prospect of litigation.”¹⁸ This standard has been expressly adopted by all the Circuit Courts of Appeal except the Fifth, Tenth, and Eleventh.¹⁹ Under this standard, it is well recognized that a document can be prepared for dual purposes without a loss of privilege.²⁰ In *United States v. Adlman*, for example, the court held that an Andersen memorandum analyzing potential IRS challenges and related defenses regarding a proposed

¹⁶ *Hickman v. Taylor*, 329 U.S. 495, 510-11 (1947).

¹⁷ The Supreme Court has not provided a controlling standard for the meaning of the phrase “in anticipation of litigation” for purposes of Fed. R. Civ. P. 26(b)(3).

¹⁸ See *United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998); see also 8 Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, *Federal Practice & Procedure* § 2024 (2009).

¹⁹ See, e.g., *Adlman*, 134 F.3d at 1202 (2d Cir.); *Roxworthy*, 457 F.3d at 593 (6th Cir.); *United States v. Torf* (*In re Grand Jury Subpoena*), 357 F.3d 900, 907 (9th Cir. 2004); *Maine v. U.S. Dept. of Interior*, 298 F.3d 60, 68 (1st Cir. 2002); *Nat’l Union Fire Ins. Co. of Pittsburgh v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992); *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987); *P.R. ex rel. Judiciary Comm. v. U.S. Dep’t of Justice*, 823 F.2d 574, 587 (D.C. Cir. 1987); *Binks Mfg. Co. v. Nat’l Presto Indus., Inc.*, 709 F.2d 1109, 1119 (7th Cir. 1983); *In re Grand Jury Proceedings*, 604 F.2d 798, 803 (3d Cir. 1979). The Courts of Appeal for the Tenth and Eleventh Circuits have not yet expressly adopted any standard. As discussed *infra*, the Court of Appeal for the Fifth Circuit applies the “primary motivation” standard.

²⁰ 8 Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, *Federal Practice & Procedure* § 2024 (2009).

merger is protected work product even though the memorandum assisted the taxpayer in making a business decision about proceeding with the merger.²¹

Under the minority view, a document is privileged work product only if the “primary motivating purpose” in creating the document is to aid in possible future litigation.²² To date, this strict standard has been adopted only by the Fifth Circuit. As noted above, the court in *El Paso* held that the taxpayer’s tax pool analysis, which consisted of a listing vulnerable tax positions, the dollar amount per item, and a memorandum addressing the litigation risk assessment, were not privileged because they were prepared for financial reporting purposes.²³

Unlike the attorney-client and Section 7525 federal tax practitioner privileges, the work product privilege is not automatically waived when the document is shared with a third party. Instead, this privilege is waived “only if the disclosure ‘substantially increases the opportunity for potential adversaries to obtain the information.’”²⁴ The relevant test, therefore, is whether the third party is or should be considered an adversary or, expressed another way, does the third party share a common interest with the company.²⁵ Where waiver occurs, it does not result in a subject matter waiver; instead, waiver is generally on a document by document basis.²⁶

Even if waiver has not occurred, the work product privilege provides a qualified immunity. Specifically, if the privilege applies, a tax authority can obtain the information if the tax authority meets its burden of proof that (i) it has a “substantial need” for the privileged information in the preparation of its case and (ii) it is “unable without undue hardship to obtain

²¹ *Adlman*, 134 F.3d at 1195.

²² *El Paso*, 682 F.2d at 542 (quoting *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981)).

²³ *El Paso*, 682 F.2d at 535-36, 543-44.

²⁴ See, e.g., *Merrill Lynch & Co., Inc. v. Allegheny Energy*, 229 F.R.D. 441, 445 (S.D.N.Y. 2004); see also 8 Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, *Federal Practice & Procedure* § 2024 (2009).

²⁵ *Merrill Lynch*, 229 F.R.D. at 446.

²⁶ 8 Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, *Federal Practice & Procedure* § 2024 (2009); see, e.g., *Bramlette v. Hyundai Motor Co.*, No. 91 C 3635, 1993 WL 338980, at *3 (N.D. Ill. Sept. 1, 1993); *In re Air Crash Disaster at Sioux City*, 133 F.R.D. 515, 527 (N.D. Ill. 1990).

the substantial equivalent of the materials by other means.”²⁷ Even where this showing has been made, “the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party’s attorney or other representative of a party concerning the litigation.”²⁸ As a result, opinion work product is afforded greater protection than fact work product.²⁹

WHAT HAPPENED IN *TEXTRON*?

OVERVIEW OF FACTS

Textron, Inc. (“Textron”) is a publicly traded corporation with numerous subsidiaries including Textron Financial Corporation (“TFC”), which engaged in the transaction that gave rise to the IRS’ request for Textron’s tax accrual workpapers.³⁰ Like other large corporations, every one of Textron’s consolidated returns is audited by the IRS.³¹ In the prior eight audit cycles, Textron had sought administrative review of proposed adjustments at IRS Appeals seven times and, since 1959, three of its tax disputes resulted in litigation.³²

In 2001, TFC invested in multiple listed “SILO” transactions.³³ During the 1998-2001 audit cycle, the IRS requested all of Textron’s tax accrual workpapers for 2001 under the IRS’ current policy for seeking such workpapers.³⁴ Textron’s tax department had both attorneys and accountants, while TFC’s tax department had only accountants.³⁵ The tax accrual workpapers

²⁷ Fed. R. Civ. P. 26(b)(3).

²⁸ *Id.*

²⁹ Some states have codified absolute protection for opinion work product while, in other states, courts provide absolute protection or have found waiver only in rare or remarkable circumstances. *See, e.g.*, Cal. Civ. Proc. Code § 2108.030(a); *see also* 8 Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, Federal Practice & Procedure § 2026 (2009).

³⁰ *United States v. Textron*, 507 F. Supp. 2d 138, 141 (D. R.I. 2007). For purposes of this publication, the District Court decision is referred to as “*Textron I.*”

³¹ *Id.*

³² *Id.* at 141-42 n1.

³³ *Id.* at 142.

³⁴ *Id.*

³⁵ *Id.* at 141.

were prepared shortly after the tax return was filed.³⁶ The accountants first circulated to the attorneys a copy of the prior year workpapers with recommendations regarding proposed changes for the current year.³⁷ The attorneys then reviewed the materials and proposed further changes to the spreadsheets and hazard litigation percentages, which were returned to the accountants to complete the mathematical computations for the tax reserve amount.³⁸ The attorneys then met with the accountants to give final approval so that the workpapers could be finalized by the accountants.³⁹ TFC went through a similar process except that it did not have in-house attorneys so that its accountants relied on tax advice obtained from outside accounting and law firms before meeting with Textron's tax attorneys to finalize the workpapers.⁴⁰ Once the tax reserves were established, they were aggregated with the corporation's other contingent liabilities and reported as "other liabilities" on Textron's financial statements.⁴¹ During the financial statement audit, E&Y reviewed the final tax accrual workpapers with the agreement that such information was confidential.⁴²

When Textron refused to produce the requested workpapers during the audit, the IRS issued a summons seeking the tax accrual workpapers, which were defined as:

[A]ll accrual or other financial workpapers or documents created or assembled by the Taxpayer, an accountant for the Taxpayer, or the Taxpayer's independent auditor relating to any tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to any footnotes disclosing reserves or contingent liabilities on audited financial statements. They include, but are not limited to, any and all analyses, computations opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes.⁴³

³⁶ *Id.* at 143.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.* at 142.

This summons also sought all such workpapers “in the actual or constructive possession, custody, or control of Textron or its accountants.”⁴⁴ According to the government, the requisite control exists if Textron “has access upon inquiry or through a legal right to obtain” the workpapers.⁴⁵ The government allegedly needed the workpapers to navigate a 4000-page return, to understand the substance of the SILO transaction, and to identify potential issues with the return.⁴⁶ When Textron refused to comply with the summons, the government filed an enforcement proceeding.

