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## WORK PRODUCT IMMUNITY FOR ATTORNEY-CREATED TAX ACCRUAL WORKPAPERS?: THE AFTERMATH OF *UNITED STATES V. TEXTRON*

by

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## I. INTRODUCTION

*United States v. Textron, Inc.*<sup>1</sup> has been a high-profile case involving the applicability of work product immunity to attorney-prepared documents known as “tax accrual workpapers.” The *Textron* decision is worthy of careful analysis because it is the first decision at the Court of Appeals level to consider work product immunity for attorney-created tax accrual workpapers. The U.S. District Court ruled that work product immunity applied to the tax accrual workpapers, the First Circuit Court of Appeals ruled that work product immunity did not apply, and on May 24, 2010, the United States Supreme Court denied the *certiorari* petition in the case. Accordingly, the *Textron* decision is final, and it is appropriate to review the scope of work product immunity as it may apply to tax accrual workpapers. The denial of *certiorari* means that the lower federal courts must decide, without the benefit of Supreme Court guidance in *Textron*, whether work product immunity applies to attorney-prepared tax accrual workpapers.

I conclude that attorney-prepared tax accrual workpapers technically do not and, as a matter of policy, should not qualify for protection as work product because of (1) the significant role of tax accrual workpapers in financial accounting and federal income tax reporting and (2) the specific statutory authority of section 7602 empowering the Internal Revenue Service (IRS) to collect information from taxpayers. I propose that courts embrace a doctrine of “tax exceptionalism” for purposes of work product immunity cases, and this doctrine acknowledges the unique public policy considerations that support effective tax administration. Permitting discovery of tax accrual workpapers raises significant fairness issues, but discovery of these workpapers is consistent with extant caselaw regarding work product immunity as well as with the purposes underlying work product immunity.

Part II provides background information necessary to the analytical heart of the article in Part III, which provides (1) a policy-based analysis of whether tax accrual workpapers should be protected by work product immunity and (2) a technical analysis of whether the various requirements of Federal Rule of Civil Procedure Rule 26(b)(3) are satisfied with respect to attorney-prepared tax accrual workpapers.

## II. BACKGROUND

This Part provides a summary of the *Textron* case and also an overview discussion of topics that are necessary components to the analysis of whether work product immunity should apply to attorney-prepared tax

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1. 577 F.3d 21 (1st Cir. 2009), *vacating and remanding*, 507 F. Supp. 2d 138 (D.R.I. 2007), *cert. denied.*, 130 S.Ct. 3320 (2010).

accrual workpapers: (1) the IRS summons authority, (2) the meaning of the phrase "tax accrual workpapers," (3) the general scope of the work product immunity doctrine, and (4) synopses of the key cases regarding application of the work product immunity to tax accrual workpapers.

#### A. The *Textron* Case

The *Textron* case involved Textron, Inc. (Textron), and Textron Financial Corporation ("TFC"), a subsidiary of Textron that provided commercial lending and financial services. Textron was a publicly traded company and was required by securities regulation laws administered by the Securities and Exchange Commission to submit financial statements that had been certified by a public accounting firm.<sup>2</sup> The certified public accountant (CPA) determines whether the financial statements have been prepared in accordance with generally accepted accounting principles and, if so, the CPA may certify whether the financial statements, taken as a whole, fairly present the financial position and operations.

The professional practice rules of the accounting profession applicable in *Textron* required disclosure of contingent liabilities on the balance sheet.<sup>3</sup> One of the contingent liabilities disclosed by Textron was a dollar amount reserve for unpaid federal taxes as to which liability might exist if the Textron federal income tax returns were audited and challenged by the IRS. On its balance sheet, Textron aggregated all the contingent tax liability items (only a total amount was disclosed; there was no listing of each contingent tax liability item).<sup>4</sup>

Textron personnel prepared tax accrual workpapers to support its reserve for federal taxes.<sup>5</sup> For the years in question in the *Textron* litigation, the tax accrual workpapers consisted of (1) a spreadsheet and (2) "backup workpapers."<sup>6</sup> The spreadsheet contained: (1) a listing of items on Textron's tax returns, "which, in the opinion of Textron's counsel, involve issues on which the tax laws are unclear, and, therefore, may be challenged by the

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2. See 15 U.S.C. §§ 781, 78mi; 17 C.F.R. § 210.2-01.

3. See *Textron*, 577 F.3d at 23. It is noteworthy that both a contingent reserve for taxes and tax accrual workpapers are required not only by publicly traded companies, but also by anyone seeking certified financial statements for purposes of reporting financial results to owners, creditors, and others.

4. *Textron*, 507 F. Supp. 2d at 143.

5. With respect to the tax years in controversy, Textron had six tax attorneys and a number of CPAs in its tax department, but TFC's tax department consisted only of CPAs. Consequently, TFC relied on attorneys in Textron's tax department, private law firms, and outside accounting firms for additional assistance and advice regarding tax matters.

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

IRS,”<sup>7</sup> (2) a percentage estimate by Textron’s counsel as to Textron’s chances of prevailing in litigation as to each item,<sup>8</sup> and (3) the dollar amount reserved as to each item to reflect the possibility that Textron might not prevail in litigation.<sup>9</sup> The backup workpapers consisted of: (1) the previous year’s spreadsheet and (2) earlier drafts of the current-year spreadsheet together with notes, emails, and memoranda written by Textron’s in-house tax attorneys reflecting their opinions as to which items should be included on the spreadsheet and the related hazard of litigation percentages.<sup>10</sup>

The Textron tax accrual workpapers were prepared in the following sequence: (1) “Textron’s accountants [would] circulate to Textron’s attorneys a copy of the previous year’s tax accrual workpapers together with recommendations” regarding proposed revisions for the current year, (2) Textron’s attorneys would “review those materials, propose further changes to the spreadsheets and hazard [of] litigation percentages,” and then return the materials to the accountants who would compile the information and perform the calculations necessary to compute the tax reserve amounts, and (3) the attorneys and accountants would meet to give their approval so that the accountants could finalize the workpapers.<sup>11</sup> According to the District Court, Textron’s tax lawyers were “centrally involved” in preparing Textron’s tax accrual workpapers.<sup>12</sup>

During the course of a financial audit by Ernst & Young (“E&Y”) for purposes of certifying Textron’s financial statements with respect to the taxable year in controversy in *Textron*, Textron permitted E&Y to examine (but not keep a copy of) the tax accrual workpapers with the understanding that the information was to be treated by E&Y as confidential. The examination of the Textron tax accrual workpapers was permitted so that E&Y could evaluate the adequacy of Textron’s reserve for contingent tax liabilities.

The tax returns of the Textron family of entities often were audited by the IRS. In seven of Textron’s eight previous audit “cycles” (which involved audits of more than one taxable year), the IRS proposed various deficiencies in tax.<sup>13</sup> Textron had appealed various “unagreed” issues to the

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7. *Id.* at 142.

8. The Court of Appeals added to that description by noting that, in some cases, the spreadsheet entries estimated the probability of IRS success at 100 percent. See *Textron*, 577 F.3d at 25.

9. *Textron*, 507 F.Supp. 2d at 142-143.

10. *Textron*, 507 F. Supp. 2d at 143. The District Court found that the workpaper files did not contain any “factual” materials, such as transaction documents. *Id.* The absence of “factual” material is relevant with respect to application of work product immunity, as discussed in Part II.D.3.

11. *Id.*

12. *Textron*, 577 F.3d at 24.

13. *Textron*, 507 F.Supp. 2d at 141-42.

IRS Appeals function (an internal IRS fresh-look appeal of the deficiencies proposed by IRS audit personnel), and Textron conceded that it usually settled issues with the IRS, but three of those unagreed issues were litigated in federal court.<sup>14</sup>

The *Textron* case results from Textron's 2001 taxable year federal income tax return. During the 1998-2001 audit cycle examination of Textron's 2001 return, the IRS learned that TFC had engaged in nine "sale-in, lease-out" (sometimes referred to as "SILO") transactions involving telecommunications equipment and rail equipment.<sup>15</sup> The IRS had classified such transactions as "listed transactions" because it considered them to be of a type engaged in for the purpose of tax avoidance.<sup>16</sup>

The IRS issued to Textron more than 500 Information Document Requests in connection with the 1998-2001 audit cycle, and Textron complied with all of them, except for the ones seeking its tax accrual workpapers. The IRS eventually issued an administrative summons pursuant to Internal Revenue Code section 7602 seeking the tax accrual workpapers, which were defined in the summons to include:<sup>17</sup>

[A]ll accrual and 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. . . .<sup>18</sup>

Textron declined to provide the requested workpapers, and the government commenced a summons enforcement action pursuant to section 7604. In the section 7604 summons enforcement proceeding, the issues before the District Court related to whether the tax accrual workpapers could be protected by any of three potentially applicable doctrines: (1) attorney-client privilege, (2) section 7525 federally authorized tax practitioner privilege, or (3) work product immunity.

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14. *Id.*

15. *Id.* at 142.

16. *Id.*; see generally Notice 2005-13, 2005-1 C.B. 630; IRC § 6011; Reg. § 1.6011-4(a), (b)(2); IRC § 6707A.

17. The § 7602 summons authority is discussed in Part II.B.

18. *Textron*, 507 F. Supp. 2d at 142.

The District Court, in its findings of fact, stated that according to Textron officials, “Textron’s ultimate purpose in preparing the tax accrual workpapers was to ensure that Textron was ‘adequately reserved with respect to any potential disputes or litigation that would happen in the future.’”<sup>19</sup> The District Court also found it reasonable to infer that Textron’s desire to establish adequate reserves also was prompted, in part, by its wish to satisfy an independent auditor that Textron’s reserve for contingent liabilities satisfied the requirements of generally accepted accounting principles so that a “clean” opinion would be given with respect to the financial statements filed by Textron with the SEC.<sup>20</sup>

The District Court held that neither the attorney-client privilege nor the section 7525 privilege applied, and those holdings were not challenged on appeal. The District Court held that work product immunity did apply to the tax accrual workpapers, but the First Circuit (in an *en banc* three to two majority) reversed and held that work product immunity did not apply. The First Circuit *en banc* majority considered Textron’s tax accrual workpapers as having been created to obtain certified financial statements and not created in anticipation of litigation.<sup>21</sup> The *en banc* majority reviewed and accepted the finding of the District Court that Textron wanted to be “adequately reserved” to cover liabilities that might be determined in litigation. The *en banc* majority also noted that the District Court did not say that the Textron tax accrual workpapers were prepared for use in possible litigation, and the

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19. *Id.* at 143. The District Court went on to observe that there would have been no need for Textron to create a reserve for contingent taxes “if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding.” *Id.* at 150. I consider this statement of the District Court to be incorrect because Textron would have been required to have tax accrual workpapers in all cases if it wanted certified financial statements (which it was required to have under the applicable federal securities laws). See text accompanying notes 35-37.

20. *Id.* at 150.

Thus, while it may be accurate to say that the workpapers helped Textron determine what amount should be reserved to cover any potential tax liabilities and 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.

*Id.* The word “useful” in the foregoing quotation is inapposite; the tax accrual workpapers were required for Textron to obtain the “clean” opinion from E&Y.

21. See *Textron*, 577 F.3d at 27-28 (purpose of the work papers was to make book entries, prepare financial statements, and obtain a “clean” audit).

*en banc* majority stated that, had the District Judge made such a finding, it would have held such a finding to be clearly erroneous.<sup>22</sup>

The *en banc* majority addressed a suggestion intimated by a Textron witness that, if litigation were to occur, the tax accrual workpapers could be useful to Textron in that litigation. According to the *en banc* majority, this assertion (1) was not supported by any detailed explanation, (2) was not adopted by the District Judge in his opinion, and (3) was “more than dubious” on the merits because the “main aim” of the tax accrual workpapers was to identify and quantify vulnerable tax return positions, not to prepare for litigation.<sup>23</sup>

### B. The IRS Summons Authority

Section 7602 grants extremely broad authority to the IRS to collect information. Section 7602 authorizes the IRS, for the purpose of ascertaining the correctness of any return of tax that has been filed, to summon a representative of a taxpayer to produce “books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material.”<sup>24</sup> This is an administrative summons requiring no judicial approval, and this generous scope of authority reflects the willingness of Congress to grant very broad investigatory powers to the IRS to enforce the federal tax laws.<sup>25</sup>

In *United States v. Powell*, the Supreme Court held that a section 7602 summons is valid and enforceable if the IRS shows that (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the summons inquiry may be relevant to the legitimate purpose, (3) the information sought in the summons is not already within the possession of the IRS, and (4) the administrative procedures related to the summons that are required by the Internal Revenue Code have been satisfied.<sup>26</sup> The “legitimate purpose” requirement has been broadly construed, but the Court in *Powell* stated that a court may not permit its process to be abused and that such “an abuse would take place if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good

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22. See *id.*

23. *Id.* at 28.

24. IRC § 7602(a)(2).

25. See generally *United States v. Powell*, 379 U.S. 48 (1964), *United States v. Bisceglia*, 420 U.S. 141 (1975), *United States v. Euge*, 444 U.S. 707, 711 (1980), *United States v. Arthur Young & Co.*, 465 U.S. 805, 814 (1984); see also Bryan T. Camp, Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998, 56 Fla. L. Rev. 1 (2004).

26. *Powell*, 379 U.S. at 57-58.



faith of the particular investigation.”<sup>27</sup> The *Powell* legitimate purpose requirements are not trivial, but they are not particularly difficult for the IRS to satisfy in most cases because of the generous language of section 7602, which reflects the intent of Congress to authorize the IRS to obtain items of potential relevance without reference to its admissibility at trial.<sup>28</sup> The Supreme Court in *Arthur Young* confirmed that section 7602 may be used by the IRS with respect to materials (such as tax accrual workpapers) not actually used in the preparation of the federal tax return.<sup>29</sup>

### C. Tax Accrual Workpapers

#### 1. Definition of Tax Accrual Workpapers

In *Arthur Young*, the Supreme Court defined tax accrual workpapers as “documents and memoranda relating to Young’s evaluation of [its client’s] reserves for contingent tax liabilities. Such workpapers sometimes contain information pertaining to [its client’s] financial transactions, identify questionable positions [its client] may have taken on its tax returns, and reflect Young’s opinions regarding the validity of such positions.”<sup>30</sup> It is clear that such tax accrual workpapers, if available to the IRS, would provide a “roadmap” for the IRS to identify issues worthy of audit,<sup>31</sup> and that is why taxpayers vigorously resist disclosure of tax accrual workpapers to the IRS.<sup>32</sup>

In *Textron*, the District Court explained that the meaning of tax accrual workpapers is not uniform.<sup>33</sup> Moreover, tax accrual workpapers may be created by different persons. The *Textron* tax accrual workpapers were

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27. *Id.* at 58.

28. See *Arthur Young*, 465 U.S. at 814.

29. See *id.* at 815.

30. *Arthur Young*, 465 U.S. at 808. *Arthur Young* is more fully discussed in Part II.D.4.b.

31. See *id.* at 813. The tax accrual workpapers would provide a resource for the IRS, if the IRS can get access to them, by “pinpoint[ing] 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,” and provide “an item-by-item analysis of the corporation’s potential exposure to additional liability.” *Id.*

32. This also raises the issue of whether disclosure to the IRS unfairly burdens the taxpayer, and this fairness issue is discussed in Part III.B.1.b.

33. See *United States v. Textron*, 507 F. Supp. 2d 138, 142 (2007). The variation occurs because companies organize their records in different ways. *Id.* at 142 n. 2. The IRS defined tax accrual workpapers in IRS Chief Couns. Notice 2004-101 (Jan. 22, 2004). For additional explanation, see I.R.M. 4.10.20.2, Audit Workpapers, Tax Accrual Workpapers, and Tax Reconciliation Workpapers Defined (07-12-2004).

prepared by both Textron attorney personnel (plus Textron in-house CPAs) and outside counsel.<sup>34</sup>

Realistically, the tax accrual workpapers in *Textron* were necessary because the E&Y CPA firm would not certify, without qualification, the financial statements unless Textron provided tax accrual workpapers (or Textron authorized E&Y to prepare tax accrual workpapers satisfactory to E&Y). Tax accrual workpapers are a necessity for a taxpayer seeking unqualified certified financial statements, which are required with respect to publicly traded companies such as Textron. In addition, tax accrual workpapers are required by the CPA in every situation in which financial statements are to be certified, even if there is no reserve for contingent taxes. The tax accrual workpapers must (1) provide the CPA with a reasonable understanding of what the federal tax issues are and how the taxpayer reported each on the previously filed federal tax returns and (2) persuade the CPA that the amount of the reserve for contingent taxes (if any) is reasonable.<sup>35</sup> The CPA must certify that the financial statements fairly present the financial position and operations for the specified period, so the CPA has just as much of a duty to identify and adjust for an overstatement of federal taxes (the contingent "reserve" for taxes actually would be a deferred tax asset rather than a liability)<sup>36</sup> as for an understatement of federal taxes (the contingent reserve for taxes would be a liability).<sup>37</sup>

## 2. IRS Policy of Restraint with Respect to Tax Accrual Workpapers

In the 1984 *Arthur Young* decision, the Supreme Court made explicit reference to the then-existing IRS policy of restraint with respect to tax accrual workpapers,<sup>38</sup> and the Court complimented the IRS administrative sensitivity to the intrusiveness concerns expressed by the accounting profession. The favored administrative sensitivity was based on the

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34. See *Textron*, 507 F. Supp. 2d at 143.

35. See Public Company Accounting Oversight Board, AU § 9326, Evidential Matter: Auditing Interpretation of § 326, ¶¶ 11-17, available at <http://pcaobus.org/Standards/Auditing/Pages/AU9326.aspx>.

36. Large banks, for example, often have deferred tax assets because they are not permitted to use for tax purposes the "reserve" method with respect to loan losses that have been claimed for financial accounting purposes (instead, the loss is allowed for federal income tax purposes when the loan is disposed of or becomes worthless). See IRC § 585; Lee A. Sheppard, Alternatives to the Obama Banking Fee, 126 Tax Notes 898, 905 (Feb. 22, 2010).

