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OPEN RESERVE-ATIONS?:
UNITED STATES V. TEXTRON INC. AND ITS
APPLICATION TO INTERNATIONAL
TAX ACCOUNTING

*Adam M. Braun**

INTRODUCTION

It has been described as an “upheaval” of established law.¹ It will open up a “Pandora’s box” and “turn the tables” on previous legal understandings.² It “eviscerates” long-standing legal doctrine.³ What sort of revolutionary event could invoke such grim language? Surely, “It” must be a headline case involving a high-profile social issue like the constitutionality of same-sex marriage,⁴ corporate contributions to political campaigns,⁵ or restrictions on First Amendment rights.

Instead, “It” is the First Circuit’s opinion in *United States v. Textron Inc.*,⁶ a case involving an Internal Revenue Service (IRS) summons for tax accrual workpapers and Textron’s attempts to protect the documentation under the work-product doctrine. The First Circuit reversed the Federal District Court of Rhode Island and set aside a First Circuit panel’s holding the workpapers as privileged, instead holding that, because the workpapers were prepared “to support financial filings and gain auditor approval,”⁷ and not for use in litiga-

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1 David E. Frank, *Attorneys Predicting ‘Upheaval’ in Wake of Work-Product Ruling*, MASS. LAW. WKLY., Aug. 24, 2009, at 1.

2 *Id.*

3 Amir Efrati, *Ruling in Tax-Auditing Case Puts Corporations on Edge*, WALL ST. J., Aug. 20, 2009, at A9, available at <http://online.wsj.com/article/SB125072397055744533.html>.

4 See, e.g., *Strauss v. Horton*, 207 P.3d 48 (Cal. 2009).

5 See *Citizens United v. FEC*, 130 S. Ct. 876 (2010).

6 577 F.3d 21 (1st Cir. 2009).

7 *Id.* at 31.

tion, the IRS could freely discover the tax accrual workpapers. The corporate world immediately criticized the controversial ruling, as critics rushed to assert that the ruling makes it more difficult to protect their clients in an increasingly opaque tax system.⁸

Why such strong criticism? First, corporate tax departments and IRS auditors have engaged in a tug-of-war over the IRS's ability to access a corporation's tax accrual workpapers, which are generally prepared both to support tax calculations published in its financial statements and its tax return and to gain insight into certain transactions whose tax effects may not have found their way onto the corporation's tax return. *Textron*, by rejecting the argument that tax accrual workpapers are prepared "in anticipation of [future] litigation" with the IRS, serves as the latest blow to the corporate world's hopes of work product protection. In addition, the First Circuit's conclusions in *Textron* have ramifications beyond the current financial reporting regime; as early as 2014, U.S. companies may be required to implement new international standards for income tax accounting, particularly when accounting for uncertain tax positions. This Note attempts to lay the foundation for how (if at all) these new international standards, in conjunction with the *Textron* decision and recent IRS Announcement 2010-75, will affect corporate tax departments across the United States.

Part I of this Note briefly provides the foundational background on financial statement preparation and the current rules regarding tax accrual calculations. Part II then discusses the current status of work-product doctrine with respect to tax accrual documentation, including an analysis of the First Circuit's *Textron* decision. Part III lays out the major policy arguments both for and against discoverability of tax accrual documentation. Finally, Part IV considers the upcoming transition to International Financial Reporting Standards (IFRS) and hypothesizes the consequences of the *Textron* decision with respect to these new rules.

I. THE NECESSARY BACKGROUND: FIN 48 AND THE WORK-PRODUCT PRIVILEGE

As a general matter, all publicly held companies in the United States are required to file financial statements with the Securities and Exchange Commission (SEC),⁹ and the SEC requires that an independent auditor must audit all financial statements in accordance with

⁸ See, e.g., Efrati, *supra* note 3 (discussing the reaction of corporate attorneys to the *Textron* decision).

⁹ 15 U.S.C. § 78m (2006).