DISTRICT COURT’S DECISION IN TEXTRON.

The District Court first identified the tax accrual workpapers at issue as consisting only of two things: (1) a spreadsheet containing (a) a list of issues where the tax laws were unclear and may be subject to IRS challenge, (b) the percentage estimates of the chances of prevailing on these issues in litigation, and (c) the dollar amount of tax reserves, and (2) backup workpapers with the prior year’s spreadsheet, draft spreadsheets, notes, and memoranda from in-house tax attorneys with opinions on uncertain items and percentage estimates.⁴⁷ Textron testified that the workpapers were prepared to ensure Textron was “adequately reserved with respect to any potential disputes or litigation that would happen in the future.”⁴⁸ The District Court also inferred that the establishment of adequate reserves was promoted, in part, by the desire to satisfy GAAP and obtain a unqualified audit opinion.⁴⁹

A critical issue before the District Court was whether the tax accrual workpapers were prepared in the ordinary course of business to satisfy the GAAP requirements or whether they

⁴⁴ *United States v. Textron Inc.*, No. 07-2631, slip op. at 4 (1st Cir. Jan. 21, 2009), *withdrawn & reh’g en banc granted*, No. 07-2631, 2009 WL 775439 (1st Cir. Mar. 25, 2009). For purposes of this publication, the First Circuit decision is referred to as “*Textron II*.”

⁴⁵ Brief of Appellant, at 7-8, *United States v. Textron Inc.*, Docket No. 07-2631 (1st Cir. Jan. 28, 2008).

⁴⁶ *Textron II*, slip op. at 6-7.

⁴⁷ *Textron I*, 507 F. Supp. 2d at 142-43.

⁴⁸ *Id.* at 143.

⁴⁹ *Id.*

were prepared in anticipation of litigation.⁵⁰ The court recognized that, in the First Circuit, this determination is governed by the more lenient “because of” standard.⁵¹ Applying this standard, the District Court emphasized that the workpapers:

would not have been prepared at all “but for” the fact that Textron anticipated the possibility of litigation with the IRS. If Textron had not anticipated a dispute with the IRS, there would have been no reason for it to establish any reserve or to prepare the workpapers used to calculate the reserve. Thus, while it may be accurate to say that . . . the workpapers were useful in obtaining a “clean” opinion from E&Y regarding the adequacy of the reserve amount, there 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.⁵²

As expected, the government relied on *El Paso*, but the court found this reliance to be misplaced because Fifth Circuit applied the primary motivation standard.⁵³ The dual purpose nature of the workpapers (i.e., to also satisfy the auditors that the reserves complied with GAAP) did not alter the result.⁵⁴ Based on Textron’s history with IRS audits, the appeals process, and litigated cases, the District Court found the taxpayer’s belief of anticipated litigation to be well-founded, and Textron’s tax accrual workpapers were protected work product.⁵⁵

The District Court then turned to the issue of waiver.⁵⁶ As noted above, this determination hinges on whether disclosure of the workpapers to E&Y as outside auditors “substantially increases” the opportunity for potential adversaries to obtain the privileged information.⁵⁷ The District Court correctly point out that the majority of courts addressing this

⁵⁰ *Id.* at 150. The District Court also held that the summons was properly issued under I.R.C. § 7602 and that the tax accrual workpapers were protected by the attorney-client and Section 7525 federal practitioner privileges but that such privileges were waived by disclosure of the workpapers to E&Y. *Id.* at 143-48.

⁵¹ *Id.* at 150 (citing *Maine*, 298 F.3d at 68).

⁵² *Id.* at 150.

⁵³ *Id.*

⁵⁴ *Id.* at 150-51 (citing *Lawrence E. Jaffe Pension Plan v. Household Int’l, Inc.*, 237 F.R.D. 176 (N.D. Ill. 2006) (letters containing litigation risk assessment were privileged notwithstanding SEC requirement that letters be provided to shareholders)).

⁵⁵ *Textron I*, 507 F. Supp. at 150.

⁵⁶ *Id.* at 152.

⁵⁷ *Id.*

precise issue have held no waiver occurs.⁵⁸ Notwithstanding this on-point authority, the government relied on *United States v. Mass. Inst. of Tech* (“MIT”)⁵⁹ for the proposition that waiver occurs when a document is disclosed to an auditor.⁶⁰ In *MIT*, however, the taxpayer disclosed documents to the Defense Contract Audit Agency (“DCCA”), which was the auditing arm of the Department of Defense (“DOD”), as part of the DCCA’s review of contract performance to determine whether MIT overcharged the government for its services.⁶¹ The IRS issued a summons for these same documents during an audit of MIT’s tax-exempt status.⁶² The First Circuit concluded that any work product privilege was waived when MIT disclosed the documents to the DCCA because the DCCA was auditing MIT and DOD was the party charged with litigating any disputes over billing.⁶³ In other words, disclosure had been made to a potential adversary.

In *Textron*, the District Court found *MIT* unpersuasive.⁶⁴ Unlike the situation in *MIT*, E&Y had no obligation to determine the accuracy of Textron’s tax liability and it was not a potential adversary or acting on behalf of a potential adversary.⁶⁵ The District Court also emphasized E&Y’s obligation, by express agreement and under the AICPA Code of Professional Conduct, not to disclose confidential client information.⁶⁶ Even if there was no guaranteed confidentiality, these factors made it unlikely that an adversary had a substantially increased

⁵⁸ *Id.* at 152-53; *see, e.g., In re JDS Uniphase Corp. Sec. Litig.*, C-02-1486 CW (EDL), 2006 U.S. Dist. LEXIS 76169 (N.D. Cal. Oct. 5, 2006) (redacted board minutes); *Lawrence E. Jaffe Pension Plan*, 237 F.R.D. 176 (audit letters); *Frank Betz Assocs., Inc. v. Jim Walter Homes, Inc.*, 226 F.R.D. 533 (D.S.C. 2005) (individual reserve amounts); *Merrill Lynch*, 229 F.R.D. 441 (investigation reports); *Gutter v. E.I. DuPont De Nemours & Co.*, 95-2152-CIV-GOLD, 1998 U.S. Dist. LEXIS 23205 (S.D. Fla. July 10, 1998) (documents with individual reserve amounts, status reports, litigation reports to the Board, legal opinions, and drafts); *In re Pfizer Sec. Litig.*, No. 90 Civ. 1260 (SS), 1993 WL 561125 (S.D.N.Y. Dec. 23, 1993) (general reserves).

⁵⁹ *United States v. Mass. Inst. of Tech*, 129 F.3d 681 (1st Cir. 1997).

⁶⁰ *Textron I*, 507 F. Supp. 2d at 153.

⁶¹ *MIT*, 129 F.3d at 683.

⁶² *Id.* at 681-83.

⁶³ *Id.* at 687.

⁶⁴ *Textron I*, 507 F. Supp. 2d at 153-54; *see also Regions*, 2008 WL 2139008, at *8.

⁶⁵ *Textron I*, 507 F. Supp. 2d at 154; *see also Regions*, 2008 WL 2139008, at *8.

⁶⁶ *Textron I*, 507 F. Supp. 2d at 153; *see also Regions*, 2008 WL 2139008, at *8.

opportunity to get the information.⁶⁷ The District Court held that the disclosure to E&Y did not waive the work product privilege.⁶⁸

Because no waiver occurred, the District Court addressed the qualified nature of the work product privilege and the IRS' alleged need for Textron's tax accrual workpapers. Although the workpapers would provide insight on Textron's tax liability, the court held that the determination of the tax liability must be based on factual information, none of that information was available in the workpapers, and all of that information was readily available from other documents.⁶⁹ Disclosure of counsel's workpapers would have created an unfair advantage for the IRS, and the District Court rejected the IRS' claim that it had a substantial need for the workpapers.⁷⁰ This holding is consistent with the IRS' own policy that the primary source of facts should be the corporation's records.⁷¹

FIRST CIRCUIT'S DECISION IN *TEXTRON*.