37. See Statement of Financial Accounting Standards No. 109, ¶¶ 16-25, available at [www.fasb.org/pdf/fas109.pdf](http://www.fasb.org/pdf/fas109.pdf); Christopher H. Hanna, Mark R. Martin, Michael J. Donohue, E. Daniel Leightman & Cym H. Lowell, Corporate Income Tax Accounting, § 2.09 (2007).

38. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 820-21 (1984).

significant (and self-imposed) IRS requirements and limitations with respect to the issuance of a section 7602 summons seeking tax accrual workpapers.

After *Arthur Young*, which permitted the IRS to summon tax accrual workpapers from CPAs, the IRS continued its policy of “restraint” regarding tax accrual workpapers.<sup>39</sup> Under this continuing policy of restraint, the IRS would not seek tax accrual workpapers in all audits in which tax accrual workpapers might exist. Even though the workpapers would be very helpful to the IRS to fulfill its obligation to ensure that taxpayers are in compliance with the tax laws, the IRS declined to seek tax accrual workpapers in all cases, thus limiting the intrusiveness of the IRS into the affairs of taxpayers.

#### D. Work Product Immunity

##### 1. Overview

Work product immunity<sup>40</sup> provides privacy that protects an attorney’s preparation for litigation under an adversarial system of justice.<sup>41</sup> If applicable, the immunity protects from discovery those documents and other tangible things prepared in anticipation of litigation. Work product immunity is not an absolute privilege, however, and the immunity generally may be overcome by an appropriate showing of need by the party seeking the discovery.<sup>42</sup> The work product doctrine derives from the famous Supreme Court case of *Hickman v. Taylor*,<sup>43</sup> which is discussed in Part II.D.2, and the

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39. See Announcement 84-46, 1984-18 I.R.B. 18. For a discussion of the IRS policy of restraint before the *Arthur Young* decision, see Mortimer Caplin, IRS Toughens Its Stance on Summoning Accountants’ Tax Accrual Workpapers, 53 J. Tax’n 130 (1980); Mortimer Caplin, Government Access to Independent Accountants’ Tax Accrual Workpapers, 1 Va. Tax Rev. 57 (1981).

40. Technically, the work product protection is better thought of not as a privilege, but as an immunity from discovery. See *Diamond State Ins. Co. v. Rebel Oil Co.*, 157 F.R.D. 691, 698-99 (D. Nev. 1994); *City of Philadelphia v. Westinghouse Elec. Corp.*, 210 F.Supp. 483, 485 (E.D. Pa. 1962); Sherman L. Cohn, The Work Product Doctrine: Protection, Not Privilege, 71 Geo. L.J. 917 (1983). The Supreme Court has referred to work product protection as a “privilege” in *F.T.C. v. Grolier, Inc.*, 462 U.S. 19, 25 (1983), and in *N.L.R.B. v. Sears, Roebuck & Co.*, 421 U.S. 132, 154-55 (1975), and as a “qualified privilege” in *United States v. Nobles*, 422 U.S. 225, 237-38 (1975), but I will refer to the doctrine as an “immunity” because the work product protection is not an absolute privilege (as discussed in the text).

41. See generally Edna S. Epstein, *The Attorney-Client Privilege and the Work Product Doctrine*, Volume 2, Part 2. The Work Product Protection (5th ed. 2007).

42. See generally Fed. R. Civ. P. 26(b)(3), which is discussed in Part II.D.3. Opinion work product enjoys more robust protection, as discussed in Part III.C.3.

43. *Hickman v. Taylor*, 329 U.S. 495 (1947).

Federal Rules of Civil Procedure now provide work product immunity in Rule 26, which is discussed Part II.D.3. Work product immunity arguably promotes the workings of the adversary system of justice in many ways.<sup>44</sup> The scope of work product immunity is far from clear, however, and work product protection is a frequently litigated discovery issue.<sup>45</sup>

Work product immunity exists at the crossroads of several potentially competing policies: (1) full and open pre-trial discovery under the Federal Rules of Civil Procedure,<sup>46</sup> (2) the need to protect an attorney's preparation for litigation under an adversarial system of justice, and (3) in the context of a federal tax proceeding, the public interest in facilitating tax compliance.<sup>47</sup> The discussion below in this Part considers *Hickman*, Rule 26, and other relevant caselaw.

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44. See Elizabeth G. Thornburg, Rethinking Work Product, 77 Va. L. Rev. 1515, 1525-26 (1991).

Work product immunity, its supporters believe, protects the adversary system in five, related ways. First, it encourages the most complete possible investigation. Second, it allows the advocate to commit the results of that investigation and other litigation-related thought processes to writing. Third, it discourages "sharp practices." Fourth, it allows surprise as a vehicle for encouraging truthful testimony. Fifth, it avoids forcing litigants to freeze their contentions too early in a lawsuit.

*Id.* at 1526. Thornburg does not accept that these five factors advance the adversary system, or that work product immunity actually has these effects. *Id.*

See also Steve R. Johnson, The Work Product Doctrine and Tax Accrual Workpapers, 124 Tax Notes 155 (2009).

*Hickman* and later cases indicate that five not-fully-independent values underlie the work product privilege. They are (1) the undesirability of calling attorneys as witnesses at trial, especially against their own clients; (2) avoiding a chilling effect on attorneys committing their views to paper, thereby undermining effective accounting supervision; (3) preserving a zone of privacy in which the attorney can develop theories and plan strategies for handling the case; (4) preventing the party seeking the documents (here the IRS) from gaining an unfair advantage, free-riding on the work of the taxpayer's advisers; and (5) maintaining the orderly operation of the legal system, forestalling inefficiency and sharp practice.

45. *Id.* at 160. See Jeff A. Anderson et al., Special Project, The Work Product Doctrine, 68 Cornell L. Rev. 760, 762-63 (1983).

46. The deposition-discovery rules are to be broadly and liberally construed. See *Hickman*, 329 U.S. at 507.

47. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 815-16 (1984).

## 2. *Hickman v. Taylor*

### a. *Protection for Attorney Work Product*

The famous *Hickman v. Taylor* case involved the sinking of a tug boat and the demise of several members of the crew.<sup>48</sup> Three days after the sinking, attorney Fortenbaugh was retained by the tug owners (and their underwriters) to defend them against potential claims and lawsuits related to the sinking. Eventually, interrogatories were directed to the tug owners. The particular interrogatories in controversy (1) inquired whether any statements of crew members had been taken and, if so, (2) requested production (a) of an exact copy of each written statement and (b) with respect to any oral statement, “in detail the exact provisions of any such oral statements or reports.”<sup>49</sup> The tug owners did not answer the interrogatories in controversy.

*Hickman* addresses the scope of work product protection, which requires balancing between potentially conflicting public policy considerations that (1) support reasonable and necessary inquiries to facilitate full and open pre-trial discovery and (2) seek to preclude unwarranted incursions into the privacy of an attorney’s work.<sup>50</sup> The Court stated that permitting discovery would contravene the public policy underlying the orderly prosecution and defense of legal claims, and discovery would constitute an unwarranted inquiry into the files and the mental impressions of an attorney.<sup>51</sup> The Court confirmed that it is essential that a lawyer be able to work within a zone of privacy, “free from unnecessary intrusion by opposing parties and their counsel,” and observed that, if the sought-after materials were available to opposing counsel on demand, attorneys might not reduce their thought processes to writing.<sup>52</sup> The result would be “[i]nefficiency, unfairness and sharp practices[,]” the effect of which on the legal profession would be demoralizing and would poorly serve the interests of the clients and the cause of justice.<sup>53</sup> In his concurring opinion, Justice Jackson observed that discovery was not intended to enable a lawyer to perform the lawyer’s functions “either without wits or on wits borrowed from the adversary.”<sup>54</sup>

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48. See *Hickman*, 329 U.S. at 498-99.

49. *Id.* at 499.

50. See *id.* at 497. Professor Thornburg describes this conflict as a “monumental clash.” Thornburg, *supra* note 44, at 1515.

51. See *Hickman*, 329 U.S. at 510.

52. *Id.* at 510-11.

53. *Id.* at 511.

54. *Id.* at 516 (Jackson, J concurring).

*b. Documents Created in the Ordinary Course of Business*

In *Hickman*, the Supreme Court identified, but did not develop, an important carve-out from the scope of work product immunity that is particularly relevant to tax accrual workpapers such as in the *Textron* litigation. In footnote nine of the *Hickman* opinion, the Court referred to English law regarding a privilege that extends to all documents prepared by or for counsel with a view to litigation. The relevant language quoted in footnote nine is: “Reports by a company’s servant, if made in the ordinary course of routine, are not privileged, even though it is desirable that the solicitor should have them and they are subsequently sent to him”<sup>55</sup> This “ordinary course of business” doctrine is discussed in Part II.D.3.e .

*3. Federal Rule of Civil Procedure 26(b)(3)*

After *Hickman*, several advisory groups proposed revisions to the Federal Rules of Civil Procedure regarding work product immunity, but none was adopted until 1970.<sup>56</sup> Accordingly, from the 1947 *Hickman* decision to the 1970 adoption of Federal Rule of Civil Procedure 26(b)(3), the scope of work product immunity was developed by caselaw. The 1970 adoption of Rule 26(b)(3) was intended to be a partial codification of the *Hickman* doctrine and, according to the Supreme Court, to “clarify” the scope of discovery with respect to trial preparation materials.<sup>57</sup> Rule 26(b)(3) provides as follows:

(3) Trial Preparation: Materials

(A) Documents and Tangible Things. Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party’s attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:

- (i) they are otherwise discoverable under Rule 26(b)(1) [which generally requires that

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55. *Id.* at 510.

56. See Charles Alan Wright, Arthur R. Miller, Mary Kay Kane & Richard L. Marcus, *Federal Practice and Procedure* § 2023 (3d ed. 2008).

57. *Grolier, Inc.*, 462 U.S. at 25. The scope of Rule 26(b)(3) is not co-extensive with *Hickman*. See Wright et al., *supra* note 56, § 2023; Thornburg, *supra* note 44, at note 27.

the matter be relevant and not privileged];  
and  
(ii) the party shows that it has substantial  
need for the materials to prepare its case and  
cannot, without undue hardship, obtain their  
substantial equivalent by other means.<sup>58</sup>

*a. General Scope of Immunity Under Rule 26(b)(3)*

Rule 26(b)(3) generally precludes discovery of “documents and tangible things that are prepared in anticipation of litigation or for trial” by or for another party (or by or for that party’s representatives).<sup>59</sup> Accordingly, with respect to the materials being sought, three conditions must be satisfied for Rule 26(b)(3) protection to apply; the materials must be: (1) “documents and tangible things,” (2) “prepared in anticipation of litigation or for trial,” and (3) by or for another party or its representative.<sup>60</sup> Ordinary and relevant “facts,” however, are subject to discovery (even if such facts are contained in a document that is not itself discoverable).<sup>61</sup> Over time, three tiers became manifest as to work product immunity: (1) facts contained in work product, which are subject to discovery, (2) opinion work product, which rarely is subject to discovery,<sup>62</sup> and (3) other work product, which is subject to discovery if the party seeking discovery establishes under Rule 26(b)(3) substantial need and undue hardship.

*b. Prepared in Anticipation of Litigation or for Trial*

*General rules.* Rule 26(b)(3) generally protects from discovery documents “that are prepared in anticipation of litigation or for trial.”<sup>63</sup> In many cases it will be clear that material is prepared in anticipation of litigation or for trial because counsel will be retained in the context of specific litigation that has been initiated or will be initiated by that counsel. In many other cases, however, it may be far from clear whether material was

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58. Fed. R. Civ. P. 26(b)(3).

59. *Id.* Even though Rule 26 restricts itself to documents and tangible things, *Hickman v. Taylor* continues to protect from discovery attorney work product that is not in tangible form such as in the memory of the attorney. See *In re Seagate Tech., LLC*, 497 F.3d 1360, 1375-76 (Fed. Cir. 2007); *Wright et al.*, *supra* note 56, § 2024; *James W. Moore et al.*, *Moore’s Federal Practice-Civil* § 26.70 [2]-[4] (3d ed. 2010).

60. *Wright et al.*, *supra* note 56, § 2024.

61. See Fed. R. Civ. P. 26(b)(3) (1970 Amendment).

62. See *Hickman*, 329 U.S. at 510-11; Fed. R. Civ. P. 26(b)(3)(B).

Opinion work product is further discussed in Part II.D.3.d.

63. Fed. R. Civ. P. 26(b)(3)(A).

prepared in anticipation of litigation or for trial. In today's litigious society, prudence dictates that a party be wary of possible litigation and prepare proactively for the possibility of litigation.<sup>64</sup> The question is whether work product immunity should be construed so as to apply broadly to documents prepared by or for such prudent persons, even though litigation is not imminent or even likely at the time of creation of the document. In *Hickman*, the Court provided immunity with respect to documents created by an attorney retained, immediately after the sinking of the tug boat, to defend the tug owners (and their underwriters) against potential suits by representatives of the deceased crew members. Claims and litigation were quite likely. Subsequent caselaw has struggled with the question of how likely litigation must be at the time of creation of the document to satisfy the Rule 26(b)(3) requirement that the materials be prepared in anticipation of litigation. In this article, I do not undertake an analysis of all the many cases that struggle with the issue;<sup>65</sup> instead, I discuss in Part II.D.4 the work product immunity cases I deem most relevant to tax accrual workpapers.

*"Dual purpose" documents.* Some documents may be useful, not only with respect to possible litigation, but also for one or more other reasons. These documents sometimes are referred to as "dual purpose" documents, and they have been problematic for the courts. Indeed, a significant split has developed among the Circuit Courts of Appeal regarding

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64. See *Nat'l Union Fire Ins. Co. v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992) ("Because litigation is an ever-present possibility . . . it is more often the case than not that events are documented with the general possibility of litigation in mind."). See also *In re Sealed Case*, 146 F.3d 881, 886-88 (D.C. Cir. 1998) (if lawyer claims having advised client regarding the risks of potential litigation, the absence of a specific claim represents one factor to consider in determining whether the work-product immunity applies).

65. For digests of those many cases, I defer to the leading commentators on questions of federal practice, Wright et al. in *Federal Practice & Procedure*, which digests various cases, conclude that:

[T]he test should be whether, in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation. And litigation should be understood generally to include proceedings before administrative tribunals if they are of an adversarial nature.

Wright et al., *supra* note 56, § 2024.

Moore's *Federal Practice* reviews the cases that require, at the time of preparation of the document, either (1) "more than a remote possibility of litigation," (2) "an identifiable prospect of litigation," and also that specific claims arose before the document is prepared, or (3) the party (or its representative) "must have in mind a 'specific claim supported by concrete facts which would likely lead to litigation.'" Moore, et al., *supra* note 59, § 26.70[3][a]. See generally Epstein, *supra* note 41, at Part 2.



these dual purpose documents. According to the principal decided cases, two competing standards exist to determine whether materials are prepared in anticipation of litigation: (1) the “primary motivating purpose” standard and (2) the “because of” standard.<sup>66</sup>

Under the more demanding “primary motivating purpose” standard, a document qualifies for work product immunity, even if litigation is not imminent, “as long as the primary motivating purpose behind the creation of the document was to aid in possible future litigation.”<sup>67</sup> The leading case for this standard, *United States v. El Paso Co.*,<sup>68</sup> involved tax accrual workpapers, and the Fifth Circuit held that (1) the “primary motivating purpose” standard had not been satisfied and (2) the workpapers were subject to discovery.<sup>69</sup> The “primary motivating purpose” standard had not been satisfied because the tax accrual workpapers were not prepared to ready El Paso Co. for litigation over its federal income tax returns. Instead, the primary motivation for creation of the tax accrual workpapers was “to anticipate, for financial reporting purposes, what the impact of litigation might be on the company’s tax liability. El Paso thus creates the . . . [tax accrual workpapers] with an eye on its business needs, not on its legal ones.”<sup>70</sup>

Under the “because of” standard, which has been adopted by the majority of Circuits,<sup>71</sup> work product immunity applies if the document is

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66. See generally Wright et al., *supra* note 56, § 2024; Moore et al., *supra* note 59, § 26.70[3][a]; Claudine Pease-Wingenter, *Prophetic or Misguided?: The Fifth Circuit’s (Increasingly) Unpopular Approach to the Work Product Doctrine*, 29 *Rev. Litig.* 121, 123-25 (2009). For another articulation of the standard, see *infra* text accompanying notes 179-80

67. *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982). See also *United States Fire Ins. Co. v. Bunge N. Am., Inc.*, 247 F.R.D. 656, 658-659 (D. Kan. 2007); *McEwen v. Digitran Sys., Inc.*, 155 F.R.D. 678, 682 (D. Utah 1994); *Gottlieb v. Wiles*, 143 F.R.D. 241, 253 (D. Colo. 1992).

68. *El Paso Co.*, 682 F.2d at 542. See also *United States v. Davis*, 636 F.2d 1028 (5th Cir. Unit A 1981).

69. See also *United States v. Gulf Oil Corp.*, 760 F.2d 292, 296-97 (Temp. Emer. Ct. App. 1985) (documents generated in response to accountant’s request for legal opinions concerning the financial implications of a declaratory judgment suit are not entitled to work product immunity because they were created, at accountant’s request, to allow accountant to prepare financial reports that would satisfy the requirements of the federal securities laws, even though the documents also were used to assist in litigation).

70. *El Paso Co.*, 682 F.2d at 543.

71. See, e.g., *United States v. Roxworthy*, 457 F.3d 590, 593 (6th Cir. 2006); *In re Grand Jury Subpoena*, 357 F.3d 900, 907-08 (9th Cir. 2004); *Maine v. United States*, 298 F.3d 60, 68 (1st Cir. 2002); *United States v. Adlman*, 134 F.3d 1194, 1202-03 (2d Cir. 1998); *Martin v. Bally’s Park Place Hotel & Casino*, 983 F.2d 1252, 1260 (3d Cir. 1993); *Nat’l Union Fire Ins. Co. v. Murray Sheet Metal*

prepared because of existing or expected litigation.<sup>72</sup> Under the “primary motivating purpose” standard, a document created primarily to assist in making a business decision would not qualify for work product immunity, but under the “because of” standard such a document might qualify because the primary purpose does not control the outcome.<sup>73</sup> If the business reason does not overwhelm the litigation-related purpose, the “because of” standard may protect the document even though the primary purpose for creation of the document is not litigation-related.<sup>74</sup> The “because of” standard and the “primary motivating purpose” standard are discussed further in Part III.C.2 with respect to tax accrual workpapers.