Generally Accepted Auditing Standards (GAAS).¹⁰ The independent auditor evaluates the company's financial statements relative to Generally Accepted Accounting Principles (GAAP), which the Financial Accounting Standards Board (FASB) promulgates, and then expresses an opinion on whether the financial statements fairly present the financial condition of the firm.¹¹

A. *Accounting for Uncertain Tax Positions and FIN 48*

More specific to tax accounting, GAAP requires publicly held corporations to provide a reserve¹² for contingent tax liabilities and uncertain tax benefits,¹³ which includes estimates of potential liabilities to the IRS if the IRS decides to challenge a corporation's positions in its annual tax return.¹⁴ To prepare its tax reserve, a corporation reviews the positions it takes in its financial statements—that is, which tax benefits the corporation intends to record—and determines the likelihood that the position will be sustained after an IRS audit.¹⁵ If it is “more likely than not” that the tax position will be sustained on the merits, then the “uncertain” tax position (UTP) can be recognized in

10 See 17 C.F.R. § 210.1-02(d) (2009) (requiring auditors to audit financial statements in accordance with GAAS); see also DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 199 (4th ed. 2006) (explaining how the requirement affects the demand for auditing services).

11 17 C.F.R. § 210.1-02(d). Under the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.), the newly created Public Company Accounting Oversight Board (PCAOB) has stated that auditors must examine documentation underlying the numbers and assertions published in the financial statements, and if the audited company refuses to produce the documentation, the auditor must decide whether the omission of such underlying documentation is material to the auditor's opinion on whether the financial statements are produced in conformity with GAAP. Andrew Golodny, Note, *Lawyers Versus Auditors: Disclosure to Auditors and Potential Waiver of Work-Product Privilege in United States v. Textron*, 61 TAX LAW. 621, 630-31 (2008).

12 A “reserve,” as used in this Note, refers to a liability that is recorded when uncertainty exists about the amount or timing of the transfer of the economic benefits that the obligation's payment or satisfaction will entail. HERWITZ & BARRETT, *supra* note 10, at 1125.

13 FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES 5-6, 8 (Mar. 1975), available at <http://www.fasb.org/pdf/fas5.pdf>.

14 *United States v. Textron Inc.*, 557 F.3d 21, 22-23 (1st Cir. 2009) (en banc).

15 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, 339 (2008).

the corporation's financial statements.¹⁶ Corporations prepare workpapers to support their treatment of UTPs; these workpapers generally contain counsel opinions on the likelihood that the corporation's UTPs will be sustained in the event of an IRS audit.¹⁷ Therefore, these workpapers list the "soft spots" of a corporation's tax return, which "could potentially serve as a 'roadmap' for the I.R.S. on audit."¹⁸

Tax lawyers often play a prominent role in the decisionmaking process for recognition of UTPs; consequently, many tax reserve workpapers contain opinions from either in-house or outside counsel regarding whether it is "more likely than not" that UTPs would be sustained after an IRS audit.¹⁹ As one scholar notes, "[w]here a tax position involves any significant amount of uncertainty, an outside opinion often will be the tax director's or CFO's best choice for documenting a decision to recognize all or part of the benefits from the position."²⁰ Further, in undertaking their duty to evaluate a corporation's financial statements, independent auditors will most likely ask to see the tax reserve workpapers, which may result in the waiver of attorney-client privilege regarding the tax opinions expressed in those workpapers.²¹ To protect itself, then, a corporation generally would prefer not to disclose these workpapers, and would be especially averse to allowing the IRS to have access to them.

B. *Hickman v. Taylor and the Origins of Rule 26(b)(3)*

The work-product doctrine is intended to allow attorneys to prepare for litigation without opposing counsel having access to their thought processes, legal theories, or trial preparation work.²² It is derived from the rule pronounced in *Hickman v. Taylor*,²³ and is now

16 DANIELLE E. ROLFES, AN ANALYSIS OF FIN 48 § 1.01 (2009) ("[FASB Interpretation No. 48] answers the 'when' question by imposing a 'recognition threshold,' which provides that a UTP can be recognized in the financial statements only if it is 'more likely than not' . . . of being sustained on the merits . . .").

17 Pease-Wingenter, *supra* note 15, at 339.

18 *Id.*

19 Paul McCord, *Circling Sharks: Toward a Better Understanding of the Tax Lawyer's Role Under Circular 230, FIN 48 and the Work-Product Doctrine*, 34 MICH. TAX L. 26, 27 (2008).

20 *Id.*

21 *Id.* This waiver of attorney-client privilege will not be fully explored in this Note, but is a significant issue for many corporations. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984).

22 Ricardo Colón, Comment, *Caution: Disclosures of Attorney Work Product to Independent Auditors May Waive the Privilege*, 52 LOY. L. REV. 115, 123 (2006).