The District Court decision in *Textron* was a significant taxpayer victory but, as expected, the government appealed. There were three issues on appeal: (1) whether the work product privilege protects the tax accrual workpapers, (2) whether that privilege was waived by disclosure of the workpapers to E&Y and (3) whether the District Court erred in not considering the government's request for Textron to produce E&Y's own workpapers.⁷²

1. Textron's Tax Accrual Workpapers Are Privileged Work Product.

As noted above, the First Circuit follows the rule of law that a document is protected from disclosure "if, 'in the light of the nature of the document and the factual situation in the

⁶⁷ *Textron I*, 507 F. Supp. 2d at 153.

⁶⁸ *Textron I*, 507 F. Supp. 2d at 152-54; *see also Regions*, 2008 WL 2139008, at *8.

⁶⁹ *Textron I*, 507 F. Supp. 2d at 155. Satisfaction of the relevance standard for purposes of issuing a summons under I.R.C. § 7602 does not mean that the substantial need standard under Fed. R. Civ. P. 26(b)(3) also has been met, especially where the mental impressions, conclusions, opinions, or legal theories of counsel are at issue. *Id.* at 154.

⁷⁰ *Id.* at 155.

⁷¹ *See* I.R.M. 4.10.20.3.1(1) (July 12, 2004).

⁷² *Textron II*, slip op. at 11.

particular case, the document can be fairly said to have been prepared or obtained *because of* the prospect of litigation.”⁷³ Under this standard, privilege does not protect documents that are prepared in the ordinary course of business or that would have been prepared in essentially similar form regardless of litigation.⁷⁴

The First Circuit first addressed the ongoing debate of whether a non-docketed tax dispute with the IRS can constitute “litigation” for purposes of the work product privilege.

According to the Restatement of Law, “litigation” includes:

civil and criminal trial proceedings, as well as adversarial proceedings before an administrative agency, an arbitration panel or a claims commission, and alternative-dispute-resolution proceedings such as mediation or mini-trial. It also includes a proceeding such as a grand jury or a coroner’s inquiry or an investigative legislative hearing. In general, a proceeding is adversarial when evidence or legal argument is presented by parties contending against each other with respect to legally significant factual issues.⁷⁵

The First Circuit concluded that, while not all dealings with the IRS (e.g., initial processing of disputes during an audit) are litigation, “the resolution of disputes through adversary administrative processes, including proceedings before the IRS Appeals Board, meets the definition of litigation.”⁷⁶

After reaching this conclusion, the First Circuit addressed the privileged nature of Texton’s workpapers and, more specifically, the purpose for creating them. The government predictably continued to rely on *Arthur Young* and *El Paso*.⁷⁷ The majority panel, however, was not persuaded by either of these cases. Unlike in *Arthur Young*, the First Circuit was not being confronted with the question of whether to recognize a new privilege; instead, it was addressing

⁷³ *Textron II*, slip op. at 12 (quoting *Maine*, 298 F.3d at 68, and *Adlman*, 134 F.3d at 1202).

⁷⁴ *Textron II*, slip op. at 12.

⁷⁵ *Id.* at 13 (quoting Restatement (Third) of the Law Governing Lawyers § 87 cmt. h (2000)).

⁷⁶ *Id.* at 15.

⁷⁷ *Id.* at 24-28.

the protection of dual purpose documents under an existing privilege.⁷⁸ As for *El Paso*, the government contended a finding of privilege would create a split among the Circuits for tax accrual workpapers.⁷⁹ The majority panel rejected this argument as well because a split could not exist where the Circuits applied different legal standards for interpreting the phrase “in anticipation of litigation.”⁸⁰

Because privilege protection is based on the “function” of the document, the key determination under the “because of” standard is whether the document “would have been prepared [in essentially the same form] irrespective of the expected litigation with the IRS.”⁸¹ Applying these basic principles, the First Circuit found that the function of the workpapers was to analyze tax litigation risks and, as a result, “the driving force behind the preparation of the documents was the need to reserve money in anticipation of disputes with the IRS.”⁸²

Notwithstanding Textron’s need to analyze the risk of litigating with the IRS, the government tried to defeat the privilege claim under two theories.⁸³ First, the IRS argued that the workpapers were prepared to get a clean audit opinion from E&Y and, therefore, were necessarily prepared in the ordinary course of business.⁸⁴ Second, the workpapers were prepared to comply with reporting and securities obligations.⁸⁵ The First Circuit correctly rejected the notion the mere presence of a business or regulatory purpose defeats privilege.⁸⁶ By analogy, the court stated that:

[L]ike in a case where a company analyzes pending litigation for the purpose of setting aside a reserve, here the business purpose derives from and is inextricably related to anticipating litigation. That the anticipation of such disputes (and

⁷⁸ *Id.* at 24-26.

⁷⁹ *Id.* at 25.

⁸⁰ *Id.* at 26.

⁸¹ *Id.* at 12, 16.

⁸² *Id.* at 17.

⁸³ *Id.* at 18.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.* at 19.

corresponding potential litigation) also triggered certain business and accounting obligations does not bar the protection of the work-product doctrine.⁸⁷

As noted above, dual purpose documents can be protected.⁸⁸ Otherwise, in this case, Textron's opposing counsel would be able to discover information that effectively disclosed counsel's ultimate mental impressions of the case, which are afforded the greatest level of protection.⁸⁹

As a final argument, the government contended that, unlike *Adlman*⁹⁰ and *United States v. Roxworthy*⁹¹ where the privilege applied to documents addressing specific litigation or specific transactions, Textron did not have any specific litigation in mind.⁹² This argument also was not persuasive. While a party may have to identify the litigation, Textron met its burden of proof because the workpapers at issue identified individual tax positions where a dispute with the IRS was excepted.⁹³ As a result, the government was not successful in defeating a privilege claim for Textron's tax accrual workpapers.

2. Waiver of Work Product Privilege.

The First Circuit also addressed the issue of whether Textron waived the privilege by disclosing the tax accrual workpapers to an adversary.⁹⁴ The First Circuit, like other courts, found that Textron and E&Y were indisputably not actual adversaries and were also not potential adversaries.⁹⁵ The purpose of E&Y's audit was not to identify disputes with Textron but rather to certify its financial statements.⁹⁶ The government could not identify any "conceivable scenario in which E&Y would file a lawsuit against [Textron] because of something E&Y

⁸⁷ *Id.* at 20-21.

⁸⁸ *Id.* at 20-23.

⁸⁹ *Id.* at 23.

⁹⁰ *Adlman*, 134 F.3d 1194.

⁹¹ *United States v. Roxworthy*, 457 F.3d 590.

⁹² *Textron II*, slip op. at 28.

⁹³ *Id.* at 28-32.

⁹⁴ *Id.* at 33.

⁹⁵ *Id.* at 34 (citing *Regions*, 2008 WL 2139008; *Lawrence E. Jaffe Pension Plan*, 237 F.R.D. 176; *Merrill Lynch*, 229 F.R.D. 441).

⁹⁶ *Textron II*, Slip Op. at 34.

learned from [Textron's] disclosures."⁹⁷ As a result, E&Y and Textron had a cooperative, and not adversarial, relationship.⁹⁸

Notwithstanding this conclusion, the First Circuit went on to analyze whether E&Y could be a conduit to a potential adversary.⁹⁹ This is the issue that led to the remand. Although E&Y had a professional obligation of confidentiality, the government argued that E&Y may be required to turn over its workpapers to the SEC, to Textron's shareholders, or in response to a subpoena.¹⁰⁰ For the first time and out of an abundance of caution, the First Circuit fell for the government's wrong-minded view of the facts and the law. It is true that the Supreme Court in *Arthur Young* did not create a new accountant privilege to protect audit workpapers but, as discussed below, this does not make E&Y a conduit to a potential adversary for purposes of the work product doctrine. The First Circuit raised the question of whether the disclosure of E&Y's workpapers would substantially increase the risk that the contents of Textron's workpapers also would be disclosed to an adversary.¹⁰¹ Because the District Court did not make any factual findings regarding the contents of E&Y's workpapers, the First Circuit remanded to determine the extent to which disclosure of these workpapers would effectively constitute disclosure of Textron's own assessments.¹⁰²

3. Government's Request for E&Y's Workpapers.

The final issue on appeal was the District Court's failure to enforce the summons (which was issued only to Textron) for E&Y's workpapers. This summons requested the tax accrual workpapers within the possession, custody, or control of both Textron and E&Y.¹⁰³ Textron

⁹⁷ *Id.* at 34-35.