### *c. Limited Protection for Work Product*

Rule 26(b)(3) provides that “documents and tangible things that are prepared in anticipation of litigation or for trial” generally may be discovered if the party seeking the materials establishes that (1) the materials are relevant and not privileged, (2) the party has substantial need for the materials, and (3) the party cannot, without undue hardship, obtain a substantial equivalent by other means. The “substantial need” and “undue hardship” provisions demonstrate that application of the work product immunity requires a delicate balancing process of various and perhaps competing considerations.

### *d. Special Treatment of Opinion Work Product*

In *Hickman v. Taylor*, the Supreme Court expressed support for protecting the thought processes of the attorney.<sup>75</sup> The Court provided strong protection to such material by stating that, under the circumstances of the case, no adequate showing of necessity could be made.

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Co., 967 F.2d 980, 984 (4th Cir. 1992); *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1989), 484 U.S. 917 (1987); *Senate of Puerto Rico v. United States*, 823 F.2d 574, 587 n.42 (D.C. Cir. 1987); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.*, 709 F.2d 1109, 1118-19 (7th Cir. 1983), *In re Grand Jury Proceedings*, 604 F.2d 798, 803 (3d Cir. 1979). See also, Pease-Wingenter, *supra* note 66, at 121.

72. See *Wright et al.*, *supra* note 56, § 2024.

73. See 357 F.3d at 908.

74. Moore's Federal Practice states that dual purpose documents are protected if the litigation purpose sufficiently permeates any non-litigation purpose. See Moore, *et al.*, *supra* note 59, § 26.70[3][b].

75. See *Hickman v. Taylor*, 329 U.S. 195, 510-11, 947. In *Sears, Roebuck & Co.*, the Supreme Court further elaborated the scope of the attorney work product doctrine by holding that the immunity applies to memoranda prepared by an attorney in contemplation of litigation which set forth the attorney's theory of the case and litigation strategy. *NLRB v. Sears, Roebuck & Co.* 421 U.S. 132, 132 (1975).

The lower court cases are not consistent as to whether *Hickman v. Taylor* provided an absolute ban with respect to discovery of attorney opinion materials.<sup>76</sup> In its 1981 decision in *Upjohn*, the Supreme Court declined the opportunity to decide whether work product protection is absolute for attorney opinion work product under the *Hickman* case, but the Court stated that “a far stronger showing of necessity and unavailability by other means”<sup>77</sup> is required with respect to attorney opinion work product.<sup>78</sup> This higher standard is consistent with the Court’s attempt to balance conflicting values, because (1) protecting opinion work product generally will not deprive the opponent of facts and (2) the danger of interfering with trial preparation incentives is higher.

Even if Rule 26(b)(3)(A) is satisfied and the specified documents and tangible things are subject to discovery, Rule 26(b)(3)(B) provides explicit and mandatory protection against disclosure of “mental impressions, conclusions, opinions, or legal theories of a party’s attorney or other representative concerning the litigation.”<sup>79</sup> Thus, opinion work product must be protected pursuant Rule 26(b)(3), and this is relevant to the *Textron* case. Part III.C.3 considers whether *Textron*’s tax accrual workpapers are within the protection afforded opinion work product.

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76. See Wright et al., *supra* note 56, § 2026 (digesting cases); Moore et al., *supra* note 59, at § 26.70[2][c]; Duplan Corp. v. Moulinage et Retorderie de Chavanoz, 509 F.2d 730, 730 (4th Cir. 1974) (“[N]o showing of relevance, substantial need, or undue hardship should justify compelled disclosure of an attorney’s mental impressions, conclusions, opinions, or legal theories.”).

77. *Upjohn v. United States*, 449 U.S. 383, 402 (1981).

78. See *Holmgren v. State Farm Mut. Auto. Ins. Co.*, 976 F.2d 573 (9th Cir. 1992) (in lawsuit alleging insurer’s bad faith in settlement of claim, opinion work product of insurer could be discovered because (1) mental impressions of insurer were facts at issue and (2) need for material was compelling).

79. The Advisory Committee Notes explain Rule 26(b)(3) as follows: Subdivision (b)(3) . . . goes on to protect against disclosure the mental impressions, conclusions, opinions, or legal theories concerning the litigation of an attorney or other representative of a party. The *Hickman* opinion drew special attention to the need for protecting an attorney against discovery of memoranda prepared from recollection of oral interviews. The courts have steadfastly safeguarded against disclosure of lawyers’ mental impressions and legal theories, as well as mental impressions and subjective evaluations of investigators and claim-agents. In enforcing this provision of the subdivision, the courts will sometimes find it necessary to order disclosure of a document but with portions deleted.

Fed. R. Civ. P. 26(b)(3) advisory committee’s note (1970).

*e. Materials Prepared in the Ordinary Course of Business*

The text of Rule 26 does not contain explicit treatment for material prepared in the ordinary course of business. The Rule may be so worded because explicit treatment would be surplusage in that such material does not satisfy the requirement, explicit in the text of Rule 26, that the material be prepared in anticipation of litigation. The Advisory Committee Notes, however, state that three separate classes of materials are not within the scope of protected work product: "Materials assembled [1] in the ordinary course of business, or [2] pursuant to public requirements unrelated to litigation, or [3] for other nonlitigation purposes . . . ."<sup>80</sup>

*4. Caselaw Relevant to Tax Accrual Workpapers*

*a. Upjohn Co. v. United States*

*Upjohn Co. v. United States*<sup>81</sup> involved Upjohn Co. ("Upjohn"), and in January 1976, the CPA firm auditing one of Upjohn's foreign subsidiaries discovered evidence that representatives of the subsidiary made potentially illegal payments to or for the benefit of foreign government officials. The CPA firm informed Gerard Thomas ("Thomas"), Upjohn's General Counsel. Thomas consulted with outside counsel and Upjohn's Chairman of the Board, and Upjohn decided to conduct an internal investigation of what it termed "questionable payments." The attorneys prepared a questionnaire letter that was sent to foreign managers of Upjohn. The letter emphasized that Upjohn management needed full information concerning any questionable payments made by Upjohn. The letter stated that the Upjohn Chairman had asked Thomas, as Upjohn's General Counsel, to conduct an investigation regarding payments made to any employee or official of a foreign government. The recipients of the letter were instructed to treat the investigation as "highly confidential" and not to discuss it with anyone other than those Upjohn employees who might be helpful in providing the requested information. The managers were to respond directly to Thomas. Thomas and outside counsel also interviewed the managers who received the questionnaire and thirty-three other Upjohn officers or employees.

On March 26, 1976, Upjohn submitted a preliminary report to the Securities and Exchange Commission disclosing certain payments, and a copy of the report was transmitted to the IRS. The IRS immediately

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80. *Id.* See Wright et al., *supra* note 56, § 2024 (no work product immunity for documents prepared in the regular course of business, rather than for purposes of the litigation, even though litigation is already in prospect); Moore et al., *supra* note 59, § 26.70[3][b].

81. *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

undertook an investigation with respect to the payments disclosed by Upjohn. On November 23, 1976, the IRS issued a section 7602 summons requesting production of:

All files relative to the investigation conducted under the supervision of Gerard Thomas to identify payments to employees of foreign governments and any political contributions made by the Upjohn Company or any of its affiliates since January 1, 1971 and to determine whether any funds of the Upjohn Company had been improperly accounted for on the corporate books during the same period.

The records should include but not be limited to written questionnaires sent to managers of the Upjohn Company's foreign affiliates, and memorandums or notes of the interviews conducted in the United States and abroad with officers and employees of the Upjohn Company and its subsidiaries.<sup>82</sup>

Upjohn declined to produce the documents specified in the second paragraph on the basis that they (1) were protected from disclosure by the attorney-client privilege and (2) constituted the work product of attorneys prepared in anticipation of litigation. On August 31, 1977, the government initiated a section 7604 summons enforcement proceeding.

With respect to work product immunity, the relevant documents were the Thomas notes and memoranda of interviews. Thomas testified that these documents went beyond recording responses to his questions; his notes of the interviews contained what Thomas considered to be the important questions, the substance of the responses to them, his beliefs as to the importance of these, his beliefs as to how they related to the inquiry, and his thoughts as to how they related to other questions. In some instances, his notes might even suggest other questions that he would have to ask or things that he needed to find elsewhere.

*Upjohn* confirms that work product immunity can apply in a section 7604 summons enforcement proceeding. The Court acknowledged that Rule 26 does not specifically refer to memoranda based on oral statements of witnesses, but the Court concluded that such memoranda are the sort of material the Rule 26 drafters had in mind as deserving special protection under the work product doctrine.<sup>83</sup>

In *Upjohn*, the government made a significant concession: work product immunity applied to the Thomas memoranda and notes. In *Textron*

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82. Id. at 387-88.

83. See id. at 400.

the government made no such concession that work product immunity applied to the tax accrual workpapers. The government argued in *Upjohn* for disclosure on the basis that it had made a sufficient showing of necessity to overcome the general rule of non-disclosure with respect to attorney opinion work product under Rule 26(b)(3)(B).<sup>84</sup> The Supreme Court stated that disclosure of attorney opinion work product requires "a far stronger showing of necessity and unavailability by other means,"<sup>85</sup> and the Court remanded the case for a determination of the applicability of Rule 26(b)(3)(B).<sup>86</sup>

The relevance of *Upjohn* to attorney-prepared tax accrual workpapers is quite limited in my opinion. I consider *Upjohn* distinguishable on the following grounds:

1. The *Upjohn* documents were prepared in anticipation of litigation, not for the purpose of obtaining certified financial statements, as is the case with respect to tax accrual workpapers.

2. The *Upjohn* documents were created for the sole purpose of the questionable payment investigation, so the ordinary course of business exception did not apply in *Upjohn*. Tax accrual workpapers created for the purpose of obtaining certified financial statements invoke the ordinary course of business doctrine, as discussed in Part III.C.4.

3. The facts in *Upjohn* unfolded quickly: the *Upjohn* investigation commenced after the CPA report in January 1976; *Upjohn* made the filing on March 26, 1976; immediately thereafter the IRS launched an investigation; and on November 23, 1976, the IRS issued its section 7602 summons. From the outset of the process, litigation seemed quite likely (and actually did ensue). These facts strongly indicate a reasonable prospect of litigation, and the government appropriately conceded in *Upjohn* that the documents were within the definition of work product. The government made no such concession in *Textron*. *Upjohn* was concerned with the adequacy of the government's proof of necessity and unavailability, not the scope of the definition of work product (because of the government concession that the documents were work product).

b. *United States v. Arthur Young*

Of particular relevance to attorney-created tax accrual workpapers is *United States v. Arthur Young & Co.*<sup>87</sup> in which the IRS, in a section 7604 summons enforcement proceeding, sought to obtain the tax accrual

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84. Opinion work product is discussed in Parts II.3.d and III.C.3.

85. *Upjohn*, 449 U.S. at 402.

86. After the Supreme Court remand, the *Upjohn* case has no further history regarding the applicability of Rule 26(b)(3).

87. 465 U.S. 805 (1984).

workpapers created and possessed by the CPA firm of Arthur Young (AY) as part of the AY audit of the financial statements of its client Amerada Hess Corp. (Amerada Hess). As part of its review, which was required by applicable federal securities laws, AY verified Amerada Hess's statement of its contingent tax liabilities, and that review caused AY to generate the tax accrual workpapers at issue.

The IRS examined Amerada Hess's tax returns for 1972-74, and the IRS eventually issued a section 7602 administrative summons to AY. The summons requested AY to make available to the IRS all its Amerada Hess files, including AY's tax accrual workpapers. Amerada Hess instructed AY not to comply with the summons, and AY complied with that instruction. The IRS then launched a summons enforcement proceeding against AY, and Amerada Hess intervened in that proceeding.

The Supreme Court granted *certiorari* to determine whether the AY tax accrual workpapers were protected from disclosure in response to a section 7602 summons. AY asserted a work product defense to the summons enforcement. AY did not qualify for attorney work product immunity, so it argued for accountant work product immunity on the basis that full and frank disclosure by the client to the CPA would be advanced by such an immunity. AY argued that the integrity of the information provided to the investing public through the securities markets would be impaired (if the tax accrual workpapers were not protected from disclosure) because communications between the client and the CPA would be chilled.

The Supreme Court's analysis in *Arthur Young* starts with the observation that the federal tax system relies upon self-assessment and reporting, which demands that all taxpayers be forthright in the disclosure to the government of relevant tax information. To further that goal, the Internal Revenue Code endows the IRS with expansive information-gathering authority, the centerpiece of which is the section 7602 administrative summons. Section 7602 is subject to the traditional privileges and limitations, but the Court stated that "any other restrictions upon the IRS summons power should be avoided 'absent unambiguous directions from Congress,'"<sup>88</sup> which direction the Court was unable to identify under the facts of *Arthur Young*. Accordingly, the Court found no justification for a judicially created accountant work product immunity for the tax accrual workpapers. To the contrary, the Court noted that the language of section 7602 reflects a congressional policy choice in favor of disclosure of all information relevant to a legitimate IRS inquiry.

With respect to AY's argument that the integrity of the securities markets would suffer if no protection were to apply to CPA-created tax accrual workpapers, the Supreme Court noted that the CPA, acting as an auditor to certify financial statements, is obligated to ascertain independently

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88. *Id.* at 816.

whether the client's contingent tax liabilities have been accurately stated.<sup>89</sup> If the CPA were to conclude that the CPA's audit had been limited materially by the client's failure fully to disclose information relating to the contingent liability for taxes, the CPA would be unable to issue an unqualified opinion, which would be an unacceptable result (as to a publicly-traded client or a client needing certified financial statements for owners or creditors). To avoid that unacceptable result, the client would have to satisfy the CPA that adequate disclosure had been provided. In other words, no chilling would result because the CPA's obligations (and, no doubt, third-party liability concerns of the CPA) would force the CPA to demand sufficient information. Accordingly, the Court was satisfied that the independent CPA's obligation to serve the public interest in certifying financial statements sufficiently promotes the integrity of the securities markets without a work product immunity for CPA-created tax accrual workpapers.<sup>90</sup>

With respect to AY's argument that fundamental fairness should preclude IRS access to accountants' tax accrual workpapers, the Court observed that the SEC or a private litigant in securities regulation litigation would be entitled to the workpapers, and the Court could discern no sound reason for granting lesser authority to the IRS under section 7602.<sup>91</sup>

The holding in *Arthur Young* that required disclosure of CPA-created tax accrual workpapers (1) discouraged the use of CPAs to prepare tax accrual workpapers and (2) encouraged the use of attorneys to prepare tax accrual workpapers. After *Arthur Young*, taxpayers hoped that an attorney privilege or attorney work product protection would apply if the attorney prepared and maintained the tax accrual workpapers. The practical challenge associated with this new strategy (of having attorneys prepare the tax accrual workpapers) was to satisfy the CPA auditing the financial statements that the reserve for contingent taxes was satisfactory. If the CPA had produced the tax accrual workpapers (as was the case in *Arthur Young*), the CPA would have a satisfactory level of confidence in the contingent tax reserve. If, however, an attorney representing the client were to prepare the tax accrual workpapers, the CPA would need to review the attorney-prepared tax accrual workpapers in order to have a satisfactory level of confidence in the contingent tax reserve amount. To provide sufficient access to the CPA, and to attempt to avoid the result in *Arthur Young*, the practice developed of (1) permitting the CPA to review (generally at the taxpayer's place of business) the attorney-created workpapers (to satisfy the CPA of the adequacy of the reserve for contingent tax liabilities) under the condition that the content of the workpapers remain confidential, but (2) not permitting the CPA to keep a copy of the tax accrual workpapers (because such a copy would be subject to

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89. See *id.* at 817-18.

90. See *id.* at 819.

91. See *id.* at 820.



discovery under the holding of *Arthur Young*). After *Arthur Young*, attorney-created tax accrual workpapers became the model in practice and, indeed, this was the factual pattern in *Textron*.

c. *United States v. Adlman*

*United States v. Adlman*<sup>92</sup> involved attorney Adlman, who was a Vice-President for Taxes of his employer, which was contemplating a corporate merger transaction. The merger was expected to produce a significant tax loss and a resulting tax refund, and Adlman “expected” that the IRS would challenge the transaction and that the challenge would result in litigation.<sup>93</sup> Indeed, the IRS had designated for litigation the type of corporate merger transaction undertaken by Adlman’s employer.

Adlman retained Sheahan, an accountant and lawyer at a major CPA firm, to evaluate the tax implications of the proposed merger, and Sheahan produced a detailed report that eventually became the subject of an IRS summons enforcement proceeding.<sup>94</sup> The Second Circuit described the issue as whether work product immunity applied to “a litigation analysis prepared by a party or its representative in order to inform a business decision which turns on the party’s assessment of the likely outcome of litigation expected to result from the transaction.”<sup>95</sup> The Second Circuit held that the document (1) was subject to work product immunity because the document was created “because of” anticipated litigation and (2) would not have been prepared in substantially similar form but for the prospect of that litigation. The court observed that “litigation was virtually certain” because the amount of the refund sought would be so large as to require approval by the staff of the Congressional Joint Committee on Taxation.<sup>96</sup>

The *Adlman* decision is unremarkable, and to me is not particularly helpful with respect to attorney-prepared tax accrual workpapers. The report in controversy in *Adlman* was not required for financial accounting purposes,

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92. 134 F.3d 1194 (2d Cir. 1998).

93. *Id.* at 1195.

