Textron and Workpaper Confidentiality

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The recent Textron decision should prompt companies to revisit the manner by which they handle the creation, management and production to third parties of documents comprising tax accrual workpapers and Financial Accounting Standards Board Interpretation No. 48 (FIN 48) supporting documentation (collectively TAW). Textron succeeded in protecting the confidentiality of its TAW under the work product doctrine, but IRS Chief Counsel Donald Korb has indicated that the resolution of TAW confidentiality is far from settled: "Nothing in the decision undermines the IRS policy of seeking tax accrual workpapers when appropriate." 2007 TNT 170-1 (August 30, 2007). In this same context, the IRS has implemented a robust training program for Examination agents on interpreting this material. Further, the Senate’s Permanent Subcommittee on Investigations (PSI) recently sent requests to more than 100 companies for details of their FIN 48 disclosures, and, although documents were not requested, one might expect that TAW will be the subject of supplemental requests.

Textron Preserves Confidentiality of Its Workpapers

In US v. Textron Inc., No. 1:06-cv-00198 (D.R.I., Aug. 29, 2007), the court held that Textron’s TAW were protected work product not subject to disclosure pursuant to an IRS administrative summons. At the outset, the court noted that "[b]ecause there is no immutable definition of the term ‘tax accrual workpapers,’ the documents that make up a corporation’s ‘tax accrual workpapers’ may vary from case to case." Textron, slip op. at 4. Textron’s TAW consisted of spreadsheets for the current and previous taxable years listing items that Textron’s in-house tax counsel anticipated could be challenged by the IRS. The evidence presented by Textron established that the TAW
contained counsel’s evaluations of the litigating hazards of each item, as well as back-up documentation including notes, short memos, or e-mails from other in-house attorneys. The TAW did not contain factual information.

The court found that the TAW contained information potentially protected as work product, the attorney-client privilege, and the tax practitioner-client (I.R.C. § 7525) privileges. Textron’s disclosure of the information to its auditor waived the attorney-client privilege and the tax practitioner-client privilege. However, the court held that work product protection was not similarly waived because the independent auditor was not a potential adversary or acting on behalf of a potential adversary. Moreover, the court noted that the auditor had a professional obligation of confidentiality and had expressly agreed to treat the TAW as confidential and to not disclose the information in the TAW.

Protecting the Confidentiality of Corporate TAW

The Textron decision evidences that protecting the confidentiality of TAW is possible. There are strategic as well as practical considerations to be taken into account as companies analyze their approach to handling TAW. Companies that do not lay the proper foundation to support a claim of work product protection forfeit the ability to make strategic choices concerning when and whether to assert such a claim in response to IRS or other third party requests.

The first step to improve a company’s probability of success in TAW work product disputes is to craft a precise definition of what constitutes TAW. As noted by the court in Textron, TAW should be limited to confidential information. Work product is determined on a document-by-document basis, so to the extent documents included in the TAW consist of factual information, they are unlikely to be protected. Also relevant is the legal standard in the relevant jurisdiction determining whether a document was created in anticipation of litigation. As the Textron court stated, depending on the jurisdiction, courts apply either the “primary purpose” or the “because of” test in applying the work product doctrine. Under the “primary purpose” test, a document is protected from disclosure “as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation.” Textron, slip op. at 21 (citing US v. El Paso, 682 F.2d 530, 542 (5th Cir 1982)). Under the more inclusive “because of” test, a document is protected if “the document was prepared or obtained ‘because of’ the prospect of litigation.” Id. (citing US v. Adlman, 134 F.3d 1194 (2d Cir. 1998)).

Determining what qualifies as work product in the relevant jurisdiction is the first step to preserving its confidentiality.

The second step is to obtain a signed nondisclosure letter from the auditor acknowledging the receipt of, and the duty to keep confidential, information that is protected work product. At its hearing, Textron personnel testified that it maintained the confidentiality of its TAW. Textron used sealed envelopes, identified as “confidential,” to deliver all work product material to its attorneys and took measures so that only attorneys participated in discussions of the issues in the TAW. Textron reviewed the information with its auditors only after reaching agreement as to maintaining its confidentiality, and its auditors were not permitted to retain a copy. When the IRS audit concluded, the TAW “would be locked away in a locked cabinet.”