⁹⁸ *Id.* at 34.

⁹⁹ *Id.* at 35.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.* at 37.

¹⁰³ *Id.*

contended that it could not produce E&Y’s workpapers because it did not have the requisite possession, custody, or control.¹⁰⁴

The First Circuit noted that “[i]n the normal discovery context, ‘so long as the party has the legal right or ability to obtain the documents from another source upon demand, that party is deemed to have control.’”¹⁰⁵ To defeat the argument that it had control of E&Y’s workpapers, Textron relied on R.I. Gen. Laws § 5-3.1.-22 (1956) and AICPA Code of Professional Conduct ET § 501, which provide that the accountant’s workpapers are the property of the accountant and that these workpapers need not be provided to the client.¹⁰⁶ The First Circuit, however, was not persuaded by Textron’s argument that ownership governed the control determination.¹⁰⁷ Although Textron did not have a copy of E&Y’s workpapers, it had reviewed them.¹⁰⁸ Based on this fact, Textron contended that it only had access to them on a temporary basis while the IRS contended it had a right to obtain the workpapers.¹⁰⁹ The First Circuit found that Textron had not produced any evidence to meet its burden of proof on the control issue.¹¹⁰ As a result, the case was remanded to determine the factual question of whether Textron could obtain E&Y’s workpapers.¹¹¹

DISSENTING OPINION IN *TEXTRON*.

Judge Boudin concurred with the remand but dissented on the conclusion that Textron’s workpapers were prepared in anticipation of litigation under the First Circuit’s “because of” standard.¹¹² The dissent took the position that the documents were prepared for “reasons independent of the need to prepare for or conduct litigation,” which conclusion was based on the

¹⁰⁴ Brief of Appellee at 58, *United States v. Textron Inc.*, Docket No. 07-2631 (1st Cir. Mar. 28, 2008).

¹⁰⁵ *Textron II*, slip op. at 39 (quoting *Mercy Catholic Med. Ctr. v. Thompson*, 380 F.3d 142, 160 (3d Cir. 2004)).

¹⁰⁶ See *Textron II*, slip op. at 40.

¹⁰⁷ *Textron II*, slip op. at 40.

¹⁰⁸ *Id.* at 40.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.* at 42-49.

Federal securities law requirement for a financial statement audit that necessarily included an analysis of tax reserves.¹¹³ The dissent contends that, under the authority of *State of Maine v. United States*,¹¹⁴ it is not the “subject matter” of the document that controls but the whether the document itself was prepared in the ordinary course of business or otherwise independently required to be prepared.¹¹⁵ The dissent, therefore, concludes that a finding of privilege in this case runs afoul of *Maine*¹¹⁶ and *Adlman*¹¹⁷ because the tax accrual workpapers are mandated by the accounting requirements.¹¹⁸ In reaching this conclusion, the dissent relies heavily on *El Paso*, stating that it is the “only circuit precedent that directly involves tax accrual workpapers” and, therefore, is “precise precedent.”¹¹⁹ According to the dissent, *Maine*, *Adlman*, and *El Paso* govern the case and only an *en banc* hearing can change the rule.¹²⁰

WITHDRAWAL OF FIRST CIRCUIT’S DECISION IN *TEXTRON*.

Subsequent to the First Circuit’s decision, both parties filed a Petition for Rehearing. *Textron*’s petition was limited to the court’s suggestion that E&Y may be a conduit to an adversary and, therefore, privilege may have been waived.¹²¹ The government, on the other hand, essentially adopted the dissenting opinion that the tax accrual workpapers were prepared to comply with federal securities laws and a finding of privilege is inconsistent with governing precedent.¹²² The government also argued that this hearing was necessary because the

¹¹³ *Id.* at 42.

¹¹⁴ *Maine*, 298 F.3d 60.

¹¹⁵ *Textron II*, slip op. at 45.

¹¹⁶ *Maine*, 298 F.3d 60.

¹¹⁷ *Adlman*, 134 F.3d 1194.

¹¹⁸ *Textron II*, slip op. at 44-46.

¹¹⁹ *Textron II*, slip op. at 47, 49-50.

¹²⁰ *Id.* at 50.

¹²¹ *Textron*, Docket No. 07-2631, Doc. 00113553199, at 2 (1st Cir. Feb. 23, 2009).

¹²² *Textron*, Docket No. 07-2631, Doc. 00114289318, at 4 (1st Cir. Mar. 9, 2009).

government needed a “uniform rule regarding tax-accrual workpapers.”¹²³ On March 25, 2009, the First Circuit withdrew its decision and scheduled an *en banc* for June 2, 2009.¹²⁴

TEXTRON: WHAT IS THE RIGHT ANSWER?

PRIVILEGED NATURE OF TAX ACCRUAL WORKPAPERS.

It is important to keep in mind that the determination of whether a particular document is prepared “in anticipation of litigation” is a fact specific determination. In *Textron*, the specific workpapers at issue are limited to a list of uncertain tax positions, the probabilities of success, the dollar amount of individual reserves, and the supporting analysis prepared by in-house attorneys. The dissent and the government, however, are ignoring these particular facts, including the purpose for which these workpapers are prepared. They also erroneously apply the “because of” standard to get the same outcome as in *Arthur Young* and *El Paso* and, in doing so, they overlook relevant case law. As discussed below, the District Court got it exactly right in *Textron*—the workpapers are protected by the work product privilege and this privilege was not waived upon disclosure to the outside auditors.

1. Taxpayer’s Workpapers vs. Auditor’s Workpapers.

A fundamental problem with the government and dissent’s position in *Textron* is the failure to understand the SEC requirements and the auditor’s unique role as described in *Arthur Young*. As discussed below, not only is the audit itself required by law, but the preparation of the audit workpapers are required by law. In contrast, the actual preparation of the financial statements are management’s responsibility¹²⁵ and, as part of this process, the taxpayer’s tax

¹²³ *Textron*, Docket No. 07-2631, Doc. 00114289318, at 7-8 (1st Cir. Mar. 9, 2009).

¹²⁴ *Textron*, Docket No. 07-2631, Doc. 00115199850 (1st Cir. Mar. 25, 2009).

¹²⁵ Codification of Statements on Auditing Standards, AU § 110.03, *Responsibilities and Functions of the Independent Auditor* (AICPA 2008); *see also* Codification of Statements on Auditing Standards, AU § 311.09, *Planning and Supervision* (AICPA 2008).

accrual workpapers are prepared to evaluate the corporation's litigation risks and to record tax reserves.

Interestingly, an independent public accountant is the only type of professional legally required to be engaged by a public company. Since 1933, U.S. securities laws have required that the financial statements of public companies be audited and “certified by an independent public or certified accountant.”¹²⁶ The objective of this audit, “is the expression of an opinion on the fairness with which they present, in all material respects, financial positions, results of operation, and its cash flows in conformity with general accepted accounting principles.”¹²⁷ This unique “public watchdog” role was recognized in *Arthur Young*.¹²⁸ Without the audit report, a public company cannot meet its statutory and regulatory requirements for its financial statements and cannot sell its securities to the public. In other words, the audit would not be performed “but for” the SEC requirements.