94. According to the court, Sheahan’s report was a 58-page detailed legal analysis of likely IRS challenges to the reorganization and the resulting tax refund claim; it contained discussion of statutory provisions, IRS regulations, legislative history, and prior judicial and IRS rulings relevant to the claim. It proposed possible legal theories or strategies for [Sheahan’s employer] to adopt in response, recommended preferred methods of structuring the transaction, and made predictions about the likely outcome of litigation.

*Id.*

95. *Id.* at 1197.

96. *Id.* at 1196.

and the report (a "litigation analysis") was prepared because litigation with the IRS was expected. With respect to tax accrual workpapers such as in *Textron*, however, the prospects for litigation are much more attenuated, as discussed in Part III.C.1. Accordingly, the Sheahen report comfortably fits within the Rule 26(b)(3) prepared in anticipation of litigation standard, and work product immunity is appropriate for such a document. In addition, the ordinary course of business doctrine in Rule 26(b)(3)(B) clearly does not apply in *Adlman* because the Sheahen report was prepared solely to assist in the expected challenge from the IRS.

*d. United States v. El Paso Co.*

*United States v. El Paso Co.*<sup>97</sup> involved a summons enforcement proceeding with respect to tax accrual workpapers prepared by the taxpayer.<sup>98</sup> The Fifth Circuit opinion noted that the tax accrual workpapers were not prepared to assist in filling out a tax return because the tax accrual workpapers were prepared after the return was filed.<sup>99</sup> The court held that no work product immunity applied because the tax accrual workpapers were not prepared by El Paso in anticipation of litigation with the IRS regarding El Paso's federal tax returns. Instead, the primary motivating force behind creation of the tax accrual workpapers related to business needs, i.e., to establish the adequacy of the reserve for contingent liabilities so that the accountants would certify the financial statements.<sup>100</sup> The court acknowledged that the tax accrual workpapers involve "weighing legal

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97. 682 F.2d 530 (5th Cir.1982).

98. *Id.* at 533.

99. *Id.* Publicly-traded companies generally prepare the tax accrual workpapers before filing of the tax return because (1) many corporate taxpayers obtain extensions for the due date of the federal income tax return and (2) the company needs to issue certified financial statements at a date earlier than the due date of the tax return.

100. *Id.* at 543.

In sum, we believe that the tax [accrual workpaper] analysis does not contemplate litigation in the sense required to bring it within the work product doctrine. The tax [accrual workpaper] concocts theories about the results of possible litigation; such analyses are not designed to prepare a specific case for trial or negotiation. Their sole function, from all that appears in the record, is to back up a figure on a financial balance sheet. Written ultimately to comply with SEC regulations, the tax [accrual workpaper] analysis carries much more the aura of daily business than it does of courtroom combat. We hold, therefore, that the tax [accrual workpaper] and backup memoranda are not protected work product materials.

*Id.* at 543-44.

arguments, predicting the stance of the IRS, and forecasting the ultimate likelihood of sustaining El Paso's position in court," but the court concluded that the analysis was created because of business needs, not the "press of litigation."<sup>101</sup> In addition, the court noted that the tax accrual workpapers would not provide El Paso's litigating strategy to the IRS (if litigation were to occur).<sup>102</sup>

*e. United States v. Deloitte LLP*

The most recent addition to the relevant case law is the District of Columbia Circuit Court of Appeals 2010 decision in *United States v. Deloitte LLP*.<sup>103</sup> Dow Chemical Company (Dow) was a party to litigation with the government regarding Dow's federal income tax liability with respect to a transaction in which Dow had engaged. Deloitte was Dow's independent CPA/auditor, and Deloitte was the subject of a separate subpoena enforcement proceeding. The government was seeking, in the subpoena enforcement proceeding against Deloitte, production of three documents in the possession of Deloitte. Little is known of these three documents because the District Court did not review any of them. Each of the documents related to the Dow transaction. For purposes of the Deloitte litigation, the documents are described in Dow's privilege log and in a declaration by Dow's Director of Taxes as:

1. "[A] 1993 draft memorandum prepared by Deloitte that summarizes a meeting between Dow employees, Dow's outside counsel, and Deloitte employees about the possibility of litigation over the [relevant transaction], and the necessity of accounting for such a possibility in an ongoing audit."<sup>104</sup> This meeting occurred after Dow advised Deloitte about the prospects for litigation with respect to the transaction.

2. "[A] 1998 memorandum and flow chart prepared by two Dow employees—an accountant and an in-house attorney."<sup>105</sup>

3. "[A] 2005 tax opinion prepared by Dow's outside counsel."<sup>106</sup> The D.C. Circuit Court of Appeals refers to the first document as the "Deloitte Memorandum" and the second and third documents as the "Dow Documents."<sup>107</sup>

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101. *Id.* at 543.

102. *Id.*

103. 610 F.3d 129 (D.C. Cir. 2010).

104. *Id.* at 133.

105. *Id.*

106. *Id.*

107. *Id.* at 133-34.

The declaration of the Director of Taxes explained that the Dow Documents were provided to Deloitte so that Deloitte could “review the adequacy of Dow’s contingency reserves for the [relevant] transactions.”<sup>108</sup> The Director also stated that Deloitte “compelled Dow’s production of these documents by informing the company that access to these documents was required in order to provide Dow with an unqualified audit opinion for its public financial statements.”<sup>109</sup> Dow’s privilege log described the subject matter of these documents as “[t]ax issues related to the [relevant transaction],” and the log states that each document is “prepared in anticipation of litigation.”<sup>110</sup>

The District Court ruled that all three documents were protected from discovery under the work-product doctrine.<sup>111</sup> On appeal, the government contended that the Deloitte Memorandum was not work product because it was prepared by Deloitte during the audit process. In a hugely significant concession, the government agreed that the Dow Documents were work product, but the government argued that Dow waived work product protection as to the Dow Documents when it disclosed them to Deloitte.

The Court of Appeals vacated the District Court’s decision that the Deloitte Memorandum was work product and remanded for *in camera* review to determine whether the Deloitte Memorandum is entirely work product. With respect to the two Dow Documents, the Court of Appeals affirmed the district court’s decision that Dow did not waive work product protection when it disclosed them to Deloitte.

The Deloitte case is significant in many ways. The evidence in the record as to Dow’s reason for creation of the tax accrual workpapers is that the workpapers were compelled by Deloitte so that Dow could secure unqualified certified financial statements. The privilege log states, in a very self-serving manner, that the documents were prepared in anticipation of litigation, but the significant evidence in the record is that the tax accrual workpapers were prepared to obtain certified financial statements, not because of anticipated litigation.

The Court of Appeals addressed two issues regarding the Deloitte Memorandum: (1) could the document be protected work product if it were created by Deloitte rather than Dow, and (2) was the document not work product because it was generated as part of the “routine audit process,” not in anticipation of litigation? The Court concluded that Deloitte’s creation of the document did not preclude the document from being work product as to Dow

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108. *Id.* at 133.

109. *Id.*

110. *Id.*

111. *United States v. Deloitte & Touche USA LLP*, 623 F. Supp. 2d 39 (D. D.C. 2009).

because the Deloitte Memorandum recorded the discussion of Dow and Dow's outside counsel.

With respect to the issue of whether the Deloitte Memorandum was not work product because it was generated as part of the routine audit process, rather than in anticipation of litigation, the Court of Appeals held that the Deloitte Memorandum might qualify for protection under work product immunity. Applying the "because of" test discussed above at Part II.D.3.b, the Court of Appeals rejected the government's assertion that the function of a document, not its content, determines whether it is work product. Notwithstanding the record from the District Court to the effect that the reason for production of the tax accrual workpapers was to obtain certified financial statements, the Court held that the Deloitte Memorandum might qualify as work product because "a document can contain protected work-product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation."<sup>112</sup> The Court of Appeals remanded the case to the District Court for an *in camera* review of the Deloitte Memorandum so that the District Court could determine whether the Deloitte Memorandum did meet the requirements for work product immunity.

I take exception to the Court of Appeals analysis at this point, and the Court of Appeals decision demonstrates to me the weakness of the "because of" test (discussed in Part II.D.3.b), which permits the *Deloitte* court to conclude that work product immunity may apply even though the record in the case indicates that the purpose for preparation of the document was to secure certified financial statements, rather than prepare for litigation.<sup>113</sup> I ignore the self-serving declaration in the Dow privilege log that the documents were prepared in anticipation of litigation.

With respect to the two Dow Documents, the government, for one or more reasons that I cannot discern from the opinions in the case, conceded that the documents were qualifying work product. As to discovery of the Dow Documents, the government relied solely on the argument that Dow had waived work product immunity with respect to the Dow Documents by disclosure to Deloitte. The D.C. Circuit held that no waiver occurred, and this holding is discussed in Part III.C.5.

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112. *Id.* at 138. The Court of Appeals for the District of Columbia clearly was not persuaded by the opinions in *El Paso* and *Textron*. The D.C. Circuit distinguished *El Paso* on the basis that it applied the more demanding "primary motivating purpose" standard, and the D.C. Circuit essentially ignored *Textron* even though *Textron* purports to be a "because of" standard decision.

113. *Id.* at 136-38.

5. Cases Demonstrate that the Purpose of Work Product Immunity is Protection of Litigation Process

As *Hickman* and subsequent cases make clear, the rationale supporting work product immunity is protection of the litigation process: "Proper preparation of a client's case demands that [the lawyer] assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference."<sup>114</sup>

Rule 26 similarly is concerned with the litigation process. Accordingly, legal advice in the form of writings should be protected under work product immunity only if there is a significant relationship to litigation.<sup>115</sup> The caselaw has made clear that the burden of proof rests with the proponent of work product immunity.<sup>116</sup>

III. SHOULD WORK PRODUCT IMMUNITY APPLY TO ATTORNEY-CREATED TAX ACCRUAL WORKPAPERS?

A. Overview

Part III is concerned with whether work product immunity should apply to attorney-created tax accrual workpapers, such as the workpapers in *Textron*, which raise some of the most vexing issues regarding the scope of the work product doctrine. Technical issues that were presented in *Textron* included the following: (1) did the *Textron* tax accrual workpapers satisfy the "prepared in anticipation of litigation or for trial" language of Rule

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114. *Hickman v. Taylor*, 329 U.S. 495, 511 (1947). See also *Shields v. Sturm, Ruger & Co.*, 864 F.2d 379, 382 (5th Cir. 1989) (work product immunity protects fruits of attorney's trial preparations); *United States v. Am. Tel. & Tel. Co.*, 642 F.2d 1285, 1299 (D.C. Cir. 1980) (primary purpose of the work product immunity is to promote the adversary system by safeguarding the fruits of an attorney's trial preparations from opposing parties); *Moore et al.*, supra note 59, § 26.70[1] ("purpose of the work product doctrine is to protect an attorney's mental processes so that the attorney can analyze and prepare for the client's case without interference from an opponent").

115. See *Jordan v. United States*, 591 F.2d 753, 775 (D.C. Cir. 1978) (explaining that "purpose of [work product immunity] is to encourage effective legal representation within the framework of the adversary system by removing his fears that counsel's thoughts and information will be invaded by his adversary;" immunity focuses on the integrity of the adversary trial process as reflected in the limitation to materials "prepared in anticipation of litigation or for trial"). See also *Anderson et al.*, supra note 45, at 784-85 (central justification for work product immunity is its preservation of the privacy of the attorney/adversary's preparation; invasion of this privacy could impair the adversary system.).

116. See generally *Moore et al.*, supra note 59, § 26.70[5][a].

26(b)(3)?, (2) if the tax accrual workpapers are work product, are they “opinion” work product, which is entitled to a greater level of protection?, (3) if the tax accrual workpapers are opinion work product, can the IRS satisfy the higher standard of proof necessary to obtain discovery?, (4) does the ordinary course of business exception apply to the *Textron* tax accrual workpapers?, and (5) does disclosure of the tax accrual workpapers to *Textron*’s CPA constitute a waiver of the immunity?<sup>117</sup> In addition to those technical issues, various public policy factors bear on the issue of whether work product immunity should apply to tax accrual workpapers. Such a policy-based analysis must compare the burdens and benefits with respect to both the taxpayer involved and the public interest.

Part II.B provides a policy-based analysis of whether attorney-prepared tax accrual workpapers should be protected as work product, and Part III.C. analyzes specific technical issues regarding whether the workpapers should qualify as work product.

#### *B. Policy-Based Analysis Regarding Tax Accrual Workpapers*

It seems to me that one’s conclusion regarding whether work product protection should apply to attorney-prepared tax accrual workpapers will depend to a significant degree on policy considerations, and the Supreme Court has relied on policy factors in reaching decisions in work product cases. In *Hickman v. Taylor*, the Supreme Court stated that a balancing of conflicting considerations was required,<sup>118</sup> and the Supreme Court in *Arthur Young* used a policy-based analysis in rejecting the proposed accountant work product immunity. Accordingly, I expect that court decisions regarding the applicability of work product immunity to attorney-prepared tax accrual workpapers ultimately will be resolved by a policy-based analysis (and that the technical issues will thereafter be resolved generally in accordance with the overall policy conclusion).

The discussion below proceeds first by identifying the policy factors relevant to whether tax accrual workpapers should be subject to discovery. Second, I assign weight to the various policy factors. Third, I balance the weighted factors to determine whether the balance favors a particular outcome with respect to whether work product immunity should apply to attorney-created tax accrual workpapers.<sup>119</sup>

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117. Issues (1) and (4) are closely related, and they may be opposite statements of the same proposition. Nevertheless, the caselaw tends to deal with them separately, and I do the same.

118. See *Hickman* 329 U.S. at 497.

119. It seems to me that balancing is not only appropriate, it is compelled by prior Supreme Court case law. See *Hickman*, 329 U.S. at 511-12; *Euge*, 444 U.S. at 711 (§ 7602 summons authority “should be upheld absent express statutory

### 1. Identification and Weighting of Relevant Policy Factors

The following policy considerations are discussed below: (1) the public interest in effective tax compliance, (2) the unfairness, cost shifting, and free riding that would result from discovery of the tax accrual workpapers, (3) the potential chilling effect on attorney-client communications that would result from discovery of the tax accrual workpapers, (4) concern regarding the scope of a holding that tax accrual workpapers are subject to discovery, and (5) intrusiveness concerns and the IRS policy of restraint.

Attribution of weight to the factors is an admittedly subjective process, and my particular attributions of weight may not conform to others'. I am of the opinion, however, that the Supreme Court has provided significant guidance as to how weight should be attributed, as discussed more fully below.

#### a. Public Interest in IRS Having Effective Tools to Advance Tax Compliance

The U.S. tax system must strike a delicate balance between (1) protecting individual-oriented rights of privacy and (2) providing suitable tools to the government to investigate and collect taxes due.<sup>120</sup> The U.S. tax system relies to a significant extent on self-reporting by taxpayers, and enforcement of such a self-reporting system requires that the IRS be given appropriate investigatory tools to confirm that the self-reporting was correct.<sup>121</sup>

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prohibition or substantial countervailing policies"). See also *Arthur Young*, 465 U.S. at 821:

Beyond question it is desirable and in the public interest to encourage full disclosures by corporate clients to their independent accountants; if it is necessary to balance competing interests, however, the need of the Government for full disclosure of all information relevant to tax liability must also weigh in that balance. This kind of policy choice is best left to the Legislative Branch.

See also *United States v. Swift & Co.*, 24 F.R.D. 280, 284 (N.D. Ill. 1959) (application of work product immunity rests upon the balance struck in the particulars of a concrete case between the competing interests of full disclosure and protection for the fruits of the lawyer's labor).

120. See *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 734 (1979) ("That collection of taxes is vital to the functioning, indeed existence, of government cannot be denied."); *Couch v. United States*, 409 U.S. 322, 336 (1973) (society has legitimate interest in "enforcement of its laws and collection of the revenues").

121. See *Arthur Young*, 465 U.S. at 814; *Powell*, 379 U.S. at 56-58. See generally Staff of the Joint Committee on Taxation, JCS-02-05, Options to Improve



Congress struck the balance between individual-oriented rights of privacy and the scope of the investigatory tools provided to the IRS by enacting a broad grant of investigatory authority to the IRS in the form of section 7602, the administrative summons provision, which is of impressive breadth.<sup>122</sup> Because taxpayers generally have vastly more information relevant to their tax liability than does the government, an information asymmetry exists, and that asymmetry arguably supports a broad interpretation of section 7602.<sup>123</sup>

The Supreme Court has confirmed on multiple occasions the broad scope of section 7602. In *United States v. Powell*, the Court stated that the burden of proof must be satisfied by a person opposing enforcement of a section 7602 summons.<sup>124</sup> In *United States v. Euge* (which enforced an IRS summons requiring the taxpayer to appear and provide handwriting exemplars), the Court recognized “a formidable line of precedent construing congressional intent to uphold the claimed enforcement authority of the [IRS] if [this] authority is necessary for the effective enforcement of the revenue laws and is not undercut by contrary legislative purposes”<sup>125</sup> and stated that the section 7602 summons authority “should be upheld absent express statutory prohibition or substantial countervailing policies.”<sup>126</sup> In *United States v. Bisceglia*<sup>127</sup> (which enforced an IRS “John Doe” summons issued to a financial institution to discover the identity of an unnamed individual who had deposited a large amount of money in severely deteriorated bills), the Court advised that section 7602 seeks not to accuse, but to inquire, and the Court acknowledged that IRS investigations unquestionably involve some invasion of privacy, but “the investigations are essential to our self-reporting system, and the alternatives could well involve far less agreeable invasions of house, business, and records.”<sup>128</sup> In *Tiffany Fine Arts*,<sup>129</sup> the Supreme Court enforced a section 7602 summons on a

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Tax Compliance and Reform Tax Expenditures 7-9 (2005), available at <http://www.jct.gov/s-2-05.pdf>.

122. See generally *supra* note 25.

123. See *Camp*, *supra* note 25, at 4 (explaining how (1) the “information asymmetry between taxpayers and government,” combined with the service’s ability to acquire necessary information, “forms the basis for an inquisitorial system of tax administration” and (2) this information asymmetry justifies an expansive reading of the § 7602 summons power). See also *Johnson*, *supra* note 44, at 163. With respect to a listed transaction, however, the IRS may have collected extensive information about the transaction.