23 329 U.S. 495 (1947).

codified in Federal Rule of Civil Procedure 26(b)(3). In *Hickman*, the Supreme Court held that the plaintiff could not discover the defendant attorney's notes taken while interrogating a witness.²⁴ The *Hickman* Court specifically held that an attorney's mental impressions were not discoverable because "[p]roper preparation of a client's case demands that he 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."²⁵ The *Hickman* Court continued by stating its policy considerations:

Were such materials open to opposing counsel on mere demand, much of what is now put down in writing would remain unwritten. An attorney's thoughts . . . would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served.²⁶

Rule 26(b)(3) codified *Hickman*'s work-product doctrine. Rule 26(b)(3) states that documents prepared "in anticipation of litigation or for trial" by an opposing party or his representative are generally not discoverable, absent a showing of undue hardship.²⁷ Basing the codification on *Hickman*'s policy concerns, the Advisory Committee enacted Rule 26(b)(3) because it deemed that "each side's informal evaluation of its case should be protected, that each side should be encouraged to prepare independently, and that one side should not automatically have the benefit of detailed preparatory work of the other side."²⁸ However, Rule 26(b)(3) also states that its protection can be overcome by showing a "substantial need" of the documents and the inability, "without undue hardship," to obtain equivalent documents through other means.²⁹

Rule 26(b)(3) is broader than the attorney-client privilege in that it protects more than just communications between an attorney and his client.³⁰ The reason behind the work-product doctrine's breadth is that it protects the adversarial system and an attorney's thoughts

24 *Id.* at 510.

25 *Id.* at 511.

26 *Id.*

27 FED. R. CIV. P. 26(b)(3) ("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 . . .").

28 FED. R. CIV. P. 26(b)(3) advisory committee's note.

29 *Id.* R. 26(b)(3)(A)(ii).

30 Charles M. Yablon & Steven S. Sparling, *United States v. Adlman: Protection for Corporate Work Product?*, 64 BROOK. L. REV. 627, 633 (1998).

and impressions in preparation for litigation; alternatively, the attorney-client privilege seeks only to preserve candor in the lawyer-client relationship.³¹ Finally, the work-product doctrine may be waived in a number of different ways. For example, work product protection is waived if the material sought to be protected is disclosed “in a way inconsistent with keeping it from an adversary.”³²

C. *Applying Rule 26(b)(3) to Auditing: United States v. Arthur Young*

As a final prefatory note, *Textron* is not the first time the federal court system has considered privilege and tax accrual workpapers; nearly twenty years prior to the issuance of FIN 48, the Supreme Court took up the issue in *United States v. Arthur Young & Co.*³³ In *Arthur Young*, the IRS issued a summons to a corporation’s independent auditor requiring it to turn over tax accrual workpapers prepared during its audit of the subject corporation.³⁴ The independent auditor objected to the disclosure, arguing for the creation of an auditor-client privilege for documents prepared by a corporation’s auditors.³⁵ The Supreme Court, holding that “the independent auditor assumes a *public* responsibility transcending any employment relationship with the client,” refused to extend the work-product doctrine to accountant-client relationships.³⁶ Therefore, the IRS had the right to obtain tax accrual workpapers pursuant to its summons authority.³⁷ How-

31 *Id.* at 633 n.35.

32 *United States v. Mass. Inst. Tech.*, 129 F.3d 681, 687 (1st Cir. 1997). In *MIT*, the First Circuit held that actions inconsistent with keeping work product protection include disclosure to an adversary, a potential adversary, or a conduit to adversaries. *Id.* Further, there may be no waiver of work product protection if disclosure is made to a party under a reasonable expectation of confidentiality. *See United States v. Gulf Oil Corp.*, 760 F.2d 292, 295 (Temp. Emer. Ct. App. 1985) (holding that work protection applied where parties had a common interest at the time of disclosure as well as afterwards when the parties’ interests diverged).

33 465 U.S. 805 (1984).

34 *Id.* at 808–09.

35 *See id.* at 809–10, 815.

36 *Id.* at 817. The Court emphasized that “work-product doctrine was founded upon the private attorney’s role as the client’s confidential adviser and advocate,” whereas the accountant’s “‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.” *Id.* at 817–18.