In addition, auditors have always been required to maintain audit documentation.¹²⁹ After the Sarbanes-Oxley Act, the auditor must maintain its records relevant to the audit for seven years, including workpapers and other documents that form the basis of the audit and memoranda, correspondence, communications, other documents, and records, which (i) are created, sent or received in connection with the audit and (ii) contain conclusions, opinions, analyses, or financial data related to the audit.¹³⁰ For purposes of this requirement, workpapers means “documentation of auditing or review procedures applied, evidence obtained, and

¹²⁶ See, e.g., Securities Exchange Act of 1933, Schedule A, Items 25 and 26 (codified at 15 U.S.C. §§ 77aa(25) and (26)); see also Securities Exchange Act of 1934, § 13(a)(2) (codified at 15 U.S.C. § 78m); Public Utility Holding Company Act of 1935, § 14 (codified at 15 U.S.C. § 79n); Investment Company Act of 1940, § 30(e) (codified at 15 U.S.C. § 80a-29(g)); *Arthur Young & Co.*, 465 U.S. 805 at 819.

¹²⁷ Codification of Statements on Auditing Standards, AU § 110.01, *Responsibilities and Functions of the Independent Auditor* (AICPA 2008).

¹²⁸ *Arthur Young*, 465 U.S. at 819 n15.

¹²⁹ See, e.g., Statement on Auditing Standards No. 41, *Audit Documentation* (AICPA 1982); Statement on Auditing Standards No. 96, *Audit Documentation* (AICPA 2002); Statement on Auditing Standards No. 103, *Audit Documentation* (AICPA 2005).

¹³⁰ 17 C.F.R. § 210.2-06(a); see also 15 U.S.C. § 7213(a)(2)(A).

conclusions reached by the accountant in the audit or review engagement, as required by standards established by the Public Company Accounting Oversight Board” (the “PCAOB”).¹³¹ Subsequently, these requirements were detailed in the PCAOB’s Auditing Standards No. 3, *Audit Documentation*.¹³²

In *Textron*, the dissent and the government erroneously rely on *Arthur Young* for the proposition that the treatment of the auditor’s own tax accrual workpapers governs the treatment of the taxpayer’s workpapers. However, as noted above, the audit workpapers are required by law. This is not true for a corporation’s internally prepared tax accrual workpapers. Although *Arthur Young* was decided many years before the Sarbanes-Oxley Act or the issuance of the PCAOB’s auditing standards, the role of the auditor has not changed and the Supreme Court understood the need to support the auditor’s conclusions through the preparation of audit workpapers. Specifically, the Supreme Court stated:

The independent auditor draws upon many sources in evaluating the sufficiency of the corporation’s tax accrual account. Initially, the corporation’s books, records, and tax returns must be analyzed in light of the relevant Code provisions, Treasury Regulations, Revenue Rulings, and case law. The auditor will also obtain and assess the opinions, speculations, and projections of management with regard to unclear, aggressive, or questionable tax positions that may have been taken on prior tax returns. In exploring the tax consequences of certain transactions, the auditor often engages in a “worst-case” analysis in order to ensure that the tax accrual account accurately reflects the full extent of the corporation’s exposure to additional tax liability. From this conglomeration of data, the auditor is able to estimate the potential cost of each particular contingency, as well as the probability that the additional liability may arise.

The auditor’s tax accrual workpapers record this process of examination and analysis. Such workpapers may document the auditor’s interviews with corporate personnel, judgments on questions of potential tax liability, and suggestions for alternative treatments of certain transactions for tax purposes. Tax accrual

¹³¹ 17 C.F.R. § 210.2-06(b); *see also* Sarbanes-Oxley Act, § 103 (codified at 15 U.S.C. § 7213) (PCAOB also was directed to establish auditing standards that require auditors to maintain audit documentation “in sufficient detail to support the conclusions reached” in the auditor’s report).

¹³² *See, e.g.*, Public Company Accounting Oversight Board, Form 19b-4 Final Rules, File No. PCAOB-2004-06 (Audit Documentation and Amendment to Interim Auditing Standards) (June 9, 2004), at Auditing Standards No. 3, ¶¶ 2 and 10.

workpapers also contain an overall evaluation of the sufficiency of the corporation's reserve for contingent tax liabilities, including an item-by-item analysis of the corporation's potential exposure to additional liability. In short, tax accrual workpapers pinpoint the "soft spots" on a corporation's tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes.¹³³

In *Arthur Young*, the auditor would not have prepared the workpapers at issue "but for" a legal requirement to do so. Unlike audit workpapers, Textron's own workpapers were not prepared for the sole purpose of complying with any SEC or accounting requirement. In short, *Arthur Young* does not govern the outcome of *Textron*.

2. Recent Precedent Involving Tax Accrual Workpapers.

As noted above, the dissent states that *El Paso* is the "only circuit precedent that directly involves tax accrual workpapers" and that this "precise precedent" governs even though it applies the primary purpose test.¹³⁴ Although *El Paso* is the only decision by a Circuit Court of Appeals involving the privileged nature of tax accrual workpapers, it cannot be viewed as "precise precedent" because the Fifth Circuit applies a different legal standard for determining whether a document is prepared in anticipation of litigation. Unlike the Fifth Circuit, the First Circuit recognizes that privileged work product can have a dual purpose. To follow *El Paso*, the First Circuit would have to overrule years of authority and adopt a new standard—the "primary motivation" standard—that is applied in only one Circuit. This is an unlikely result given all the other precedent relating to litigation risk assessments..

In addition, *El Paso* is not the only precedent involving tax accrual workpapers. In *Regions Fin. Corp. v. United States*, an Alabama District Court held that memoranda included in the tax accrual workpapers were privileged work product.¹³⁵ Like Textron, Regions had engaged

¹³³ *Arthur Young*, 465 U.S. at 812-13.

¹³⁴ *Textron II*, slip op. at 47, 50.

¹³⁵ *Regions*, 2008 WL 2139008.

in listed transactions and, therefore, the IRS requested the tax accrual workpapers and served a summons on E&Y, the outside auditor.¹³⁶ The core documents that were withheld were requested because Region’s general counsel expected an IRS review of a transaction and all of these memoranda expressed opinions, evaluated legal theories, and analyzed possible IRS challenges.¹³⁷ The documents at issue were disclosed to E&Y, who agreed to keep, and had a duty to keep, the information confidential.¹³⁸

The heart of the dispute was whether the work product privilege applied to Regions’ tax accrual workpapers.¹³⁹ In analyzing this issue, the court noted that the Eleventh Circuit had not yet adopted either the “because of” or “primary motivation” standard and, if forced to decide, it would follow the more lenient “because of” standard.¹⁴⁰ However, court did not need to make this decision because the court found that, under either standard, privilege protected the documents from disclosure.¹⁴¹

Under either test, the court emphasized that the critical inquiry is the purpose for creating the documents.¹⁴² The government argued that the documents were created to establish the corporation’s tax reserves and satisfy its auditor.¹⁴³ Regions argued that it would not have needed to establish reserves for contingent liabilities at all unless it thought the IRS would contest the transaction’s tax treatment.¹⁴⁴ The court agreed with Regions.¹⁴⁵ The court noted that, even under the Fifth Circuit’s primary motivation standard, the “litigation need not necessarily be imminent,” but rather, the privilege can apply if the document was created to “aid

¹³⁶ *Id.* at *1.
¹³⁷ *Id.* at *1.
¹³⁸ *Id.* at *1.
¹³⁹ *Id.* at *2.
¹⁴⁰ *Id.* at *3, *5.
¹⁴¹ *Id.* at *5.
¹⁴² *Id.*
¹⁴³ *Id.*
¹⁴⁴ *Id.*
¹⁴⁵ *Id.* at *6.

in possible litigation.”¹⁴⁶ Importantly, the court rejected the IRS’ view that the taxpayer could not claim privilege if the contested documents had any use other than litigation.¹⁴⁷ Indeed, “[e]ven the strictest application of the ‘primary motivating purpose’ test would still allow a document whose *creation* was primarily motivated by litigation to be *used* in some other fashion.”¹⁴⁸ Because the portions of the documents at issue contained mental impressions and legal theories of its counsel, they were the type of documents that the work product privilege was designed to protect.¹⁴⁹ Ultimately, the court found the documents would not have been created if Regions was not “primarily concerned” with litigation.¹⁵⁰ The documents were protected by the work product privilege.¹⁵¹

3. The Dissent Misinterprets the “Because of” Standard.

As noted above, the dissent in *Textron* contends that the majority panel’s finding of privilege violates *Adlman*¹⁵² and *Maine*.¹⁵³ More specifically, the dissent takes the position that it is not the “subject matter” of the document that controls but the whether the document itself was prepared in the ordinary course of business or otherwise independently required to be prepared.¹⁵⁴ Under the dissent’s theory, tax accrual workpapers would never be protected because they are always created. This is not the governing standard. The standard set forth in *Adlman* and adopted by the First Circuit in *Maine* is whether the document was whether the document was prepared because of the prospect of litigation.¹⁵⁵ The privilege, however, would

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at **6-7.

