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Tensions are rising from IRS victory in *Textron* case

By Sara Shanahan

Corporate clients will likely be approaching their next audit with extra care. The reason: A recent federal appeals court decision has made it clear that information previously viewed as private under the "work-product doctrine" may no longer be protected. That means companies will now think twice before providing such information to their auditors.

Indeed, the First Circuit Court of Appeals' ruling in *U.S. v. Textron* is creating a lot of uncertainty. While it is likely that it will be appealed to the Supreme Court, the outcome is far from certain. The court could uphold the ruling, reverse it, or simply leave it in the hands of the lower courts by declining to hear the case.

Until the matter is clearly settled, companies will be taking interim steps to make sure that they aren't putting their "private" papers in jeopardy by sharing them with auditors. And that is likely to create some tensions as businesses and auditors try to balance the need for disclosure against the corporate imperative to protect internal legal analyses from potential adversaries.

Currently, the ruling only affects the First Circuit, which includes Massachusetts, Maine, New Hampshire, Rhode Island and Puerto Rico. And it also only deals with the issue of Internal Revenue Service access to tax accrual work papers. Still, the decision raises some important questions about the future ability of companies to protect a wide range of documents commonly prepared as part of their ongoing business operations but that are also prepared in anticipation of future litigation.

Issued in August, the ruling takes clear aim at the work-product doctrine, which has in the past protected papers prepared "in anticipation of litigation." This standard, in effect, prevented potential opponents from getting a roadmap to corporate thinking on issues that might later end up in court. As such, a company could have an attorney candidly assess its position on an issue without fear that such an evaluation might later be used in legal action taken against the company.

But in a 3-2 decision, the First Circuit Court of Appeals adopted a more narrow definition of privileged documents, saying that to qualify for protection under the work-product doctrine, they must be prepared "for use in possible litigation." In the *Textron* case, that gave the IRS access to documents drawn up by the defense contractor to assess whether its tax liability calculations would survive a possible IRS audit. The court found that the documents were not protected by the attorney-client privilege because Textron had already allowed its accountants a brief look at the documents to demonstrate how it was calculating tax reserves.

Because *Textron* deals with specific tax issues, it is unclear how broadly the ruling will be applied. The IRS audit, for example, focused on tax shelters, with the majority opining that the IRS should not be prevented from uncovering any under-reporting of corporate taxes. But a strongly worded dissent by the minority took the majority to task, saying that in trying to craft a ruling favorable to the IRS, the majority "has thrown the law of work-product protection into disarray."

The minority went on to call on the Supreme Court to intervene to create a single standard for the country. Since the rules for work-product protection now vary from circuit to circuit, there will be a great deal of corporate tiptoeing around the work-product issue until the Supreme Court's position on the matter is clear.

Thus, auditors unaware of concerns raised by the Textron ruling may be surprised to find themselves navigating new terrain with their corporate clients. For one thing, clients may provide less-detailed back-up memos than they have in the past to support their tax reserves

or other audit items. They may even be reluctant to orally discuss the contents of their back-up memos, since allowing an outsider access to such information could be considered a waiver of the attorney-client privilege and work-product protection.

Then, too, there is the fear that the IRS could use this ruling to push for the disclosure of key memos not shared with auditors. It could, for example, seek documents never shared with auditors that address tax reserve issues, arguing that the memos do not provide legal advice and are therefore neither privileged nor protected by work-product rules.

Auditors should be aware that their clients may also be considering the implications of the *Textron* decision in areas extending well beyond tax-reserve calculations. If a document is prepared in order to inform the auditor of pending litigation, rather than to assist with the litigation, an aggressive adversary might actually seek to obtain it during discovery.

Until businesses know if the ruling will stand, they would be wise to assume that everything shared with auditors may someday be disclosed. Thus accountants may find that they have to push hard to get the information needed for a proper audit - and they should not be surprised to find clients pushing back.

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