37 Pease-Wingenter, *supra* note 15, at 342. However, prior to the Supreme Court’s opinion in the case, the IRS issued new guidelines mandating that tax accrual workpapers were only to be accessed in unusual circumstances. *Arthur Young*, 465 U.S. at 821 n.17. In 2002, the IRS broadened its policy, permitting the request of tax accrual workpapers pertaining to Listed Transactions, and, if the taxpayer failed to disclose or participated in several Listed Transactions during the period, the IRS

ever, the *Arthur Young* court did recognize that traditional privileges, including the work-product privilege, applied when the IRS issues a summons; it simply refused to create an additional accountant-client privilege in those situations.³⁸

Arthur Young's "public responsibility" terminology is also the starting point for the debate as to whether an independent auditor is a "potential adversary," and whether an entity's work product protection is waived by disclosure to its auditors.³⁹ While courts have ruled both ways, the emerging trend is to consider both the company and the auditor to share a common interest in the preparation of financial statements.⁴⁰ As such, work product protection is generally not waived because a company discloses work product to that auditor.⁴¹

II. INTERPRETING "IN THE ANTICIPATION OF LITIGATION"

While the U.S. Supreme Court has yet to speak directly on the subject, the Circuit Courts of Appeals have applied Rule 26(b)(3)'s "in anticipation of litigation" standard differently. Under the Fifth Circuit's "primary purpose" test, a document is prepared "in anticipation of litigation" if the principal or exclusive purpose of the document is to assist in litigation.⁴² Alternatively, under the "because of" test, documents prepared because of the potential for litigation or

could request all of a company's tax accrual workpapers. Pease-Wingenter, *supra* note 15, at 341.

38 *Arthur Young*, 465 U.S. at 816; *see also* *Upjohn Co. v. United States*, 449 U.S. 383, 398 (1981) (holding that the IRS summons authority remains "subject to traditional privileges and limitations," including privileges regarding attorney work product).

39 *Arthur Young*, 465 U.S. at 817.

40 Golodny, *supra* note 11, at 634. *See, e.g.,* *Merrill Lynch & Co. v. Allegheny Energy Inc.*, 229 F.R.D. 441, 448 (S.D.N.Y. 2004) ("A business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud."). *But see* *Medinol Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113, 116 (S.D.N.Y. 2002) ("[I]n order for auditors to properly do their job, they *must* not share common interests with the company they audit.").

41 Additionally, waiver of work product privilege only occurs when a party acts inconsistently with work product protection. *United States v. Mass. Inst. Tech.*, 129 F.3d 681, 687 (1st Cir. 1997); *see, e.g.,* *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, 237 F.R.D. 176, 183 (N.D. Ill. 2006) (stating that the work-product privilege may be waived for disclosures made "in a manner which substantially increases the opportunity for potential adversaries to obtain the information," (quoting *Vardon Golf Co. v. Karsten Mfg. Corp.*, 213 F.R.D. 528, 534 (N.D. Ill. 2003))); *In re Raytheon Sec. Litig.*, 218 F.R.D. 354, 360 (D. Mass. 2003) (holding that waiver of work-product privilege also occurs when there is disclosure to a "conduit" to a potential adversary).

42 Colón, *supra* note 22, at 125.

documents analyzing the outcome of litigation are protected under Rule 26(b)(3)—a more generous standard.⁴³

A. *The "Primary Purpose" Test*

The Fifth Circuit holds that documents are only protected under Rule 26(b)(3) when the primary purpose of creating the documents is to aid in litigation.⁴⁴ In *United States v. El Paso Co.*,⁴⁵ El Paso, a large public corporation, sought to protect "tax pool analysis" documents summarizing the corporation's contingent tax liabilities that could be subject to IRS challenge.⁴⁶ The Fifth Circuit rejected El Paso's arguments, holding that the documents were prepared primarily to comply with securities laws, and not in conjunction with anticipated litigation.⁴⁷ The Fifth Circuit specifically noted that El Paso employed outside counsel to assist with its litigation claims, yet its in-house staff prepared the tax pool analysis documents without any assistance from outside counsel.⁴⁸ Further, the tax pool analysis documents were prepared after El Paso filed its tax return,⁴⁹ and related to more general (as opposed to specific) litigation concerns.⁵⁰

The primary purpose rule has been criticized, in part, because Rule 26(b)(3) does not mandate that a document be prepared primarily or exclusively to assist in litigation in order to merit protection—a more lenient "in anticipation of litigation" phrasing is used.⁵¹ Further, protection under the Rule is broader than simply those documents prepared exclusively for actions directly involved with

43 *Id.*

44 Yablon & Sparling, *supra* note 30, at 640–41.

45 682 F.2d 530 (5th Cir. 1982).

46 Yablon & Sparling, *supra* note 30, at 639. El Paso had its in-house staff spend over ten thousand hours annually preparing its tax return, which included the creation of these tax-pool documents. *Id.*

47 *El Paso*, 682 F.2d at 543.