¹⁴⁸ *Id.* at *6 n11.

¹⁴⁹ *Id.* at *7.

¹⁵⁰ *Id.* at **6-7.

¹⁵¹ *Id.*

¹⁵² *Adlman*, 134 F.3d 1194.

¹⁵³ *Maine*, 298 F.3d 60.

¹⁵⁴ *Textron II*, slip op. at 45.

¹⁵⁵ *Adlman*, 134 F.3d at 1202.

not protect documents “created in essentially similar form irrespective of litigation.”¹⁵⁶ As a result, a privilege analysis necessarily takes into account whether the workpapers would substantively be different if there was no litigation risk. Clearly, if there is no prospect of tax disputes and, therefore, no need for tax reserves, the tax accrual workpapers would have been prepared in a substantially different form. The First Circuit’s conclusion that Textron’s workpapers were privileged would be directly consistent with *Maine* and *Adlman*.

4. Individual Reserve Documentation Is Held to Be Privileged.

Because the documents at issue in *Textron* were limited to litigation risk assessments on an issue by issue basis, the First Circuit should not ignore the precedent discussion or addressing the privilege nature of general litigation reserves. In *Adlman*, for example, the Second Circuit listed several hypotheticals to demonstrate why privilege should not be denied for dual purpose documents, including the following:

A business entity prepares financial statements to assist its executives, stockholders, prospective investors, business partners, and others in evaluating future courses of action. Financial statements include reserves for projected litigation. The company’s independent auditor requests a memorandum prepared by the company’s attorneys estimating the likelihood of success in litigation and an accompanying analysis of the company’s legal strategies and options to assist it in estimating what should be reserved for litigation.¹⁵⁷

The court concluded that, in this scenario, “the company involved would require legal analysis that falls squarely within *Hickman*’s area of primary concern -- analysis that candidly discusses the attorney’s litigation strategies, appraisal of likelihood of success, and perhaps the feasibility of settlement.”¹⁵⁸ This is exactly the issue in *Textron*. Although *Adlman* involved the protection of a document analyzing the tax consequences of a transaction for purposes of proceeding with that transaction, other courts have directly addressed the issue of litigation risk assessments.

¹⁵⁶ *Id.* at 1203.

¹⁵⁷ *Id.* at 1200.

¹⁵⁸ *Id.*

In *Simon v. G.D. Searle & Co.*, the issue was whether risk management documents reflecting products liability litigation reserves were privileged work product.¹⁵⁹ In this particular case, the individual case reserves were set by the legal department and then used by the risk management department for a variety of reserve analysis functions that were motivated by budget, profit, and insurance considerations.¹⁶⁰ The court stated:

The individual case reserve figures reveal the mental impressions, thoughts, and conclusions of an attorney in evaluating a legal claim. By their very nature they are prepared in anticipation of litigation and, consequently, they are protected from discovery as opinion work product. We do not believe, however, that the aggregate reserve information reveals the individual case reserve figures to a degree that brings the aggregates within the protection of the work product doctrine. The individual figures lose their identity when combined to create the aggregate information.¹⁶¹

Because the documents at issue were prepared by the risk management department for purely business reasons and revealed only aggregate reserve amounts (not individual reserve amounts), the court held that the documents were not protected from discovery under the work product privilege.¹⁶²

By comparison, the District Court in *Rhone-Poulenc Rorer Inc. v. Home Indemnity Co.* found both individual and aggregate reserves relating to an insurer's reinsurance claims to be privileged.¹⁶³ Here, the court pointed out that a "reserve essentially reflects an assessment of the value of the claim taking into consideration the likelihood of an adverse judgment."¹⁶⁴ Individual case reserves "reveal the mental impressions, thoughts, and conclusions of an attorney in evaluating a legal claim [and] [b]y their very nature they are prepared in anticipation of

¹⁵⁹ *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th Cir. 1987).

¹⁶⁰ *Id.* at 401.

¹⁶¹ *Id.* at 401-02; see also *Frank Betz Assocs.*, 226 F.R.D. 533 (documents relating to individual reserves for hear valve litigation were privileged work product); *Gen. Elec. Capital Corp. v. DirectTV, Inc.*, 184 F.R.D. 32, 35-36 (D. Conn. 1998) (while documents reflecting individual reserve amounts would be privileged work product, documents reflecting only aggregate reserves are not); *Gutter*, 1998 WL 2017926, **1-2 (S.D. Fl. 1998) (documents relating to individual but not aggregate reserves are privileged work product).

¹⁶² *Simon*, 816 F.2d at 401; see also *Gen. Elec.*, 184 F.R.D. at 36; *Gutter*, 1998 WL 2017926, at **1-2.

¹⁶³ *Rhone-Poulenc Rorer Inc. v. Home Indem. Co.*, 139 F.R.D. 609, 613-15 (E.D. Pa. 1991).

¹⁶⁴ *Id.* at 613.

litigation.”¹⁶⁵ In addition, the aggregate reserves “may give some insight into the mental processes of the lawyers in setting specific case reserves” and, therefore, “it is impossible to protect the mental impressions underlying the specific reserves without also protecting aggregate figures.”¹⁶⁶

Even under a primary motivation standard, the District Court in *In re Pfizer Inc. Sec. Litig.* held that documents reflecting individual case reserves are recognized as privileged work product because they reflected an attorney’s professional opinion as to the value of a tort claimant’s lawsuit, while documents reflecting aggregate reserves were not privileged.¹⁶⁷ In *Pfizer*, the plaintiff argued the documents were created for the business purpose of public reporting but the court was not persuaded, stating:

we do not believe that, as a practical matter, a document describing individual case reserves provides meaningful information for preparing such disclosure. An estimate of financial exposure in any individual case does not furnish a board of directors or management with a sufficiently comprehensive picture to make a business forecast or public disclosure . . . By contrast, a document containing aggregate information compiled from individual case reserve figures would serve mainly business purposes--namely, to apprise the board of directors and management of Pfizer’s current financial exposure from pending and impending tort claims and to prepare public filings to the SEC. The information embedded in an aggregate reserve figure is too generalized to be useful for planning litigation strategy in any specific case.¹⁶⁸

Consequently, individual reserve documents, but not aggregate reserve documents, were held to be privileged work product.¹⁶⁹

While there may be some conflict on whether aggregate reserve documents that do not reveal any individual reserve information should be privileged, these courts have uniformly

¹⁶⁵ *Id.* at 614.

¹⁶⁶ *Id.* at 614-15.

¹⁶⁷ *In re Pfizer*, 1993 WL 561125, **4-5; see also *Nicholas v. Bituminous Cas. Corp.*, 235 F.R.D. 325, 332-33 (N.D. W.Va. 2006) (individual loss reserve information that insurer compiled with respect to claimants' underlying tort claims).

¹⁶⁸ *In re Pfizer*, 1993 WL 561125, at *4.