124. *Powell*, 379 U.S. at 58.

125. *Euge*, 444 U.S. at 715-16.

126. *Id.* at 711.

127. *Bisceglia*, 420 U.S. at 141.

128. *Id.* at 146.

129. *Tiffany Fine Arts, Inc. v. United States*, 469 U.S. 310 (1985).

taxpayer for the dual purpose of investigating the tax liability of that taxpayer and identifying other unnamed persons because the information sought was relevant to legitimate investigation of the summoned taxpayer. In *Arthur Young*, the Court supported a broad reading of section 7602 by permitting discovery of CPA-created tax accrual workpapers.<sup>130</sup>

The thrust of the Supreme Court cases in support of a broad interpretation of the scope of section 7602 (notwithstanding the presence of countervailing considerations in each of the cases) persuades me that this factor (the public interest in the IRS having effective enforcement tools) is entitled to significant weight in favor of permitting discovery of attorney-prepared tax accrual workpapers.

*b. Unfairness, Cost Shifting, and Free Riding*

It is unlikely that discovery of attorney-prepared tax accrual workpapers would disclose the taxpayer's litigation strategy, but such discovery clearly would disclose, item-by-item, the taxpayer's contingent tax liability reserve amounts and possibly the theory or theories supporting each item.<sup>131</sup> Indeed, the tax accrual workpapers would be a "roadmap" for the IRS in conducting an audit of the taxpayer.<sup>132</sup> The disclosure, in the tax accrual workpapers, of the taxpayer's perceived likelihood of success as to each listed item also would be very useful to the IRS in setting its strategies regarding litigation and settlement.<sup>133</sup>

It is irrefutably clear that permitting discovery by the IRS of a taxpayer's tax accrual workpapers raises a significant and undeniable fairness issue in that such discovery provides a substantial (and free-of-cost) advantage to the IRS.<sup>134</sup> Tax accrual workpapers are highly sensitive and private documents that are created by experienced professionals at no

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130. The *Arthur Young* case is discussed in Part II.D.4.b.

131. See *El Paso Co.*, 682 F.2d at 543-44; Claudine Pease-Wingenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of United States v. Textron*, 8 Hous. Bus. & Tax L.J. 337 (2008).

132. See *supra* text accompanying notes 31-39.

133. For example, the IRS might offer to settle an issue for an amount that is less than the amount reserved because the IRS might expect quickly to close the issue. The taxpayer might be induced to accept the offer if creation of income (the excess of the amount reserved over the settlement amount) is useful for financial reporting purposes.

134. See *Roxworthy*, 457 F.3d at 595 ("[T]he IRS would appear to obtain an unfair advantage by gaining access to KPMG's detailed legal analysis of the strengths and weaknesses of [the taxpayer's] position. This factor weighs in favor of recognizing the documents as privileged.")

insignificant cost to the taxpayer.<sup>135</sup> Disclosure to the IRS raises the “free-riding” problem identified in *Hickman* in that the IRS may take advantage of the “wits” of the taxpayer’s tax advisors, the cost for which was borne by the taxpayer, not the IRS.<sup>136</sup> It is worth noting, however, that the costs associated with the tax accrual workpapers are not incurred for the purpose of defending against an IRS challenge. To the contrary, such costs are incurred for the purpose of securing certified financial statements from the CPA, so it can be argued that the costs of the tax accrual workpapers are a sunk cost related to obtaining certified financial statements and, thus, no marginal cost is shifted with respect to IRS discovery of tax accrual workpapers.

The Supreme Court has made clear that this cost-shifting and fairness consideration favors non-disclosure, but it does not control the outcome. Indeed, in *Arthur Young*, the Supreme Court, in refusing to recognize an accountant’s work product immunity with respect to accountant-prepared tax accrual workpapers, stated that the unfairness of disclosing the tax accrual workpapers was not dispositive.<sup>137</sup> *Arthur Young* involved CPA-created tax accrual workpapers, but attorney-created tax accrual workpapers raise this same fairness issue.

The question is the weight to attribute to this factor, and this weighting is crucial to the balancing test I use. This consideration of unfairness, cost shifting, and free-riding is certainly not trivial, given the costs associated with attorney preparation of tax accrual workpapers.<sup>138</sup> In

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135. See Stuart J. Bassin, *Managing Tax Accrual Workpapers after Textron*, 123 Tax Notes 571, 571 (2009) (noting that tax accrual workpapers are among the “most private and sensitive documents created by corporations”).

136. *Hickman*, 329 U.S. at 516.

137. *Arthur Young*, 465 U.S. at 820. The *Arthur Young* case is discussed in Part II.D.4.b.

138. The First Circuit *en banc* majority in *Textron* directly addressed the fairness issue with respect to discovery of materials prepared by another party. *Textron* argued that discovery of the tax accrual workpapers by the IRS would be fundamentally unfair in disclosing *Textron*’s analysis of its contingent tax liability, but the *en banc* majority responded that “tax collection is not a game” and that underpayment of taxes “threatens the essential public interest in revenue collection.” See *Textron*, 577 F.3d at 31. The *en banc* majority opinion stated that the IRS confronts serious practical problems in discovering under-reporting of corporate taxes; the majority opinion further noted that (1) *Textron*’s federal income tax return was massive (more than 4,000 pages) and (2) the IRS requested the work papers only after finding the *Textron* SILO transactions that the IRS considered to be abusive. *Id.* See *supra* text accompanying note 15. Because the collection of federal tax revenues is essential to the functions government, Congress granted the IRS the broad administrative summons powers of § 7602, along with other “comparatively unusual tools.” *Textron*, 577 F.3d at 31. The *en banc* majority concluded that the potential unfairness to *Textron* was outweighed by the public interest in effective tax enforcement.

*Arthur Young*, there was similar unfairness (involving CPA-created tax accrual workpapers), but the Supreme Court established that the public interest in tax administration outweighed the countervailing considerations. The holding in *Arthur Young* indicated that, in the context of certified financial statements, this fairness consideration is of lesser weight than the weight accorded to the public interest in effective tax administration. *Arthur Young* does not indicate how much less weight is attributable to this fairness consideration than is attributed to the public interest in effective tax administration, but the decision indicates the relative weights, with the public interest being the greater.

A limited weight also is justified, to some extent, by the IRS policy of restraint with respect to tax accrual workpapers because the policy of restraint restricts the scope of the potential unfairness to a limited class of taxpayers (those who have engaged in a listed transaction that the IRS considers a tax avoidance transaction).<sup>139</sup>

*c. Chilling Effect on Zone of Privacy Communications*

If attorney-prepared tax accrual workpapers are not subject to work product immunity, will this have a “chilling” effect on the frankness and fullness of communications between the tax attorney and the client within the zone of privacy with which work product immunity is concerned?<sup>140</sup> More specifically, will the written communications embodied in the tax accrual workpapers be limited in form and detail in such a fashion as to impair the quality of the representation provided by the attorney?<sup>141</sup>

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139. The IRS policy of restraint is discussed in Parts II.C.2 and III.B.1.e.

140. Textron’s brief in support of its Supreme Court petition for *certiorari* made this assertion of chilling effect, as did many of the Briefs filed in support of Textron’s petition. See Petition for Writ of Certiorari at 23, *Textron, Inc. and Subsidiaries v. United States*, 130 S.Ct. 3320 (2010), (No. 09-750); Brief for Washington Legal Foundation as Amicus Curiae Supporting Petitioner, at 7; *Textron*, 130 S.Ct. 3320 (2010) (No. 09-750); Brief for Reed Smith LLP, et al. As Amici Curiae Supporting Petitioner, at 6-12; *Textron*, 102 S.Ct. 3320 (2010) (No. 09-750); Brief for Financial Executives Institute as Amicus Curiae Supporting Petitioner, at 3; *Textron*, 130 S.Ct. 3320 (2010) (No. 09-750); Brief for DRI as Amicus Curiae Supporting Petitioner, at 17-18; *Textron*, 130 S.Ct. 3320 (2010) (No. 09-750); Brief for Association of Corporate Counsel as Amicus Curiae Supporting Petitioner, at 10-11, 14-16; *Textron*, 130 S.Ct. 3320 (2010) (No. 09-750); Brief for Chamber of Commerce of United States as Amicus Curiae Supporting Petitioner, at 11-12, 14-21, *Textron*, 130 S.Ct. 3320 (2010) (No. 09-750).

141. See *Textron*, 577 F.3d at 37 (Torreulla, J., dissenting). See also Bassin, *supra* note 135, at 579 (disclosure would “erode the quality of the financial reporting process and would impose costs throughout the economy”).

Proponents of work product immunity for attorney-prepared tax accrual workpapers argue that the prospect of disclosure will chill and impair the fullness of the written advice provided by the attorney. I am unpersuaded by that argument. If attorney-prepared tax accrual workpapers were to be subject to discovery, the attorney services would not be limited unless the client chooses limited services. An attorney-prepared document, if maintained as confidential between the client and the attorney, generally is protected by attorney-client privilege. It is the client's use of such a document that controls whether the document is subject to discovery. If the client chooses to maintain the confidentiality of the document, attorney-client privilege (and possibly work product immunity) generally will protect the document from discovery. It is the client's choice (after the legal services are provided) to use a document in a manner that may expose the document to discovery. If the client intends to use the document in a way that may cause loss of attorney-client privilege and work product immunity, that is the choice of the client, but that client choice in no way impairs or limits the fullness of the services the attorney can provide if the client so desires.

I have no doubt that the absence of work product immunity would tend to have an impact on the nature and extent of the writings in the tax accrual workpapers. If work product immunity does not apply, taxpayers clearly will desire the absolute minimum of disclosure in the tax accrual workpapers.<sup>142</sup> That is a tactical choice the client is free to make regarding

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142. Indeed, some tax professionals are suggesting segregation into separate documents of what now is included within a single tax accrual workpaper document. See James R. Browne, *FIN 48: Avoiding the Roadmap Trap*, *Strasburger Tax Strategies Newsl.*, Dec. 4, 2009, at 1, available at <http://www.strasburger.com/calendar/news/tax/FIN-48-Avoiding-the-Roadmap-Trap.htm> (taxpayers should consider segregating (1) "the process of identifying, quantifying, and assessing the technical merits of their tax positions," a legal analysis intended to be protected by attorney-client privilege or work product immunity from (2) the process of obtaining certified financial statements, which would "merely document the conclusions reached with respect to recognition and measurement, and to include only the critical facts and legal authorities supporting the accounting conclusions" and "would not disclose the company's detailed evaluation of competing factual and legal arguments or its subjective analysis of alternative settlement strategies."). See also Pease-Wingenter, *supra* note 131, at 353-54 (suggests providing independent auditor with "specially prepared factual summaries of its tax reserve" but not revealing the "attorney's underlying legal analysis"); Posting of Scott Novick to Global Tax Blog, *What In-House Tax Professionals Should Do in Light of Textron*, <http://web20.nixonpeabody.com/globaltaxblog/> (Aug. 31, 2009, 15:03 EST) (tax departments should limit tax accrual work papers to numerical analysis with minimal supporting narrative). See also Bassin, *supra* note 135, at 580 (suggesting three documents: (1) one containing the "factual material," (2) one containing a discussion of "available legal arguments," and (3) one "containing conclusions regarding the likelihood of success"). Apparently, the suggestion is that document (1) would be

the scope of the engagement with the attorney and the nature of the work product to be provided by the attorney.

Counter-balanced against that desire for minimal disclosure in the tax accrual workpapers if they are subject to discovery, however, is the taxpayer's need to obtain unqualified certified financial statements. Because the purpose of certified financial statements is to provide investors and creditors with useful financial information, any impairment of the nature and extent of the content of the tax accrual workpapers would be contrary to the public interest. In reality, however, it is unlikely that the tax accrual workpapers would be significantly abbreviated (if tax accrual workpapers were to be subject to discovery) because the taxpayer must satisfy the CPA of the adequacy of the contingent liability for taxes. The CPA simply will not (without qualification) certify the financial statements if insufficient written information is provided in the tax accrual workpapers.<sup>143</sup> The CPA must determine whether the financial statements fairly present the financial position and operations for the specified period, and the CPA will not accept, as adequate, tax accrual workpapers that are significantly abbreviated; indeed, the CPA may demand additional information in support of the reserve amount.<sup>144</sup> Accordingly, tension—probably a healthy tension—

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subject to disclosure, and (2) presumably would be required by the CPA, but (3) would not be provided to the CPA. I doubt that this strategy of limiting the scope of disclosure to the CPA will succeed, as the CPA will not likely be satisfied (and would not, without qualification, certify the financial statements) without the legal/substantive analysis regarding each item listed in the tax accrual workpapers.

Some practitioners have discussed conferring with tax litigation specialists or including additional trial- and appeal-related information into the tax accrual workpapers for the purpose of enhancing the likelihood of work product immunity for tax accrual workpapers. See Kenneth B. Clark, *A Different View of Textron*, 125 *Tax Notes* 1197, 1199 (2009) (increasing importance of client conferring with tax litigation specialist early in the reserve-creation process). See Kenneth J. Krupsky, *After Textron: "What Is to be Done?"*, *Tax Mgm't Int'l J.*, Nov. 13, 2009 at 717, 717-18, available at [http://www.bna.com/tm/insights\\_knpsky26.htm](http://www.bna.com/tm/insights_knpsky26.htm) (discussing whether taxpayers would be willing to pay professionals to include in the tax accrual workpapers discussions of trial and appeal scenarios and strategies).

143. See AU § 9326, *Evidential Matter: Auditing Interpretations of § 326*, ¶¶ 2.10, 2.23, (as amended Apr. 9, 2010), available at <http://www.pcaobus.org/Standards/Auditing/Pages/AU9326.aspx> (auditor must obtain "sufficient competent evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements;" absent such matter, auditor must qualify or disclaim an opinion on the statements).

144. The American Institute of Certified Public Accountants auditing standard AU § 326 (regarding income tax accruals) provides that the auditor should obtain access to supporting documents, "notwithstanding potential concerns regarding attorney-client or other forms of privilege." AU § 9326, *Evidential Matter:*

would exist between the taxpayer and the CPA because of the CPA's obligation of independence.<sup>145</sup> the taxpayer would want to minimize disclosure in the tax accrual workpapers, but the CPA would demand sufficient disclosure to justify the reserve amount.<sup>146</sup> Because the CPA has obligations independent of its obligations in favor of its client the taxpayer, the CPA will require adequate-to-the-task disclosure in the tax accrual workpapers.<sup>147</sup> That does not mean, however, that there will be a chill with respect to the communications between attorney and client, and it does not mean that the attorney will perform less comprehensive services unless that is what the client desires as a matter of strategy with respect to tax accrual workpapers.

In sum, there will be no necessary chill in terms of attorney-client communications. If tax accrual workpapers are less comprehensive because of considerations about disclosure, that is the choice of the client for tactical reasons; it is not because the attorney would be unwilling to advise (or

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Auditing Interpretations of § 326, ¶ 2.22, available at <http://www.pcaob.com/Standards/AuditingPages/AU9326.aspx>. See also ¶ 2.09:

Limitations on the auditor's access to information considered necessary to audit the tax accrual will affect the auditor's ability to issue an unqualified opinion on the financial statements. Thus, if the client does not have appropriate documentation of the calculation or contents of the accrual for income taxes and denies the auditor access to client personnel responsible for making the judgments and estimates relating to the accrual, the auditor should assess the importance of that inadequacy in the accounting records and the client imposed limitation on his or her ability to form an opinion on the financial statements. Also, if the client has appropriate documentation but denies the auditor access to it and to client personnel who possess the information, the auditor should assess the importance of the client-imposed scope limitation on his or her ability to form an opinion.

145. Under the rules of the Public Company Accounting Oversight Board, the auditor must be independent of the client. See Public Company Accounting Oversight Board, Professional Standards R. 3520, Auditor Independence, at 57-58 (2007), available at [http://www.pcaob.org/Rules/PCAOBRules/Documents/Section\\_3.pdf](http://www.pcaob.org/Rules/PCAOBRules/Documents/Section_3.pdf).

146. See *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113, 116-17 (S.D.N.Y. 2002) (good auditing requires adversarial tension).

147. See Petro Lisowsky, Leslie A. Robinson & Andrew P. Schmidt, An Examination of FIN 48: Tax Shelters, Auditor Independence, and Corporate Governance 31 (2010), <http://areas.kenan-flagler.unc.edu/Accounting/TaxCenter/taxsym2010/Documents/Lisowsky-LRS%20JAN2010%20-%20UNC%20Tax%20Symposium.pdf> (finding that client's economic importance to auditor does not impair auditor's independence and does not enable client to under-reserve for its tax shelter activity because economic and reputation risks to auditor may cause auditor to ensure a more proper tax reserve accrual for tax shelters).

produce comprehensive documents) regarding uncertain tax positions. Because I conclude that there need be no meaningful chill, I give no weight to this factor.

*d. Uncertainty Regarding Scope of Attorney Work Product Immunity*

It is not uncommon for an attorney to be involved in assessing and quantifying a reserve with respect to possible claims or possible litigation against a client. The attorney's work product as to such a reserve analysis likely would be in writing. Extant case law protects certain reserve-amount documents from discovery.<sup>148</sup> If attorney-created tax accrual workpapers are not protected by work product immunity, will many other attorney-created documents be subject to discovery causing a substantial diminishment in the scope of work product immunity? The First Circuit *en banc* dissent in *Textron* was much worried about this issue,<sup>149</sup> and several commentators have argued that, if tax accrual workpapers are not protected, many other attorney-produced documents will be subject to discovery.<sup>150</sup> For example, some commentators (and many of the Briefs filed in support of *Textron's* petition for *certiorari*) have asserted that, if tax accrual workpapers are not protected, then an attorney-produced document assessing the likelihood of success as to any contingent liability will not be protected by work product immunity.<sup>151</sup> Several commentators have argued that an attorney-produced

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148. See *Simon*, 816 F.2d at 401; *Rhone-Poulenc Rorer, Inc. v. Home Indem. Co.*, 139 F.R.D. 609, 614 (E.D. Pa. 1991).