El Paso establishes its non-current tax account to bring its financial books into conformity with generally accepted auditing principles. . . . The primary motivating force behind the tax pool analysis, therefore, is not to ready El Paso for litigation over its tax returns. Rather, the primary motivation is to anticipate, for financial reporting purposes, what the impact of litigation might be on the company's tax liability.

Id.

48 *Id.*

49 *Id.* at 534.

50 *Id.* at 534–35.

51 *United States v. Adlman*, 134 F.3d 1194, 1198 (2d Cir. 1998).

litigation.⁵² As the Second Circuit articulated, “[i]f the drafters of [Rule 26(b)(3)] intended to limit its protection to documents made to assist in preparation for litigation, this would have been adequately conveyed by the phrase ‘prepared . . . for trial.’”⁵³ In reading Rule 26(b)(3) broadly, the Second Circuit opted to minimize references to “trial preparation materials” both in the caption to the Rule and in the advisory committee notes.⁵⁴

B. The “Because of” Test

The more frequently applied interpretation⁵⁵ of Rule 26(b)(3)’s “in anticipation of litigation” verbiage is commonly known as the “because of” test. The “because of” test states that a document falls within the protection of the work-product doctrine if “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.”⁵⁶

1. *United States v. Adlman*

In *United States v. Adlman*,⁵⁷ the Second Circuit directly applied the “because of” test to dual purpose tax documentation—documentation prepared to aid both the financial statements and the tax return. In *Adlman*, the defendant sought to protect a memorandum that evaluated the tax implications of a proposed corporate restructuring plan and included a detailed legal analysis of any likely IRS chal-

52 *Id.* (“Nowhere does Rule 26(b)(3) state that a document must have been prepared to aid in the conduct of litigation in order to constitute work product, must less primarily or exclusively to aid in litigation.”).

53 *Id.*

54 *Id.* at 1199.

55 According to one scholar’s count, perhaps nine of the thirteen circuits have adopted the “because of” test. The First, Second, Third, Fourth, Sixth, Seventh, Eighth, Ninth and D.C. Circuits apply the “because of” standard. See Dennis J. Ventry, Jr., *A Primer on Tax Work Product for Federal Courts*, 123 TAX NOTES 875, 877 n.20 (2009) (listing the various circuits that have applied the “because of” test).

56 *Adlman*, 134 F.3d at 1202 (quoting 8 CHARLES ALAN WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* § 2024, at 343 (1994)). There is some debate as to whether the “because of” test is equivalent to a “but for” standard. Later courts, such as the District Court of Rhode Island in *United States v. Textron*, 507 F. Supp. 2d 138 (D.R.I. 2007), have used “but for” terminology when interpreting the “because of” standard. *Id.* at 150. However, a “but for” standard may be broader than what was intended in the wording of Rule 26(b)(3), as it “casts a much wider net to include materials that are not necessarily useful in such litigation.” Pease-Wingenter, *supra* note 15, at 346.

57 134 F.3d 1194 (2d Cir. 1998).

lenges to that plan.⁵⁸ In holding that the work-product doctrine protected the memorandum, the Second Circuit stated that “[w]here a document is created because of the prospect of litigation, analyzing the likely outcome of that litigation, it does not lose protection under this formulation merely because it is created in order to assist with a business decision.”⁵⁹ In so holding, the Second Circuit expressly rejected the Fifth Circuit’s primary purpose test and refused to embark on an analysis of whether the primary intent of the memorandum was to comply with securities regulations or prepare for potential IRS litigation.⁶⁰

Additionally, the Second Circuit attempted to define a test for determining whether a dual-purpose document was created “because of” potential litigation, and thus was privileged under Rule 26(b)(3).⁶¹ Specifically, the Second Circuit held that “[w]here a document was created because of anticipated litigation, and would not have been prepared in *substantially similar* form but for the prospect of that litigation, it falls within Rule 26(b)(3).”⁶² Therefore, a document prepared in the ordinary course of business or “that would have been created in essentially similar form irrespective of litigation” is specifically excepted from the Second Circuit’s holding.⁶³

From a tax accrual documentation perspective, *Adlman*’s “substantially similar” holding is both significant and confounding. The Second Circuit provided valuable guidance in the debate as to what constitutes unprotected “ordinary course of business” documentation and similar, yet protected, “in anticipation of litigation” documents.⁶⁴ However, it left the tasks of defining “substantially similar” and deciding what differences are material to the evaluation of similarity to later

58 *Id.* at 1195.