¹⁶⁹ *Id.*

found individual reserve documents to be privileged under the “because of” standard and, in at least instance, under the “primary motivation” standard. This authority is directly on point and should not be ignored by the First Circuit simply because these cases relate to general reserves as opposed to tax reserves. In both situations, the corporation is completing a litigation risk assessment because of the prospect of litigation and will use this assessment to record reserves on its financial statements. And, in both situations, the individual reserves reveal the mental impressions, thoughts, and conclusions of an attorney in evaluating a legal claim. As noted above, such opinion work product is afforded greater protection under any standard. As a result, the District Court’s decision should be affirmed.

WAIVER: AUDITORS ARE NOT ADVERSARIES OR CONDUITS TO ADVERSARIES.

With two exceptions, the courts have uniformly found that no waiver occurs when privileged documents are disclosed to the outside auditors.¹⁷⁰ As noted above, the First Circuit in *Textron* found that E&Y was not an actual or potential adversary but remanded for a determination of whether Textron’s privileged information was included in E&Y’s workpapers such that E&Y was a conduit to an adversary. Regardless of whether the auditor is being evaluated as a actual or potential adversary or a conduit to an adversary, the pivotal question is

¹⁷⁰ See, e.g., *Westernbank P.R. v. Kachkar*, No. Civ. 07-1606 ADC/BJM, 2009 WL 530131 (D. P.R. 2009) (no waiver for investigation report); *Regions*, 2008 WL 2139008, at *8; *SEC v. Roberts*, 254 F.R.D. 371 (N.D. Cal. 2008) (no waiver for attorney’s interview notes); *In re JDS Uniphase Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 76169, *11 (no waiver for redacted board minutes); *Lawrence E. Jaffe Pension Plan.*, 237 F.R.D. 176 (no waiver for audit letters); *Int’l Design Concepts, Inc. v. Saks Inc.* 2006 U.S. Dist. LEXIS 36695 (no waiver for audit committee report); *Frank Betz Assocs.*, 226 F.R.D. at 535 (no waiver for individual reserve amounts); *Merrill Lynch*, 229 F.R.D. 441 (no waiver for investigation reports); *Gutter*, 1998 U.S. Dist. LEXIS 23205 (no waiver for documents with individual reserve amounts, status reports, litigation reports to the Board, legal opinions, and drafts); *In re Pfizer*, 1993 WL 561125 (waiver for aggregate but not individual reserve amounts); *Gramm v. Horsehead Indust., Inc.*, No. 87 Civ. 5122 (MJL), 1990 WL 142404 (S.D.N.Y. Jan. 25, 1990) (no waiver for attorney memorandum); *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655 (S.D. Ind. 1985) (no waiver for audit letters); *Laguna Beach County Water Dist. v. Super. Court*, 22 Cal. Rptr. 3d 387 (Cal. Ct. App. 2004) (no waiver for audit response letters). Only two courts have held that waiver occurred upon the disclosure of privileged documents to the outside auditors. *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002) (waiver for minutes Special Litigation Committee); *In re Disonics Sec. Litig.*, No. C-83-45855-RFP(FW), 1986 WL 53402 (N.D. Cal. June 15, 1986) (waiver for acquisition documents). *Medinol* and *Disonics* have been overwhelmingly rejected by the other Districts and, subsequently, both the Southern District of New York and the Northern District of California have held that no waiver occurs upon disclosure to the auditors. See *Merrill Lynch*, 229 F.R.D. 441; *Int’l Design Concepts*, 2006 U.S. Dist. LEXIS 36695; *In re JDS Uniphase Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 76169.

the same—does disclosure to the auditor “*substantially increase* the opportunities for potential adversaries to obtain the information.”¹⁷¹ Generally, if the disclosing party and the third party share a “common interest,” no waiver will occur.¹⁷²

In *Merrill Lynch*, a frequently cited case, the District Court addressed the precise issue pending before the First Circuit in *Textron*. Merrill Lynch had obtained two reports in connection with an internal investigation and had produced those reports to its outside auditors Deloitte & Touche (“Deloitte”).¹⁷³ As noted by the court, auditors have always been required to maintain an independent role and that independence was strengthened by the Sarbanes-Oxley Act.¹⁷⁴ Such independence is not impaired by a conclusion that privilege is not waived upon disclosure of a corporation’s information to the auditors.¹⁷⁵ For waiver to occur, the case law requires a “tangible adversarial relationship.”¹⁷⁶ The court in *Merrill Lynch* concluded that any possible tension between the corporation and Deloitte over the accuracy of the financial statements was simply not the type of adversarial relationship required by the work product privilege.¹⁷⁷ The court found no waiver occurred upon disclosure of client confidential information to the auditor because the auditor was neither an adversary nor a conduit to an adversary.¹⁷⁸ The court in *Pfizer*, which as discussed above specifically addressing the privileged nature of individual reserve amounts, similarly held that that auditor was not a conduit to adversaries.¹⁷⁹

¹⁷¹ *Merrill Lynch*, 229 F.R.D. at 445 (emphasis added); see also *Westernbank P.R.*, 2009 WL 530131, at *7; *In re JDS Uniphase Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 76169, at *6; *Int’l Design Concepts*, 2006 U.S. Dist. LEXIS 36695, at *6; *Lawrence E. Jaffe Pension Plan*, 237 F.R.D. at 183; *Gutter*, 1998 U.S. Dist. LEXIS 23205, at *13; *In re Pfizer*, 1993 WL 561125, at *6.

¹⁷² *Merrill Lynch*, 229 F.R.D. at 446; *JDS Uniphase Corp*, 2006 U.S. Dist. LEXIS 76169, at *6.

¹⁷³ *Merrill Lynch*, 229 F.R.D. at 442, 446.

¹⁷⁴ *Id.* at 447; *Int’l Design Concepts*, 2006 U.S. Dist. LEXIS 36695, at *6.

¹⁷⁵ *Merrill Lynch*, 229 F.R.D. at 447.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* at 448; see also *Lawrence E. Jaffe Pension Plan*, 237 F.R.D. at 183.

¹⁷⁸ *Merrill Lynch*, 229 F.R.D. at 449; see also *Int’l Design Concepts*, 2006 U.S. Dist. LEXIS 36695, at *8; *Gutter*, 1998 U.S. Dist. LEXIS 23205, at *13; *Gramm*, 1990 WL 142404, at *5.

¹⁷⁹ *In re Pfizer*, 1993 WL 561125, at *6; see also *Frank Betz Assocs.*, 226 F.R.D. at 535.

A perfect example of the conduit theory can be found in *MIT* which is discussed by the court in *Merrill Lynch* and relied on by the government in *Textron*.¹⁸⁰ As discussed above, *MIT* involved documents disclosed to the DCCA who was auditing MIT on behalf of the DOD and DOD was the party charged with litigating any disputes over billing.¹⁸¹ DOD was in fact a conduit to the DCCA. This situation simply does not exist with an outside auditor of the financial statements.

Many courts have supported their no waiver conclusions by relying on the fact that the auditors were under ethical and professional obligations to maintain client confidentiality unless disclosure was required by the law or accounting standards.¹⁸² In *Textron*, the taxpayer similarly relies on E&Y's duty of confidentiality under Rhode Island state law and the AICPA Code of Professional Conduct. Rhode Island, like numerous other states, have a statute that provides an accountant cannot disclose confidential client information absent the client's consent, which accountant-client privilege does not preclude compliance with a subpoena.¹⁸³ The AICPA Code of Professional Conduct imposes a consistent rule.¹⁸⁴ Although these obligations may not guarantee confidentiality, they certainly preclude disclosure from "substantially increasing" the likelihood that *Textron's* workpapers would be disclosed to an adversary.

In addition, it is important to keep in mind that there is no subject matter waiver of the work product privilege; rather, waiver is on a document by document basis.¹⁸⁵ In *Textron*, E&Y did not retain a copy of the corporation's tax accrual workpapers and, therefore, any client confidential information would be blended in with E&Y's own analysis. As evidenced by the

¹⁸⁰ *Merrill Lynch*, 229 F.R.D. at 446.