149. *Textron*, 577 F.3d at 37-38.

150. See generally Tax Mgmt. Wkly. Rep. 9/14/09, at 1123; Robin L. Greenhouse & Joseph H. Selby, Narrowing the Scope of Work Product Protection: First Circuit Decision Puts Taxpayers on Notice, *Taxes-The Tax Mag.*, Jan. 2010, at 47 (2010); Jeremiah Coder, *En Banc First Circuit Reverses Course in Textron*, 124 Tax Notes 638, 640 (2009); Michelle M. Henkel, *Textron Eviscerates the 60-Year-Old Work Product Privilege*, 125 Tax Notes 237, 240-42 (2009).

151. *Textron's* Brief in support of its petition for *certiorari* made the assertion that, if tax accrual workpapers are not protected by work product immunity, many other attorney-created documents likewise would not be protected, and many of the Briefs filed in support of *Textron's* petition make similar assertions. See Brief for *Textron* supra note 140, at 27-28; Brief for Washington Legal Foundation supra note 140, at 7; Brief for Reed Smith supra note 140, at 12-14; Brief for Financial Executives Institute, supra note 140, at 6-7; Brief for Association of Corporate Counsel supra note 140, at 10-11, 13-14; Brief for Chamber of Commerce of United States supra note 140, at 2-3, 19-20; Brief for American Bar Association as Amicus Curiae Supporting Petitioner, at 5-6, 11-12, *Textron*, 130 S.Ct. 3320 (2010) (No. 09-750); Brief for Tax Executives Institute Amicus Curiae Supporting Petitioner, at 13, 130 S.Ct. 3320 (2010) (No. 09-750) ("[I]ts effect would extend to all litigation and allow parties in a broad range of litigation contexts



document advising with respect to a litigation reserve fund amount would be subject to discovery.<sup>152</sup> This is an overblown argument. The discovery rules require that information be “relevant” to be subject to discovery. An attorney-created litigation reserve fund document, for example, generally would not satisfy the relevance requirement because the document would not make any fact at issue in the litigation more likely or less likely.<sup>153</sup>

Moreover, if work product immunity were to apply to attorney-created tax accrual workpapers created in the context of obtaining certified financial statements, then: (1) virtually any advice by a tax attorney would be protected by work product immunity because the IRS always would be a potential adversary<sup>154</sup> and (2) work product immunity might apply to any regulatory compliance work (e.g., environmental, securities, fair labor, etc.) performed by an attorney, and any advice by a such an attorney would be protected by work product immunity because the government always would be a potential adversary. That would be an absurd result and indicates that any such construction of work product immunity would be too broad.

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both public and private—to access documents reflecting lawyers’ strategy or analysis of their clients’ claims.”); Brief of Product Liability Advisory Council as Amicus Curiae Supporting Petitioner, at 9-14., 130 S.Ct. 3320 (2010) (No. 09-750).

152. See Tax Mgmt. Wkly. Rep. 9/14/09, at 1123 (Under the newly created “for use in possible litigation” test, the adversary in any sort of litigation may seek to discover the opposing party’s analysis of the business risks of the litigation, including the amount set aside in a litigation reserve fund.”).

Furthermore, documents analyzing anticipated litigation, but prepared to assist in a business decision rather than in the conduct of litigation, may not qualify for work product protection under the reasoning of *Textron*.

See also Coder, *supra* note 150, at 640 (“There are significant nontax ramifications from this decision, and all litigators and general counsel should be concerned. This decision opens the door for one party in litigation to discover an opposing party’s litigation reserve fund.” (Quoting Robin Greenhouse of McDermott, Will & Emery)).

153. An insurance company’s litigation reserve fund document might be subject to discovery, however, in litigation against the insurer alleging a bad faith or negligent failure to settle within the dollar limit of the policy. See generally Ann Ketchen, Reserve And Reinsurance Information: Is It Discoverable?, Spring 2009 available at: <http://www.rkmc.com/Reserve-And-Reinsurance-Information-Is-It-Discoverable.htm>; Steve Rawls & Dennis M. Hudson, Jr., Selected Third-Party Bad Faith Liability Standards Governing Failure to Settle Cases, June 2006, available at <http://www.butlerpappas.com/showarticle.aspx?Show=444>.

154. See *Fid. Int’l. Currency Advisor A Fund v. United States*, Nos. 05-40151-FDS, 06-40130-FDS, 06-40243-FDS, 06-40244-FDS, 2008 WL 4809032, at \*1 (D. Mass. 2008). See also Dennis J. Ventry, Jr., A Primer on Tax Work Product for Federal Courts, 123 Tax Notes 875, at 879, 882-83 (2009); Bassin, *supra* note 135, at 571.

Indeed, any judicial decision with respect to work product immunity for attorney-prepared tax accrual workpapers necessarily would be a narrow holding because of (1) the unusually broad grant of investigatory authority granted to the IRS in section 7602 and (2) the public policy considerations supporting effective tax administration underlying section 7602. Accordingly, tax accrual workpapers should be treated uniquely for purposes of work product immunity under the rationale of tax exceptionalism.<sup>155</sup> Given the unusual circumstances of tax accrual workpapers, it seems that any judicial decision regarding the inapplicability of work product immunity as to tax accrual workpapers would be of little relevance to other contingent liabilities, so I am persuaded that a decision denying work product immunity to tax accrual workpapers would not open a floodgate resulting in the discovery of other contingent liability documents.

I conclude that this consideration of potential uncertain scope of attorney work product immunity is entitled to no weight. Courts could (and I think should) negate this concern by embracing the doctrine of tax exceptionalism, thereby restricting the scope of a decision regarding attorney-prepared tax accrual workpapers to the unusual circumstances that attend section 7602.

#### *e. Intrusiveness and IRS Policy of Restraint*

The IRS policy of restraint, discussed above in Part II.C.2, continues to limit the range of circumstances in which it will seek tax accrual workpapers, and this seems to me to demonstrate continuing IRS “administrative sensitivity” to the intrusiveness concerns raised by taxpayers, as was the case in *Arthur Young*. The IRS policy announced in 2002 was targeted at potentially abusive situations (“listed transactions”), whereas the prior standard applied in “unusual circumstances.”<sup>156</sup> The Supreme Court in *Arthur Young* viewed favorably the IRS policy of restraint, and the current policy of restraint seems sufficiently targeted to be within the parameters of the approval in *Arthur Young*.<sup>157</sup>

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155. It is not the purpose of this article to enter the raging debate on trans-substantivity under the Federal Rules of Civil Procedure that has resulted from recent Supreme Court caselaw. See generally Robert G. Bone, Twombly, Pleading Rules, and the Regulation of Court Access, 94 Iowa L. Rev. 873 (2009); Mark Herrmann, James M. Beck & Stephen B. Burbank, Plausible Denial: Should Congress Overrule Twombly and Iqbal?, 158 U. Pa. L. Rev. PENnumbra 141 (2009). I argue that the unique circumstances of tax accrual workpapers (including the statutory authority in § 7602 and the public policy rationale underlying § 7602) justify a unique and limited decision.

156. See Announcement 2002-63, 2002-2 C.B. 72.

157. In Announcement 2010-9, 2010-7 I.R.B. 408, the IRS proposed mandatory tax return disclosure with respect to uncertain tax positions (item-by-

In Announcement 2002-63,<sup>158</sup> the IRS announced a “limited expansion” in its policy of restraint and advised that, with respect to any return filed on or after July 1, 2002, the IRS would seek tax accrual workpapers in a situation in which the taxpayer claimed any tax benefit from a Treasury Regulation section 1.6011-4T(b)(2) “listed transaction.”<sup>159</sup> A listed transaction is defined under Treasury Regulation section 1.6011-4(b)(2) as “a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction.” The Announcement 2002-63 policy is as follows:

1. If the listed transaction properly was disclosed (under what now is Reg. section 1.6011-4) as part of the taxpayer’s federal income tax return, the IRS routinely will request the tax accrual workpapers only with respect to the listed transaction.
2. If the listed transaction was not so disclosed, the IRS routinely will request all tax accrual workpapers.
3. If tax benefits from multiple investments in listed transactions are claimed on a return (whether or not properly disclosed), the IRS at its discretion may request all tax accrual workpapers.
4. If, in connection with the examination of a return claiming tax benefits from a listed transaction that was properly disclosed, there also are “financial accounting irregularities,” the IRS at its discretion may request all tax accrual workpapers.

I conclude that the present policy of restraint significantly restricts the IRS as to the circumstances under which it will seek tax accrual workpapers. Accordingly, this factor weighs in favor of discovery of attorney-created tax accrual workpapers, as it weighed in favor of discovery of the CPA-created tax accrual workpapers in *Arthur Young*.<sup>160</sup> The Supreme

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item) by business taxpayers with total assets in excess of \$10,000,000, but the policy of restraint otherwise remains unchanged.

158. Announcement 2002-63, 2002-2 C.B. 72.

159. Reg. § 1.6011-4T, a temporary Regulation, was withdrawn in 2007 by T.D. 9350, 72 Fed. Reg. 43146-43154, and replaced by Reg. § 1.6011-4.

160. In Announcement 2010-9, the IRS advised that it was considering changes to the reporting requirements regarding any uncertain tax position (“UTP”) of certain business taxpayers (those who have (1) a financial statement prepared under accounting standards that require disclosure of uncertain tax positions and (2) assets over \$10 million). The IRS proposes to develop a tax return schedule on which certain business taxpayers will report their UTPs. The tax return schedule will require the annual disclosure of UTPs, and will require a concise description of those positions and a statement of the maximum amount of U.S. income tax exposure if

Court in *Arthur Young* acknowledged that this is a relevant factor, but, by my reading of the case, this factor was accorded only limited weight.

## 2. *Balancing of Weighted Factors*

To recap the foregoing discussion in which I attribute weight to the various policy-based factors:

1. The public interest in the IRS having effective tools to advance tax compliance: significant weight in favor of discovery.
2. The unfairness, cost shifting, and free riding that would result from discovery of the tax accrual workpapers: some uncertain weight in favor of not permitting discovery.
3. The potential chilling effect on attorney-client communications were tax accrual workpapers to be subject to discovery: no weight.
4. The concern regarding the scope of a holding that tax accrual workpapers are subject to discovery: no weight.
5. Intrusiveness and the IRS policy of restraint: limited weight in favor of discovery.

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the taxpayer's position is not sustained. The Announcement stated that the IRS would not require the taxpayer to disclose the taxpayer's risk assessment or any tax reserve amount, even though the IRS stated that it can compel the production of such information through a summons on the basis of *Arthur Young*. The IRS is proposing otherwise to retain its existing policy of restraint. This announcement has ignited a flurry of commentary, most of it adverse, from the business taxpayer community that will be subject to disclosure. See ABA Members Seek Withdrawal of Proposal to Require Reporting of Uncertain Tax Positions, 2010 Tax Notes Today 104-66 (May 8, 2010); TEI Comments on Proposed Schedule, Draft Instructions for Disclosure of Uncertain Tax Positions, 2010 Tax Notes Today 104-67 (May 28, 2010). On December 15, 2010, the IRS promulgated regulations to implement the UTP system. See T.D. 9510, 75 Fed. Reg. 78,160 (Dec. 15, 2010).

Given the broad authority the IRS possesses under § 6011 to collect relevant information regarding a tax return, it seems that the IRS is well within its administrative authority to require the reporting of such UTP information. See Wilkins Reiterates Administrative Rationale Behind Uncertain Tax Position Reporting, 2010 Tax Notes Today 79-1 (April 23, 2010). It should be noted that the UTP disclosure form will provide less information to the IRS than will tax accrual workpapers (tax accrual workpapers provide, in addition, the taxpayer's risk assessment analysis and the tax reserve amount, if any), but significantly enhanced reporting to the IRS will result if the UTP proposal is adopted. If such information can be obtained via the tax return, it would seem that the modestly greater disclosure associated with tax accrual workpapers would not be a significantly greater (or more unfair) burden on a taxpayer who has engaged in a transaction (or other conduct) that invokes Announcement 2002-63.

To me, *Arthur Young* establishes that factor 1 above is greater than factor 2 above. Accordingly, the weights of these five factors reflect a balance in favor of discovery.<sup>161</sup> If factor 2 above is accorded limited weight, the balance clearly favors discovery. If factor 2 above is accorded significant weight (but less than the weight of factor 1 above according to *Arthur Young*), the balance still favors discovery, but by a reduced margin. Regardless of the magnitude of weight accorded factor 2 above, this policy-based analysis concludes that tax accrual workpapers should not qualify for work product immunity.

*C. Technical Issues Regarding Tax Accrual Workpapers and Work Product immunity*

In addition to the policy analysis in Part III.B, a variety of technical/substantive issues must be resolved to determine whether work product immunity applies to attorney-created tax accrual workpapers: (1) is the possibility of a future IRS challenge regarding the taxpayer's federal income tax return sufficient to satisfy, at the time of creation of the tax accrual workpapers, the "in anticipation of" litigation requirement? (i.e., how remote is the likelihood of litigation), (2) if tax accrual workpapers must be prepared to obtain certified financial statements, are they prepared for the purpose of litigation or for trial? (i.e., what is the purpose for preparation), (3) if tax accrual workpapers are work product, are they opinion work product protected from discovery?, (4) does the ordinary course of business exception apply to tax accrual workpapers?, and (5) does disclosure of tax accrual workpapers to the CPA constitute waiver of work product immunity?<sup>162</sup> The analysis below proceeds on the basis that a doctrine of tax exceptionalism (for purposes of work product immunity) should recognize and weigh the unique public policy considerations that support effective tax administration.

*1. For purposes of work product immunity, is the possibility of a future IRS challenge sufficient to satisfy, at the time of creation of the tax accrual workpapers, the "in anticipation of" litigation requirement?*

Rule 26(b)(3) provides generally that a party "may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party . . . ." It is clear that the "in anticipation of"

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161. But see Bassin, *supra* note 135, at 571.

162. The boundaries of these five subsidiary issues may overlap, particularly (1) and (2) as well as (2) and (4).

standard does not require commencement of actual, formal litigation.<sup>163</sup> It also is clear that work product immunity can arise in a section 7604 enforcement proceeding regarding a section 7602 summons.<sup>164</sup> The question, more narrowly, is whether the “in anticipation of” standard of Rule 26(b)(3) has been satisfied:<sup>165</sup> is there a sufficient likelihood of litigation or trial, as determined at the time of creation of the workpapers?

*Taxpayer has not engaged in listed transaction.* A contingent tax reserve issue will rise to the level of litigation only if each of the following is completed: (1) the IRS selects the taxpayer’s tax return for audit, (2) the IRS discovers in the audit the issue or issues that are the subject of the contingent tax reserve amount, (3) the IRS properly understands and evaluates the issues so discovered, (4) the IRS challenges the taxpayer’s treatment of the issues so discovered by either (a) issuing a section 6212 statutory notice of deficiency or (b) seeking judicial enforcement of a section 7602 summons seeking discovery of the tax accrual workpapers, and (5) the taxpayer decides to participate in litigation (either pursuant to the section 6212 notice of deficiency or a section 7604 summons enforcement proceeding).<sup>166</sup> The IRS Statistics of Income Division does not prepare reports regarding the percentage of issues that are settled,<sup>167</sup> but it is generally acknowledged that a very high percentage of issues are resolved short of litigation. In addition, completion of all of those steps may take considerable time.

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163. See *Grolier Inc.*, 462 U.S. at 25 (“[T]he literal language of [Rule 26(b)(3)] protects materials prepared for any litigation or trial as long as they were prepared by or for a party to the subsequent litigation.”). See generally Moore et al., supra note 59, § 26.70[3][a]; Wright, et al., supra note 56, § 2023. See also *Amway Corp. v. Procter & Gamble Co.*, No. 1:98-CV-726, 2001 WL 1818698, at \*6 (W.D. Mich. 2001) (digesting cases); *In re Om Group Sec. Litig.*, 226 F.R.D. 579, 584-85 (N.D. Ohio 2005) (digesting cases); *Nat’l. Union Fire Ins. Co.*, 967 F.2d at 984 (explaining the fact that litigation does eventually ensue does not automatically invoke work product immunity, and that document must be prepared because of the prospect of litigation “when the preparer faces an actual claim or potential claim following an actual event or series of events that reasonably could result in litigation”).

164. The Supreme Court *Upjohn* decision, discussed in Part II.D.4.a, confirms that a § 7604 summons enforcement action is an adversarial proceeding that can invoke work product immunity.

165. See generally Epstein, supra note 41, at 836-54.

166. Work product immunity issues also could arise in the context of pre-trial discovery related to refund litigation (in either U.S. District Court or the Court of Federal Claims) if the government were to seek discovery of the tax accrual workpapers, but the circumstances at the time of creation of the tax accrual workpapers would be no different.

167. The IRS Databook is published periodically, but no information is provided regarding settlements. IRS Databooks available at <http://www.irs.gov/taxstats/article/0,,id=102174,00.html>.

Litigation with the IRS is an eventual possibility with respect to any contingent tax liability, but at the time the tax accrual workpapers are created, actual or even potential litigation is (1) a rather remote possibility in terms of likelihood (perhaps not such a remote possibility regarding a listed transaction, which is discussed immediately below) and (2) relatively far removed in terms of time.<sup>168</sup> Work product immunity requires a sufficient nexus to litigation (under Rule 26(b)(3)(B), it must be “concerning the litigation”).<sup>169</sup> Tax accrual workpapers are created each year (1) in conjunction with preparation of the financial statements for the relevant fiscal period and (2) before filing of the federal income tax return for that period. Litigation is not imminent or necessarily anticipated at this time, and the taxpayer could change its mind regarding whether it will claim a tax benefit on the tax return or a development could occur that changes the return reporting (relative to the analysis in the tax accrual workpapers). The fact that the taxpayer is taking a tax return position that the IRS might possibly find and challenge strikes me as insufficient to satisfy the “in anticipation of” standard because the preparation of tax accrual workpapers is too remote in terms of the likelihood of a challenge resulting in litigation and too remote in terms of the time proximity to litigation.<sup>170</sup>

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168. See generally Edna S. Epstein, *supra* note 41, at 836-45.