59 *Id.* at 1202. The Sixth Circuit later adopted this *Adlman* analysis in *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006). In *Roxworthy*, the general counsel for Yum! Brands asserted work-product privilege over two memoranda prepared by its independent auditor, KPMG, regarding stock transfers and the creation of an insurance company. The Sixth Circuit held that work-product doctrine protected the memoranda, even though the IRS audit had not begun and the tax return had yet to be filed. *Id.* at 593.

60 *Adlman*, 134 F.3d at 1197–98.

61 By “dual purpose,” it is meant that the document can be used both to aid in business purposes and to prepare for potential IRS litigation.

62 *Adlman*, 134 F.3d at 1195 (emphasis added).

63 *Id.* at 1202; *see also* FED. R. CIV. P. 26(b)(3) advisory committee’s note, quoted in *Adlman*, 134 F.3d at 1202 (“Materials assembled in the ordinary course of business . . . are not under the qualified immunity provided by this subdivision.”).

64 *See supra* notes 57–61 and accompanying text.

courts.⁶⁵ In fact, at least one scholar argues that the eventual interpretation of “substantially similar” may end up being quite comparable to the “primary purpose” test—a test the *Adlman* court specifically rejected.⁶⁶

2. *United States v. Textron Inc.*

Over a decade after the *Adlman* decision, the First Circuit adopted the “because of” test for tax accrual documentation, but came to a markedly different result. In *United States v. Textron Inc.*, the First Circuit, attempting to draw a line between case preparation materials and tax documents,⁶⁷ held that Textron’s tax accrual documentation was prepared to support judgments found in its financial statements and did not merit work product protection simply because “the *subject matter* of a document relates to a subject that might conceivably be litigated.”⁶⁸ In *Textron*, the IRS issued a summons for Textron’s tax accrual documentation relating to nine transactions it flagged as possible tax shelters subject to taxpayer abuse.⁶⁹ Rejecting the district court’s conclusion that the documentation was prepared “because of” the prospect of litigation, the First Circuit concluded that “the Textron workpapers were independently required by statutory and audit requirements” and did not merit work product protection.⁷⁰

Further, the *Textron* majority referred back to the language of Rule 26(b)(3) in an attempt to curb the excessive application of the

65 See Yablon & Sparling, *supra* note 30, at 649 (“*Adlman* gives no guidance as to how different a document needs to be from its ordinary business counterpart in order to confer work-product protection.”).

66 *Id.* at 649–50 (“Indeed, it is quite conceivable that the *Adlman* court might have reached the same result that the Fifth Circuit came to in *El Paso* by focusing not on the purpose of the documents but on their preparation in connection with regulatory requirements.”).

67 *United States v. Textron Inc.*, 577 F.3d 21, 28 (1st Cir. 2009).

68 *Id.* at 29.

69 *Id.* at 23–34. More specifically, the IRS maintains a set of “listed transactions” that it deems to be frequent vehicles for tax evasion. Taxpayers who incur these transactions, which can be defined as a form of tax shelter, are generally required to disclose and register the transaction with the IRS. Ventry, *supra* note 55, at 881 n.77. One such transaction is a sale-in, lease-out (SILO) transaction, which allows tax-exempt or tax-indifferent organizations to transfer certain income deductions to taxpayers who seek such deductions as a tax shelter. *Textron*, 577 F.3d at 24. In this case, Textron engaged in a number of these transactions, and the IRS sought the tax accrual documentation as a means to evaluate their collective legitimacy. *Id.* For a transaction to be legitimate, there must be some motive for the sale or lease other than tax avoidance. *Id.*

70 *Textron*, 577 F.3d at 26. A First Circuit panel also upheld the district court’s decision before granting a rehearing en banc. *Id.*

work-product doctrine to corporate documentation: “[It is not] enough that the materials were prepared by lawyers or represent legal thinking. Much corporate material prepared in law offices or reviewed by lawyers falls in that vast category. It is only work done in anticipation of or for trial that is protected.”⁷¹ Asserting that it adhered to *Adlman*’s precedent,⁷² the majority maintained that the summoned workpapers also did not merit work product protection because the documents were prepared in the ordinary course of business.⁷³