¹⁸¹ *MIT*, 129 F.3d 681.

¹⁸² *Merrill Lynch*, 229 F.R.D. at 448; *Int'l Design Concepts*, 2006 U.S. Dist. LEXIS 36695, at *7; *Gutter*, 1998 U.S. Dist. LEXIS 23205, at *9; *Gramm*, 1990 WL 142404, at *5 n8.

¹⁸³ R.I. St. § 5-3.1-23.

¹⁸⁴ AICPA Professional Standards, ET § 301.01, *Confidential Client Information* (AICPA 1992).

¹⁸⁵ 8 Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, *Federal Practice & Procedure* § 2024 (2009); see, e.g., *Bramlette*, 1993 WL 338980, at *3; *In re Air Crash Disaster*, 133 F.R.D. at 527.

above-quoted passage from *Arthur Young*, many different sources go into the preparation of E&Y's workpapers and, unless a specific privileged client record was included in those workpapers,¹⁸⁶ it is difficult to see how the First Circuit could do anything but affirm the District Court's decision in *Textron*.

CONTROL OVER AUDITORS' WORKPAPERS.

A final issue addressed by the First Circuit in *Textron* is whether the summons should be enforced against Textron for E&Y's workpapers. Under Fed. R. Civ. Proc. 34, a party is required to produce and allow inspection of otherwise discoverable documents that are in its possession, custody, or control.¹⁸⁷ Here, the presumption is that E&Y's own workpapers are not privileged based on *Arthur Young* and, if relevant, are otherwise discoverable.

To defeat the summons for E&Y's workpapers, Textron relied on the Rhode Island statute and the AICPA Code of Professional Conduct ET § 501, both of which provide that the accountant's workpapers are the property of the accountant.¹⁸⁸ As noted above, Textron did not have a copy of the workpapers and, because ownership vested in the auditor, it also did not have custody of the documents. The only real issue is whether Textron had sufficient control over the workpapers so that it is required to produce them. Courts vary on whether discovery is required only where there is legal right to obtain the documents or also where there is a practical ability to obtain them.¹⁸⁹ Either way, it is a very fact specific determination,¹⁹⁰ which in this particular instances requires a review of state law and the accounting standards.

¹⁸⁶ In Delaware and Maryland, the state law specifically provide that an accountant's workpapers do not include client provided records. Code Del. Regs. 24, 100 Board of Accountancy Rules and Regulations, Section 13.2; Code of Maryland, § 2-502(a)(2).

¹⁸⁷ See also 8A Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, Federal Practice & Procedure § 2210 (2009).

¹⁸⁸ R.I. Gen. Laws § 5-3.1-22; AICPA Professional Standards, ET § 501, *Acts Discreditable* (AICPA 2006)

¹⁸⁹ 8A Charles Alan Wright, Arthur R. Miller, & Richard L. Marcus, Federal Practice & Procedure § 2210 (2009).

¹⁹⁰ *Id.*

In many states, the auditor is required to provide the client with a copy of the audit workpapers “to the extent that such workpapers include records that would ordinarily constitute part of the client’s records and are not otherwise available to the client.”¹⁹¹ It is unlikely that an auditor’s independent analysis of a client’s tax reserves would ever be deemed to be an ordinary client record. In these states, therefore, the client would not likely have the requisite control to be required to produce the auditor’s workpapers. Rhode Island did not adopt this rule.

However, the AICPA Code of Professional Conduct provides that, if a client requests documents from the auditor, the auditor must provide client records but not the auditor’s workpapers unless otherwise required to do so by federal or state law.¹⁹² After the Sarbanes-Oxley Act of 2002, the PCAOB adopted interim auditing standards, which recognized an auditor’s duty of confidentiality but also recognized that there are occasions where auditors are including required by law, regulation, or audit contract to provide a “regulator” with access to workpapers.¹⁹³ Because of the risk of further disclosure can occur if copies are provided to the regulator, these standards set forth the procedures that an auditor should take upon a request for the audit workpapers.¹⁹⁴ If a regulator requests the documents, the auditor should advise the client, make arrangements for a review of the workpapers, maintain control over the workpapers, and consider submitting a letter setting forth the terms of the review.¹⁹⁵ Importantly, the auditor must maintain custody and control to ensure the integrity of the workpapers and confidentiality of client information.¹⁹⁶ Importantly, without client consent, the auditor should not agree that

¹⁹¹ See, e.g., N.H. Rev. Stat. § 309-B:19; Maine Rev. Stat. § 12280; Mass. Code of Regs., § 3.03.

¹⁹² AICPA Professional Standards, ET § 501, *Acts Discreditable* (AICPA 2006).

¹⁹³ PCAOB Interim Auditing Standards, AU § 9339A.01, *Working Papers: Auditing Interpretations of Section 339A* (AICPA 2003). Similar rules existed prior to the Sarbanes-Oxley Act of 2002. See AICPA Auditing Standards, AU § 9339.01, *Working Papers: Auditing Interpretations of Section 339* (AICPA 2002).

¹⁹⁴ *Id.*

¹⁹⁵ PCAOB Interim Auditing Standards, AU § 9339A.02, *Working Papers: Auditing Interpretations of Section 339A*; AICPA Auditing Standards, AU § 9339.02, *Working Papers: Auditing Interpretations of Section 339*.

¹⁹⁶ PCAOB Interim Auditing Standards, AU § 9339A.03, *Working Papers: Auditing Interpretations of Section 339A*; AICPA Auditing Standards, AU § 9339.03, *Working Papers: Auditing Interpretations of Section 339*.

the regulator can provide any of the information to another third party.¹⁹⁷ If the client requests to review the workpapers before allowing the regulator access, the auditor should allow access but maintain control of the documents.¹⁹⁸ For purposes of this standard, PCAOB specifically notes that “[t]he guidance in this Interpretation does not apply to requests from the Internal Revenue Service, . . . or subpoenas.”¹⁹⁹ The auditing standards do not otherwise provide for client requests for audit workpapers. Given these standards require the auditor to maintain custody and control of the workpapers, Textron arguably did not have the requisite control over E&Y’s workpapers to be required to produce them.

CONCLUSION

Although the outcome in *Textron* is far from certain, there is still an emerging line of authority that supports the proposition that tax-sensitive documents can be subject to a bona claim of work product privilege. As for tax accrual workpapers in particular, taxpayers have been assessing the hazards of litigation for years and these assessments would not be done “but for” the risk of litigation. FIN-48 does not change the nature of these analyses. Under the majority view, a document can have a dual purpose of facilitating the issuance of accurate financial statements and still be protected work product. As for the IRS’ policy on seeking tax accrual workpapers, the IRS can change its current policy of restraint whenever it wants, just as it did in 2002. Importantly, the documents prepared today will be the subject of the future policy, not the current policy. As a result, a “wait-and-see” approach to privilege protection is risky. Moreover, the state tax authorities do not necessarily share this policy of restraint. Even if

¹⁹⁷ PCAOB Interim Auditing Standards, AU § 9339A.04, *Working Papers: Auditing Interpretations of Section 339A*; AICPA Auditing Standards, AU § 9339.04, *Working Papers: Auditing Interpretations of Section 339*.

¹⁹⁸ PCAOB Interim Auditing Standards, AU § 9339A.14, *Working Papers: Auditing Interpretations of Section 339A*; AICPA Auditing Standards, AU § 9339.14, *Working Papers: Auditing Interpretations of Section 339*.

¹⁹⁹ PCAOB Interim Auditing Standards, AU § 9339A n2, *Working Papers: Auditing Interpretations of Section 339A*; AICPA Auditing Standards, AU § 9339.14 n2, *Working Papers: Auditing Interpretations of Section 339*.

the IRS does not ask for the tax accrual workpapers or other tax-sensitive documents, the states may. In addition, states are increasingly sharing information with other states and with the IRS. The work product privilege is alive and well in the tax world, and precautions should be taken to protect tax-sensitive documents.