The primary consideration in obtaining a “nondisclosure letter” with an outside auditor is to anticipate, and protect against, future arguments by governmental agencies or other third parties that the information is not protected work product or that such protection has been waived.
The nondisclosure letter should, at a minimum, describe the confidential nature of the information and include the following statements:

- The disclosed information is protected by one or more evidentiary privileges, including the work product doctrine and the attorney-client privilege.
- The auditor acknowledges the evidentiary privileges and agrees that the disclosure of such information by the company to the auditor does not alter or diminish such privileges.
- The auditor has statutory and professional confidentiality obligations with respect to the disclosed information, and will not disclose or produce such information without the express written consent of the company.
- The auditor will immediately notify the company prior to responding to any requested disclosure of the information.

The company should customize the above statements depending on the facts and circumstances. However, the company should be aware that it may be difficult to negotiate a more advantageous nondisclosure letter in future dealings with the auditor once an initial letter agreement is secured. In our experience, companies are best served by negotiating letters with their auditors that incorporate the particular processes and procedures of that company.

A carefully drafted nondisclosure letter alone will not ensure that a waiver has not occurred, and other procedures or protocols should be implemented. As Textron did, companies should give careful thought in adopting document control protocols that are consistent with their business practices and take into consideration the importance of maintaining physical segregation of TAW and ensuring limited accessibility. Access to segregated TAW should be restricted, with restrictions clearly defined and permitted parties identified. Protected channels of communication between permitted parties should also be established. E-mail communication should be included in this analysis; for example, care should be taken in crafting group e-mail composition and restrictions implemented concerning copying and forwarding.

**Anticipated Disputes**

All indications are that the government will continue to inquire into taxpayers’ analyses of their tax positions. The IRS is increasingly asking for “workpapers” in the context of IRS audits involving “Tier 1” issues. For example, a recent Tier 1 issue standard IDR seeks all “accounting or legal advice, studies or opinions.” The IRS may seek similar information from the taxpayer’s accountant through a third-party summons. One such recent summons required production of “all workpapers” supporting, or otherwise relating to, the amounts reported on a particular tax form.

The IRS policy remains one of self-restraint concerning requests for TAW, with requests generally made only in connection with listed transactions or in cases involving unusual circumstances, e.g., in the case of a restatement of earnings. Notwithstanding the current policy of restraint, the IRS has indicated that it intends to revisit this policy as appropriate, and it is possible that changes may be made in connection with the examination of tiered issues and/or transactions of interest.

The IRS is not the only government entity that has indicated an interest in corporate analyses of tax positions. As referenced above, the PSI recently mailed a questionnaire to more than 100 companies. The transmittal letter states that the PSI is “currently reviewing matters relating to corporate tax benefits, particularly, but not exclusively, with respect to transactions, activities, or structures involving foreign entities or jurisdictions.” The questionnaire inquires as to the recipient’s implementation of FIN 48, and requests
detailed information of the company’s foreign activities, including a description of “any United States tax position or group of similar tax positions that represents five percent or more of your total UBI [unrecognized tax benefits] for the period.”

The questionnaire suggests that the PSI is suspicious of tax positions involving foreign jurisdictions and is gathering facts in anticipation of a more detailed investigation. Although this initial inquiry does not request documents, supplemental inquiries likely will, and the recipients of those requests will face the same work product issues as for requests from the IRS.

As noted in Textron, the test used to determine whether a document is protected work product is not uniform among jurisdictions, and responding to the request therefore requires an understanding of the applicable circuit’s position. Although enforcement of an IRS summons would occur in a company’s domiciliary state, and that jurisdiction’s law would therefore control, the challenge by the government of resistance of a PSI request would occur in the District of Columbia, which applies the “because of” test. EEOC v. Lutheran Social Services, 186 F.3d 959 (DC Cir. 1999).

It is also important for companies to understand the application of the work product doctrine to requests from state and local agencies, given that the IRS and state and local agencies often share tax information for compliance and enforcement purposes.

Conclusion

Although we expect this area of the law to continue to develop, the taxpayer victory in Textron underscores the opportunity available to companies to maintain the confidentiality of work product under certain circumstances. Current indications are that the IRS will appeal Textron, although that decision has not been formally confirmed. Any appeal is likely to address the issue of whether the Textron court properly applied the holding of United States v. Arthur Young & Co., 465 US 805 (1984), particularly as to whether the disclosure of FIN 48 determinations in public documents effectuates a waiver as to the underlying work product documents.
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