Finally, the *Textron* majority articulated the policy considerations that motivated its holding. First, it stated that the work product privilege was aimed at protecting the litigation process and “work done by counsel to help him or her in *litigating* a case,” as opposed to generic corporate documentation.⁷⁴ Second, the majority noted that the concerns about discouraging lawsuit preparation were not present in *Textron*’s factual scenario, in part because *Textron* had to prepare the tax audit workpapers in order to produce audited financial statements and comply with federal securities laws.⁷⁵ Lastly, the majority rejected any argument of unfairness toward *Textron* in its decision, asserting that “tax collection is not a game” and “[u]nderpaying taxes threatens the essential public interest in revenue collection.”⁷⁶

However, the 3–2 decision for the IRS was supplemented by a stinging dissent from Judge Torruella, joined by Judge Lipez. The dissent characterized the majority’s test not as keeping with the “because of” standard, but as creating a new “prepared for use in litigation” test.⁷⁷ Using the *Adlman* case as its foundation, the dissent criticized several generalities the majority used to support its demarcation between tax documents and case preparation materials, including the

⁷¹ *Id.* at 29–30.

⁷² The First Circuit adopted *Adlman*’s “because of” test in *Maine v. United States Department of the Interior*, 298 F.3d 60 (1st Cir. 2002). In *Maine*, the issue was whether documents relating to an endangered species listing were protected under the work-product doctrine. In reversing the district court’s decision in *Maine*, the First Circuit specifically rejected the Fifth Circuit’s “primary purpose” test on which the district court had relied in coming to its conclusion. *Id.* at 68.

⁷³ *Textron*, 577 F.3d at 30.

⁷⁴ *Id.* at 30–31.

⁷⁵ *Id.* at 31. Additionally, *Textron* had shown its spreadsheets to its independent auditor, Ernst & Young, and the IRS summons also applied to workpapers created by Ernst & Young in determining the adequacy of the reserves. *Id.* at 24. The district court thus concluded that any attorney-client privilege had been waived through the disclosure, but work-product privilege had not been waived. *Id.* at 25.

⁷⁶ *Id.* at 31.

⁷⁷ *Id.* at 34 (Torruella, J., dissenting).

argument that “[e]very lawyer who tries cases knows the touch and feel of materials prepared for a current or possible . . . law suit.”⁷⁸

Additionally, the dissent articulated some convincing policy rationales of its own. First, it argued that the majority’s holding is contrary to the goal of work product protection—protecting an attorney’s “privacy, free from unnecessary intrusion by opposing parties and their counsel.”⁷⁹ Second, the litigation percentages calculated by Textron’s counsel in its workpaper represent the exact type of mental impressions that the work-product doctrine strives to protect.⁸⁰ Lastly, the quality of legal representation will diminish under the majority’s rule, as, contrary to the majority’s assertion, lawyers will not prepare the detailed estimates like those contained in Textron’s documentation if the IRS may easily discover such estimates.⁸¹

C. *The Discoverability of Tax Accrual Workpapers After Textron*

After *Textron*, the federal court system is now faced with at least a two-way, and possibly a three-way,⁸² circuit split regarding the IRS’s ability to access a corporation’s tax accrual workpapers. The Fifth Circuit stands alone in its belief that documents are only protected under Rule 26(b)(3) when the primary purpose of creating the documents is to aid in litigation.⁸³ However, at least six, and arguably seven, circuit courts allow for broader protection of workpaper documentation so long as the documentation is prepared because of the potential for litigation or to analyze the outcome of that potential litigation.⁸⁴

78 *Id.* (quoting *id.* at 30 (majority opinion)).

79 *Id.* at 35. The dissent goes on to quote *Adlman*, saying that there is “no basis for adopting a test under which an attorney’s assessment of the likely outcome of litigation is freely available to his litigation adversary merely because the document was created for a business purpose rather than for litigation assistance.” *Id.* at 36 (quoting *United States v. Adlman*, 134 F.3d 1194, 1200 (2d Cir. 1998)).

80 *Id.* at 36. In fact, the dissent points out that the IRS itself had sought the protection of the work-product doctrine in similar circumstances in a previous case. *Id.* In *Delaney, Migdail & Young, Chartered v. IRS*, 826 F.2d 124 (D.C. Cir. 1987), the IRS sought to protect business purpose documents prepared by IRS attorneys to aid in deciding whether to adopt a new sampling system for its large corporate audits. *Id.* at 125–26; see *Adlman*, 134 F.3d at 1201 (“[I]n [*Delaney*], the IRS successfully argued against the very position it here advocates.”).

81 *Textron*, 577 F.3d at 36–37 (Torruella, J., dissenting). The dissent notes that Textron is only required to satisfy evidentiary standards set forth by GAAP, which may not contain the form and detail of the workpapers at issue. *Id.* at 37.