[T]he concept “in anticipation of litigation” contains within it two related, but nonetheless distinct, concepts. One is temporal. The other is motivational. To be “in anticipation of” litigation a document must, obviously, have been prepared before or during the litigation. That temporal element, standing alone, however, is not sufficient. The document or material must also have been prepared for litigation and not for some other purpose. It is the second concept that is determinative for the work product protection.

169. See *Fid. Int'l. Currency Advisor A Fund*, 2008 WL 4809032, at \*13:

There must be a closer nexus between the lawyer’s advice and a specific potential claim for the work-product doctrine to apply. The mere fact that the taxpayer is taking an aggressive position, and that the IRS might therefore litigate the issue, is not enough.

See also, Lee A. Sheppard, *Textron Case Not a Game*, 2009 Tax Notes Today 180-1 (Sept. 21, 2009) (to apply work product immunity in *Textron* would push work product immunity further back in time and would ignore the requirement that actual litigation be on the horizon). See *F.T.C. v. Grolier, Inc.*, 462 U.S. 19, 25 (1983), observing that Rule 26(b)(3) contains no explicit time rule and neither do the Advisory Committee Notes.

170. It also is worthy of note that steps (1)-(4) are during investigatory/inquisitorial proceedings that are not adversarial litigation; only step (5) is in the context of adversarial litigation. See generally *Camp*, *supra* note 25. See also *United States v. Baggot*, 463 U.S. 476, 480 (1983) (“[T]he purpose of the audit

*Taxpayer has engaged in listed transaction or has history of aggressive tax positions.* Participation in a listed transaction requires reporting to the IRS by the taxpayer (and possibly others), and the likelihood of an IRS challenge possibly leading to litigation is no doubt greater than if the taxpayer did not report a listed transaction. Under the IRS policy of restraint, if the taxpayer reports participation in a listed transaction, the IRS will seek some or all of the tax accrual workpapers. In such a case, the calculus differs with respect to the likelihood of litigation, and a crucial issue is whether the likelihood is great enough to satisfy the “in anticipation of” litigation requirement.

This is a close question to me, but as I balance the considerations, I conclude that the likelihood of the availability of work product immunity should not be enhanced because a taxpayer either (1) has engaged in a listed transaction (i.e., a transaction that the IRS considers to be potentially abusive) or (2) has a history of asserting more aggressive tax reporting positions that have resulted in IRS audits and controversies, perhaps resulting in litigation (as was the case for Textron). A taxpayer in either of the two categories might well be more likely to encounter a challenge from the IRS, but it would be unwise and perverse from a public policy perspective to enhance the prospects for work product immunity based upon the taxpayer engaging in a listed transaction or having a history of aggressive positions on the taxpayer’s tax return. If availability of work product immunity were to depend to any significant extent upon such a tax posture, the more aggressive taxpayers would be rewarded with work product immunity, and the less aggressive taxpayers disadvantaged by not having such immunity.

*2. If Tax Accrual Workpapers Must be Prepared to Obtain Certified Financial Statements, are they Prepared for the Purpose of Litigation or for Trial?*

Another significant interpretive question is whether tax accrual workpapers are “prepared in anticipation of litigation or for trial” within Rule 26 if the taxpayer otherwise must create the document; this question addresses the purpose for preparation of the document. With respect to a taxpayer, such as Textron, who is seeking unqualified certified financial statements, the taxpayer must provide to the CPA suitable tax accrual workpapers in support of the contingent reserve for taxes on the balance sheet. Accordingly, at least one purpose, and the purpose first-in-time

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is not to prepare for or conduct litigation, but to assess the amount of tax liability through administrative channels”).



chronologically with respect to tax accrual workpapers, is to obtain certified financial statements.<sup>171</sup>

*a. What is Appropriate Standard for "Dual-Purpose" Documents?*

Opponents of work product immunity for tax accrual workpapers argue that work product protection does not apply because the tax accrual workpapers are not prepared in anticipation of litigation; they are prepared to obtain certified financial statements.<sup>172</sup> Proponents of work product immunity for tax accrual workpapers argue strenuously, however, that the subject matter of the document is concerned with possible litigation (with the IRS) and that the tax accrual workpapers are "dual-purpose" (one purpose is to obtain certified financial statements and the other purpose is "in anticipation of litigation") documents to which the work product immunity should apply.<sup>173</sup>

The lower courts are split with respect to the standard to apply in determining whether a document is prepared in anticipation of litigation. Wright, Miller & Marcus claim to be the source of the "because of" standard, which they advocate, and Moore's Federal Practice advises that the "because of" standard is preferable as more "administrable" by favoring a broader and more inclusive definition. I am unpersuaded that a broader standard is somehow more administrable; neither a narrow standard nor a broad standard necessarily is more administrable. Under either standard, difficult decisions at the margin must be made.

I find the "primary purpose" standard inherently more clear and precise, as well as easier to apply. The "because of" standard is less certain than the "primary purpose" standard in that the "because of" standard fails to provide any guidance as to the minimum magnitude of the litigation purpose necessary to satisfy the standard.<sup>174</sup> The "because of" standard, due to its inherent uncertainty, also invites ex-post manipulation. I also consider the "because of" standard to be over-generous in its scope because it seems to

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171. With respect to the purpose for creation of the document, see Epstein, *supra* note 41, at 854-94.

172. See generally Ventry, *supra* note 154, at 875-76; Johnson, *supra* note 44, at 155, 165. See also *El Paso Co.*, 682 F.2d at 542; *Textron*, 577 F.3d at 31-32.

173. See Moore et al., *supra* note 59, at § 26.70[3][b]; Wright et al., *supra* note 56, at § 2024; Pease-Wingenter, *supra* note 131, at 139-40; Bassin, *supra* note 135, at 578.

174. Epstein, *supra* note 41, at 855 (in deciding whether a document is prepared in anticipation of litigation, none of the following is particularly helpful: (1) the "primary purpose" standard, (2) the "because of" standard, or (3) a "but for" standard).

permit work product immunity with respect to a document even if the non-litigation purpose is greater than the litigation purpose.<sup>175</sup>

The First Circuit *en banc* opinion in *Textron* asserts that every experienced trial attorney (1) knows “the touch and feel of materials prepared for a current or possible (i.e., ‘in anticipation of’) law suit” and (2) would not consider tax accrual work papers to be work product.<sup>176</sup> The opinion elaborates by stating that a “set of tax reserve figures, calculated for purposes of accurately stating a company’s financial figures, has in ordinary parlance only that purpose: to support a financial statement and the independent audit of it.”<sup>177</sup> The opinion also states that “[e]very lawyer who tries cases knows the touch and feel of materials” that are protected by work product immunity.<sup>178</sup> The First Circuit dissent appropriately states that lower courts deserve more guidance than a statement by the Court of Appeals that it knows work product when it sees it.<sup>179</sup> I concur that the “touch and feel” articulation of the *en banc* majority is not a workable standard.

A much narrower articulation to apply in deciding whether a document is prepared in anticipation of litigation is to determine whether the document would have been prepared in any event, regardless of whether litigation was possible.<sup>180</sup> If the document would have been prepared in any event, regardless of whether litigation was possible, the document is not

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175. As discussed above in the text accompanying note 113, the *Deloitte* case is a prime example of this problem. Applying the “because of” test, the *Deloitte* court concluded that work product immunity might apply even though the record in the case indicates that the purpose for preparation of the document was to secure certified financial statements, rather than prepare for litigation.

176. *Textron*, 577 F.3d at 30. See also *id.* at 28, (“Any experienced litigator would describe the tax accrual work papers as tax documents and not as case preparation materials.”)

177. *Id.* at 30.

178. See *id.* at 30.

179. *Id.* at 34-35.

The majority also proclaims, without record support, that “[a]ny experienced litigator would describe the tax accrual workpapers as tax documents and not as case preparation materials.” *Id.* at 28. Further, this language dangerously suggests that this court can, from its general knowledge, offer an expert opinion as to how such documents are always seen by “experienced litigators.”

*Id.* at 39-40.

180. See *Epstein*, *supra* note 41, at 855:

Perhaps the only distinction that can be applied with any assurance of a fairly consistent result is to ask whether the document would have been prepared regardless of whether litigation was also in the offing. If it would have been prepared regardless of whether litigation was in the offing, then there is generally no reason to accord the document work product protection.

prepared in anticipation of litigation.<sup>181</sup> Under this articulation, attorney-prepared tax accrual workpapers such as in *Textron* do not qualify for work product immunity because the workpapers are prepared to obtain certified financial statements (regardless of the prospects of any litigation).

*b. Are Tax Accrual Workpapers Prepared in Anticipation of Litigation or for Trial?*

Regardless of the standard, if any, that a court may adopt regarding a “dual-purpose” document, ultimately the court must decide whether attorney-created tax accrual workpapers are prepared in anticipation of litigation or for trial. The language of Rule 26 is somewhat ambiguous as applied to tax accrual workpapers, but I see an important distinction between (1) a document that evaluates and quantifies, for the purpose of obtaining certified financial statements, the likelihood of litigation and the prospects for success in such litigation and (2) a document prepared to assist in the conduct of anticipated litigation. Tax accrual workpaper documents are prepared for use by the CPA to evaluate the adequacy of the taxpayer’s contingent reserve for taxes (taking into consideration the prospects for litigation and for success in litigation),<sup>182</sup> not to assist in the conduct of litigation with the government.

The tax accrual workpapers are, from a chronological perspective, created when the CPA needs information in support of the balance sheet contingent reserve for federal taxes, not when litigation with the IRS is imminent or necessarily anticipated. Tax accrual workpapers are, from a purpose perspective, created to facilitate the taxpayer’s obtaining certified financial statements, not for the purpose of preparing for litigation (even though the subject matter of the document does relate to the prospects for litigation and for success in litigation, if litigation should occur).<sup>183</sup> In

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181. *Id.*

182. Financial Accounting Standards Board ASC 740 (previously referred to as “FIN 48”) establishes a more-likely-than-not standard with respect to recording a tax benefit on financial statements. Prior to adoption of FIN 48, the minimum standard for recording a tax benefit on financial statements was not explicit. The adoption of the FIN 48 more-likely-than-not standard has made tax accrual workpapers even more important and integral to the process of obtaining certified financial statements. Arguably, the adoption of FIN 48 buttresses the argument that tax accrual workpapers are not prepared in anticipation of litigation but rather to obtain certified financial statements. See Financial Accounting Standards Board Accounting Standards Codification Topic 740. For a discussion of FIN 48, see Hanna, et al., *Corporate Income Tax Accounting*, supra note 37, Ch. 3.

183. See *Roxworthy*, 457 F.3d at 595 (explaining that “key issue” in determining whether work product immunity applies is the function served by the document; court must examine circumstances surrounding the document’s creation in addition to the document itself).

addition, work product immunity is not automatically triggered because the materials were prepared by lawyers or represent legal thinking because of the Rule 26(b)(3) ordinary course of business doctrine.<sup>184</sup>

The First Circuit majority in *Textron* characterized the issue as the applicability of the work product immunity to “a document . . . not in any way prepared ‘for’ litigation but relates to a subject that might or might not occasion litigation.”<sup>185</sup> In other words, the *en banc* majority was concerned about the purpose for creation of the document, not the subject matter of the document. The First Circuit concluded that there was no evidence that the tax accrual workpapers (1) were prepared for use in potential litigation or (2) would serve any useful purpose for *Textron* in conducting litigation if litigation were to arise.<sup>186</sup>

Given that the purpose of work product immunity is protection of the litigation process, I conclude that the “in anticipation of litigation” standard was not satisfied in *Textron* because the tax accrual workpapers were not created as part of the litigation process.<sup>187</sup> Attorney Fortenbaugh in *Hickman v. Taylor* was engaged shortly after a sinking of a tugboat by the tug owners to defend them against potential claims and lawsuits related to the sinking, both of which were likely and did result. Attorneys preparing tax accrual workpapers are not similarly situated with respect to potential litigation; actual litigation is not imminent or even likely at the time of preparation of the tax accrual workpapers.

I am persuaded that the substantive content of the tax accrual workpapers should not control; instead, the purpose (at the time of preparation) for which the document was prepared should control in determining whether attorney-prepared tax accrual workpapers are prepared

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184. See Fed. R. Civ. P. 26(b)(3) advisory committee note (1970).

185. *Textron*, 577 F.3d at 26.

186. See *id.* at 30.

187. In addition, it seems quite doubtful that any trial strategy would be disclosed upon discovery of the tax accrual workpapers, and this suggests to me that the tax accrual workpapers are not prepared in anticipation of litigation. See Ventry, *supra* note 154, at 879-80; Johnson, *supra* note 44, at 165; Pease-Wingenter, *supra* note 131, at 346. The tax accrual workpapers might disclose to some extent, however, the theories supporting the taxpayer’s position, and I consider this in Part III.B.1.b.

See also *El Paso*, 682 F.2d at 543-44:

The . . . [tax accrual workpaper] concocts theories about the results of possible litigation; such analyses are not designed to prepare a specific case for trial or negotiation. Their sole function, from all that appears in the record, is to back up a figure on a financial balance sheet. Written ultimately to comply with SEC regulations, the tax pool analysis carries much more the aura of daily business than it does of courtroom combat.

in anticipation of litigation. To me, the “anticipation of litigation” standard is not satisfied because the workpapers are created for a non-litigation purpose: to obtain unqualified certified financial statements.<sup>188</sup>

3. *If Tax Accrual Workpapers are Work Product, are they Opinion Work Product Protected from Discovery?*

If a court concludes that attorney-created tax accrual workpapers such as in *Textron* are work product, the court also must determine (1) whether the workpapers are opinion work product and (2) whether the IRS has demonstrated sufficient need and undue hardship to justify discovery (as required by Rule 26(b)(3)).<sup>189</sup> As discussed in Part II.D.3.d, Rule 26(b)(3)(B) generally protects from discovery opinion work product information. The attorney-prepared litigation hazard percentages and the contingent reserve amounts in the *Textron* tax accrual workpapers reflect opinions, and the question is whether the tax accrual workpapers (if they are deemed work product for purposes of work product immunity) should be protected under *Hickman* and Rule 26 as opinion work product.<sup>190</sup>

I conclude that the opinion protection should not apply. To be protected under Rule 26(b)(3)(B), the opinion information must be “concerning the litigation.” At the time of creation of the tax accrual workpapers, there is no imminent litigation, and the prospects for litigation are attenuated.<sup>191</sup> In addition, tax accrual workpapers result in valuation estimates, and these estimates may be created by attorneys, CPAs (and were generally created by CPAs prior to the decision in *Arthur Young* that did not protect such workpapers from discovery), or other personnel of the taxpayer. The fact that tax accrual workpapers can be created by non-attorneys in the

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188. The reserve for contingent tax liability also may be used by management for purposes of “earnings smoothing” (to reduce variations in earnings from period to period by (1) increasing the reserve and reducing current earnings when current earnings otherwise are relatively high and (2) decreasing the reserve and increasing current earnings when current earnings otherwise are relatively low). See Thomas Jaworski, SEC Charges Former Dell Execs With Misuse of Tax Reserves, 128 Tax Notes 1025 (2010). To the extent that the reserve is so used, the tax accrual workpapers are not prepared in anticipation of litigation.

189. See *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003).

190. The First Circuit dissent asserts that the litigation hazard percentages reflected within the *Textron* tax accrual workpapers “contain exactly the sort of mental impressions . . . that *Hickman* sought to protect.” The dissent characterizes the percentages as reflecting counsel’s “ultimate impression of the value of the case.” *Textron*, 577 F.3d at 36.

191. See *supra* text accompanying note 166.

context of certifying financial statements indicates that the nature of the work product is not necessarily concerning litigation.<sup>192</sup>

To conclude that attorney-created tax accrual workpapers such as in *Textron* are opinion work product, a court must address whether the IRS has satisfied (so as to justify discovery) the high burden of proof under Rule 26(b)(3) with respect to its need and undue hardship regarding the tax accrual workpapers. The argument in favor of discovery is that (1) the IRS is not, in a broad and intrusive fashion, asking for a large amount of information and (2) the scope of the IRS request is narrowly defined and is supported by specific statutory provisions and sound public policy. The IRS is not seeking information generally regarding the taxpayer's tax return and financial statements; it is asking for targeted, tax-sensitive information because the taxpayer engaged in one or more transactions that the IRS identified as potentially abusive of the tax system. Congress has added a whole structure of reporting information provisions (and related penalties for non-compliance with the reporting obligations) regarding reportable transactions, and these provisions are designed to assist the IRS in enforcing the tax laws, which tends to indicate general public policy support for disclosure with respect to reportable transactions.<sup>193</sup>

#### 4. Does the Ordinary Course of Business Exception Apply to Tax Accrual Workpapers?

Both *Hickman* and Rule 26(b)(3) provide that certain documents created in the ordinary course of business are not within the scope of work product immunity. The Advisory Committee Notes for Rule 26(b)(3) provide that three distinct categories of materials are subject to discovery: (1) materials assembled in the ordinary course of business, (2) materials assembled pursuant to public requirements unrelated to litigation, and (3) materials assembled for other non-litigation purposes.<sup>194</sup> Each of the three

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192. In addition, if work product immunity were to be provided to attorney-created tax accrual workpapers, but not to CPA-created tax accrual workpapers (which is the case because of the *Arthur Young* decision, discussed in Part II.D.4.b), attorneys would enjoy a marketplace comparative advantage relative to CPAs. For a critique of such an advantage, see Judge Posner's opinion in *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

193. See generally IRC §§ 6011, 6662A, 6707A (taxpayer duty to report "reportable transaction," taxpayer accuracy-related penalty related to reportable transactions, and taxpayer penalty based on failure to report "reportable transactions," respectively); IRC §§ 6111, 6707 (material advisor duty to report "reportable transaction" and material advisor penalty based on failure to report "reportable transactions," respectively).

194. Materials prepared in the ordinary course of business are not within the scope of protected work product even if the document also would be useful in

categories focuses on the purpose for creation of the materials, not on the substantive content of the materials, and considerable overlap among the three categories is possible.

Tax accrual workpapers clearly are prepared in the ordinary course of business (to obtain certified financial statements), so the no-work-product-immunity proponents argue that tax accrual workpapers do not meet the definitional threshold to be work product.<sup>195</sup> Proponents of work product immunity argue that the workpapers are “dual purpose” documents<sup>196</sup> and that the litigation-related purpose provides sufficient anticipation of litigation to meet the requirements of Rule 26.<sup>197</sup>

Because the rationale supporting work product immunity is to protect the litigation process, *Hickman* and Rule 26 confirm that work product immunity does not apply to the preparation of documents in the ordinary course of business. Disclosure of tax accrual workpapers would *not* discourage thorough preparation for trial because the tax accrual workpapers simply are not a trial preparation document.<sup>198</sup> The subject matter of the tax accrual workpapers (i.e., identification and valuation of tax return positions that might be challenged by the IRS) might eventually result in litigation, but the tax accrual workpapers clearly are not prepared for, and are not part of, the litigation process; they are prepared out of the business necessity of obtaining certified financial statements (and, for publicly traded companies

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litigation. See Wright et al., *supra* note 56, § 2024 (“[E]ven though litigation is already in prospect, there is no work product immunity for documents prepared in the regular course of business, rather than for purposes of litigation.”); Moore et al., *supra* note 59, § 26.70[3][b]. See also *In re Om Group Sec. Litig.*, 226 F.R.D. at 584-87 (documents prepared in connection with audit committee investigation of inventory problems, begun after initiation of shareholder litigation, would have been prepared regardless of possibility of additional litigation, and therefore documents were not protected by work product doctrine in the shareholder litigation). See also *Mims v. Dallas County*, 230 F.R.D. 479, 484 (N.D. Tex. 2005) (“If the document would have been created without regard to whether litigation was expected to ensue, it was made in the ordinary course of business and not in anticipation of litigation.”); *Roxworthy*, 457 F.3d at 593-94 (“[I]t is clear that documents prepared in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes, are not covered by the work product privilege. . . . Thus, a document will not be protected if it would have been prepared in substantially the same manner irrespective of the anticipated litigation.”).

195. See Ventry, *supra* note 154, at 875-76; Johnson, *supra* note 44, at 165; Sheppard, *supra* note 169, at 1168.

196. “Dual-purpose” documents are discussed in Part II.D.3.b.

197. See Bassin, *supra* note 135, at 571; Pease-Wingenter, *supra* note 131, at 348.

198. See *Coastal States Gas Corp. v. Dep’t of Energy*, 617 F.2d 854, 864 (D.C. Cir. 1980); *El Paso Co.*, 682 F.2d at 542-43. See also Pease-Wingenter, *supra* note 131, at 346.

such as Textron, to satisfy federal securities regulation statutes). Accordingly, attorney-created tax accrual workpapers such as in *Textron* fall within each of the three categories under Rule 26, and the ordinary course of business doctrine applies to such tax accrual workpapers so that work product immunity does not apply.

5. *Does Disclosure to CPA Constitute Waiver of Work Product Immunity?*

Disclosure of the tax accrual workpapers to the taxpayer's CPA necessarily will occur if the taxpayer is to obtain certified financial statements. Such disclosure clearly would waive attorney-client privilege because the attorney-client privilege is based upon confidentiality, and disclosure to any other person is inconsistent with that confidentiality.<sup>199</sup> The caselaw regarding work product immunity, however, generally holds that work product immunity (which is based upon the integrity of the litigation process) is waived only if the disclosure is to an adversary or to a person likely to serve as a conduit to an adversary.<sup>200</sup>

In *Arthur Young*, the Supreme Court observed that the AY-generated tax accrual workpapers (in the possession of AY) were subject to discovery in litigation and, thus, AY could be a conduit to adversaries such as the Securities and Exchange Commission or the IRS. The *Arthur Young* holding may not be apposite to attorney-created tax accrual workpapers because the CPA generally reviews the attorney-generated tax accrual workpapers (1) under the condition of confidentiality, (2) at the taxpayer's place of business under tightly-controlled physical circumstances to maintain the confidentiality of the tax accrual workpapers, and (3) for a limited period of time.<sup>201</sup> In addition, the CPA is not allowed to keep a copy of the tax accrual workpapers. Such controlled circumstances would make it difficult for the

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199. See Moore et al., *supra* note 59, § 26.70[6]; Wright et al., *supra* note 56, § 2024.

200. See generally Wright et al., *supra* note 56, § 2024. See also *United States v. Deloitte & Touche*, 623 F. Supp. 2d 39 (D. D.C. 2009) (holding that corporation's did not waive attorney work product protection by disclosing work product documents to its independent auditor); *In re Raytheon Sec. Litig.*, 218 F.R.D. 354, 359-60 (D. Mass. 2003) (work product immunity waived only if materials disclosed in a fashion inconsistent with protecting them from an adversary or a potential adversary); *Goff v. Harrah's Operating Co.*, 240 F.R.D. 659 (D. Nev. 2007).

201. See Public Company Accounting Oversight Board, AU § 9326, Evidential Matter: Auditing Interpretations of § 326, ¶¶ 2.11-14, available at <http://pcaobus.org/Standards/Auditing/Pages/AU9326.aspx> (evidence obtained from client must afford a reasonable basis for an opinion regarding the tax accrual disclosures).



CPA to be a conduit to an adversary unless service of process compelling disclosure was made on the CPA at the very time the CPA had in its temporary possession and was reviewing the tax accrual workpapers.

On the other hand, *Arthur Young* points out that the CPA, in its role as auditor, acts to protect the public interest such that investors and lenders can rely on certified financial statements in making decisions.<sup>202</sup> In such a setting, the CPA exercises independence from its client,<sup>203</sup> and recent developments, particularly Financial Accounting Standards Board ASC 740 (formerly referred to as "FIN 48")<sup>204</sup> (not applicable in *Textron*) and the Sarbanes-Oxley legislation,<sup>205</sup> indicate heightened public interest in greater disclosure to accountants and greater independence of CPAs.<sup>206</sup>

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202. See *Arthur Young & Co.*, 465 U.S. at 817-18.

203. See *Medinol, Ltd.*, 214 F.R.D. at 116-17.

204. See Financial Accounting Standards Board Accounting Standards Codification Topic 740. For a discussion of FIN 48, see Hanna, et al., *supra* note 37, Ch. 3.

205. Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), which was concerned with improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. Several corporate scandals contributed to passage of the Sarbanes-Oxley legislation. See generally *Enron: Corporate Fiascos and Their Implications* (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

206. See generally, Dep't of the Treasury, *the Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (1999), available at <http://www.ustreas.gov/offices/tax-policy/library/ctswhite.pdf>; Staff of Joint Comm. on Tax'n, 108th Cong., 1 Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (2003), available at <http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html>; Hanna, et al., *supra* note 37, Ch. 5. See James C. Treadway, Jr., Commissioner, U.A. Secur. & Exch. Comm., Remarks to SEC and Financial Reporting Institute, University of Southern California, (May 11, 1984), available at <http://www.sec.gov/news/speech/1984/051184treadway.pdf>:

Whatever discomfort this decision may cause, public companies nonetheless are required to maintain candid communications which will permit auditors to satisfy themselves about the tax accrual and express an unqualified opinion. That may be uncomfortable, but a public company cannot avoid its obligation of full and complete disclosure. That must take precedent over tax strategy.

See Donald T. Nicolaisen, U.S. Secur. & Exch. Comm., Remarks at the Tax Council Institute Conference on the Corporate Tax Practice: Responding to the New Challenges of a Changing Landscape, (February 11, 2004), available at <http://www.sec.gov/news/speech/spch021104dtn.htm>:

I know some of you might be reluctant to fully document information about sensitive transactions or positions with your independent auditor for fear that their workpapers might end up in

District Court cases not involving tax accrual workpapers are split with respect to whether disclosure to a CPA waives work product immunity. In *Medinol, Ltd. v. Boston Scientific Corp.*,<sup>207</sup> the client disclosed attorney work product to the independent CPA retained to certify the client's financial statements. The court concluded that the disclosure did not serve any litigation interest or any other policy underlying the work product doctrine and held that work product immunity was thereby waived.<sup>208</sup>

*Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*,<sup>209</sup> involved energy commodity transactions by Merrill Lynch that eventually lead to litigation. Merrill Lynch launched an internal investigation (conducted by, and under the supervision of, in-house and outside counsel). The investigation produced two reports. A CPA was retained to audit and certify Merrill Lynch's financial statements. The CPA requested and was provided the reports so that it could discharge its engagement to certify the financial statements. The reports were provided to the CPA with the understanding that (1) "they were prepared by counsel and were privileged," (2) the CPA would keep the reports confidential, and (3) "there would be no further disclosure" of the content of the reports.<sup>210</sup> The issue in *Merrill Lynch* was whether disclosure of the reports to the CPA effected a waiver of work product immunity. The court held that no waiver had occurred because the CPA was not an adversary or conduit to potential adversary. The *Merrill Lynch* court stated that, for a work product waiver to occur, there must be a

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the hands of the IRS. However the external auditor has to comply with the standards for auditor documentation. Anything less is a scope limitation. Others here are better able to address IRS policy. But, at the Commission, our policy has been that the auditor's obligation to report to shareholders on the company's financial statements takes precedence over any request from the company for confidentiality. Inherent in this obligation is the need to make sure the auditor's workpapers support the auditor's findings in each area, including accounting for income taxes. I encourage you to support the auditor in these efforts. It will be subject to review.

See also Michael Joe, *Shulman Asks Corporate Boards to Oversee Tax Risk*, 125 Tax Notes 387 (2009).

207. 214 F.R.D. at 114 ("[T]here is a difference between disclosure to accountants who have been retained by a lawyer to understand technical aspects of a case and whose interests are therefore allied with the client, and outside auditors who, in order to be effective, must have interests that are independent of and not always aligned with those of the company").

208. *Id.* at 116-117. See also *Verschoth v. Time Warner, Inc.*, 2001 WL 546630, at \*4 (S.D.N.Y. 2001) (work product immunity was waived by disclosing work product to a third party whose "interests may not have been aligned" with those of the party making the disclosure).

209. 229 F.R.D. 441 (S.D.N.Y. 2004).

210. *Id.* at 444.

“tangible adversarial relationship,” which the court found to be lacking with respect to Merrill Lynch and its CPA.<sup>211</sup>

The Court of Appeals in the *Deloitte* case discussed above at Part II.D.4.e adopted a very narrow view of adversity for purposes of its waiver analysis. The Court of Appeals states that the question is not whether “Deloitte could be Dow’s adversary in *any conceivable future litigation*, but whether Deloitte could be Dow’s adversary in *the sort of litigation the Dow Documents address*.”<sup>212</sup> The Court of Appeals stated that Dow prepared the Dow Documents in anticipation of a “dispute with the IRS, not a dispute with Deloitte.” The Dow Documents, according to the Court of Appeals, would not likely be relevant in any dispute Dow might have with Deloitte.<sup>213</sup> On that rationale, the Court of Appeals concluded that Deloitte was not a potential adversary with respect to the Dow Documents.

The *Arthur Young* decision<sup>214</sup> regarding work product immunity does not discuss waiver, but the opinion does address the possibility that a CPA firm might be required to disclose a document in its possession. The *Arthur Young* opinion states that a party (the SEC or a private party) in securities litigation would be able to obtain tax accrual workpapers from the accounting firm.<sup>215</sup> The Supreme Court held that the tax accrual workpapers were subject to discovery, and the Court did not restrict its conclusion based on “the sort of litigation” (using the language of the D.C. Circuit in *Deloitte*) that the documents address. To the contrary, the Supreme Court was concerned with whether, without concern for the subject matter of the documents in issue, this CPA firm might be required to disclose. I conclude that the D.C. Circuit’s view of adversity in *Deloitte* is too narrow and in conflict with the Supreme Court decision in *Arthur Young*.

I find the *Boston Scientific* rationale more persuasive. Given recent trends supporting greater transparency and increasing auditor independence, *Boston Scientific* seems to me to have the better argument that disclosure to a CPA does waive work product immunity.

#### IV. SUMMARY AND CONCLUSION

The purpose of the work product doctrine is to protect the attorney’s role in the litigation process, and the issue discussed in this article is whether attorney-created tax accrual workpapers sufficiently involve attorney participation in the litigation process to invoke work product immunity. I

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211. *Id.* at 447.

212. *United States v. Deloitte L.L.P.*, 610 F.3d 129, 140 (D.C. Cir 2010) (emphasis supplied).

213. *Id.*

214. *Arthur Young* is discussed above in Part II.D.4.b.

215. *Arthur Young & Co.* 465 U.S. at 820.

have argued that (1) attorney-created tax accrual workpapers do not satisfy the requirements of Rule 26(b)(3) work product immunity and (2) attorney-created tax accrual workpapers should not, as a matter of public policy, be protected from discovery.

*1. The Technical Requirements of Rule 26(b)(3) Have Not Been Satisfied.*

As discussed above in Part III.C, I conclude:

(1) The possibility of a future IRS challenge is too remote to satisfy, at the time of creation of the tax accrual workpapers, the "in anticipation of" litigation requirement.

(2) Because tax accrual workpapers must be prepared for the purpose of obtaining certified financial statements (and would have been prepared regardless of the prospects for litigation with the IRS), they are not prepared in anticipation of litigation or for trial.

(3) With respect to whether tax accrual workpapers contain attorney opinion work product information "concerning the litigation" that is protected from discovery under Rule 26(b)(3)(B), I conclude that:

(a) Tax accrual workpapers include valuation estimates, and these estimates can be (and were in the past before the *Arthur Young* decision) prepared by non-lawyers to support the certification of financial statements. This type of work product is not sufficiently related to litigation.

(b) Tax accrual workpapers are not "concerning the litigation" because the prospects for litigation are so attenuated at the time of creation of the workpapers.

(c) More fundamentally, tax accrual workpapers are not work product within the definition of Rule 26(b)(3)(A). Accordingly, Rule 26(b)(3)(B) (concerned with attorney opinion work product) is irrelevant and inapplicable because the predicate conditions of Rule 26(b)(3)(A) are not satisfied.

(4) Because tax accrual workpapers must be prepared annually to obtain certified financial statements (and would have been prepared regardless of the anticipation of litigation with the IRS), the ordinary course of business doctrine applies to tax accrual workpapers such that the workpapers are not protected from discovery under Rule 26(b)(3).

2. *As a Matter of Policy, Tax Accrual Workpapers Should be Subject to Discovery Pursuant to a Properly Issued Section 7602 Summons.*

Recognizing that (1) the discovery rules are to be broadly and liberally construed under *Hickman* and (2) section 7602 is to be broadly construed to aid the IRS in its tax enforcement efforts, I attribute weight to the policy-based factors regarding whether attorney-created tax accrual workpapers should be subject to discovery, and I conclude that the weighted factors support a conclusion that attorney-prepared tax accrual workpapers should not be protected from discovery under work product immunity.

3. *Conclusion.*

I take a narrow view of work product immunity, and I argue for tax exceptionalism, based on the broad scope of section 7602 and substantial public policy considerations. *Arthur Young* involved accountant-created tax accrual workpapers, but I conclude that the essential teaching of *Arthur Young* is applicable to attorney-created tax accrual workpapers as well. It seems to me that the rationale of *Arthur Young* (that balancing of private and public interests as to accountant-created tax accrual workpapers) should apply to attorney-created tax accrual workpapers as well. After the *Arthur Young* decision, taxpayers moved the preparation of tax accrual workpapers from the independent CPAs to attorneys, but that should not change the balance of the relevant considerations.

If the courts were to hold that attorney-created tax accrual workpapers are protected by work product immunity, work product immunity would be wandering far from its roots of protecting the litigation process, and arguably the immunity would provide protection to a vast class of documents that relate to compliance with a myriad of federal (and perhaps state) regulatory regimes.<sup>216</sup>

Although innumerable work product decisions exist in the case reporters, to date, only three key decisions have addressed whether tax accrual workpapers are protected by the work product doctrine: the Supreme Court in *Arthur Young*, the Fifth Circuit in *El Paso*, and the First Circuit in *Textron* (the D.C. Circuit in *Deloitte* did not address the merits of whether work product immunity applied to the documents in controversy). I conclude that *Arthur Young*, *El Paso*, and *Textron* reach the correct conclusion: work product immunity does not apply. Each of these cases noted that tax enforcement implicates unique statutory and policy considerations with respect to tax accrual workpapers.

The denial of the *certiorari* petition in *Textron* will frustrate those who were seeking reversal of the First Circuit decision, but I conclude that

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216. See Part III.B.1.d.

the First Circuit holding<sup>217</sup> was correct. All technical and policy factors considered, I conclude that attorney-prepared tax accrual workpapers are not properly within the scope of work product immunity.

If attorney-created tax accrual workpapers are not protected by work product immunity, the world as we know it will not end.<sup>218</sup> Work product immunity has not been available with respect to tax accrual workpapers in the jurisdiction of the Fifth Circuit Court of Appeals since 1982 (the date of the *El Paso Co.* decision), and other jurisdictions of the world do not recognize (or limit) both attorney-client privilege and work product immunity.<sup>219</sup> The balance of private and public interests favors disclosure of these workpapers.

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217. I do not, however, agree with the language used in the First Circuit opinion. See the discussion in Part II.D.3.b, *supra*.

218. One of the more interesting arguments is that denial of work product protection for tax accrual workpapers undermine diligent efforts by those seeking to promote better corporate governance. See Brief for Association of Corporate Counsel, *supra* note 140, at 8 (lack of immunity “will undermine diligent efforts by those seeking to promote better corporate responsibility, transparency, and accountability”).

219. See e.g., John Willems & Elizabeth Lefebvre-Gross, *Privilege: A Bar to Privilege*, Law.com, Feb. 4, 2008, <http://www.law.com/jsp/article.jsp?id=900005502414#>; see generally Kuo-Chang Huang, *Introducing Discovery into Civil Law* (2003).