82 The circuit split could be considered a three-way split if one accepts the *Textron* dissent’s argument that a new standard was created in that case.

83 See *supra* note 44 and accompanying text.

84 See *supra* note 55 and accompanying text.

Finally, as the dissent in *Textron* argues, the First Circuit may have adopted a separate approach, concluding that documents are only protected work-product if they are prepared for any litigation or trial.⁸⁵ In May 2010, the Supreme Court denied certiorari in the *Textron* case and, in doing so, opted not to resolve the circuit split on this topic and more clearly define the boundaries of work product protection in the federal court system.⁸⁶

III. A POLICY MATTER: ARGUMENTS FOR AND AGAINST DISCOVERABILITY OF WORKPAPERS

As courts and legal scholars line up on different sides of the “in anticipation of litigation” debate introduced in Part II, several recurring policies have come to the forefront and shaped that debate. Before delving into an analysis of *Textron* in the context of international accounting standards, it is a worthwhile exercise to examine these policy arguments, which, for efficiency’s sake, can be lumped into three general categories: the balance between the adversarial system and procedural efficiency, the preservation of quality legal representation, and the importance of truthfulness in reporting tax liability.

A. *Protecting the Adversarial System*

The starting point for the debate about the discoverability of tax accrual workpapers is the intent of Rule 26(b)(3). Proponents of the discoverability of tax workpapers, such as the *Textron* majority, argue that Rule 26(b)(3) was designed to protect the litigation process, and should be restricted only to work done by lawyers in preparing to actually litigate a case.⁸⁷ Therefore, extending the work product privilege to documents that analyze the effects of a UTP *in the event that* litigation occurs defeats the purpose of the privilege and harms the adversarial process.⁸⁸

At least one scholar, Professor Dennis Ventry, argues that tax accrual workpapers can never be protected under the work product privilege because preparers “can never possess an objectively reasona-

85 See *supra* note 77 and accompanying text.

86 *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009), *cert. denied*, 130 S. Ct. 3320 (2010).

87 *Id.* at 30–31; see also *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982) (stating that the work-product doctrine “is not an umbrella that shades all materials prepared by a lawyer”).

88 Ventry, *supra* note 55, at 880.

ble belief that litigation is likely.”⁸⁹ The reason, Professor Ventry argues, is that so few IRS audits result in litigation that the “in anticipation of litigation” standard can never be met⁹⁰:

It is never reasonable as a matter of logic or mathematical probability for a taxpayer to anticipate litigation with the IRS when preparing tax accrual workpapers. It is highly unlikely that the government will identify an abusive transaction in a corporate taxpayer’s consolidated return or that it will glean sufficient information from the return and disclosure documents to adequately evaluate the transaction’s true substance and challenge it on the merits.⁹¹

In Professor Ventry’s view, an IRS audit does not merit an adversarial proceeding—it is an assessment and review process⁹²—and challenged transactions may go through several levels of administrative review and alternative dispute resolution before they result in an adversarial litigation process.⁹³ “Even if the government manages to identify, investigate, and dispute a particular transaction, the parties will manage to exhaust all avenues of dispute resolution over proposed adjustments only in exceedingly rare circumstances.”⁹⁴

However, there are several opponents to discoverability of tax accrual workpapers that disagree with Professor Ventry. Judge Torruella, dissenting in *Textron*, succinctly summarized the opponents’ view:

Textron’s [tax accrual workpapers] contain exactly the sort of mental impressions about the case that *Hickman* sought to protect. In fact, these percentages contain counsel’s ultimate impression of the value of the case. . . . With this information, the IRS will be able to immediately identify weak spots and know exactly how much Textron should be willing to spend to settle each item. Indeed, the IRS explicitly admits that this is its purpose in seeking the documents.⁹⁵

In other words, returning to the spirit of *Hickman*, opponents to discoverability contend that allowing the IRS to access tax accrual workpapers would undermine the adversarial system. Just as the *Hickman* Court contended that access to a lawyer’s mental impressions

89 *Id.* at 880–82.

90 *Id.* at 882.

91 *Id.*

92 *Id.* at 880.

93 *Id.* at 881.

94 *Id.* at 882.

95 *United States v. Textron Inc.*, 577 F.3d 21, 36 (1st Cir. 2009) (Torruella, J., dissenting).

during a deposition would be “demoralizing” to the profession,⁹⁶ revealing assessments of success at trial to one’s adversary through tax workpapers would defeat the ability of lawyers to protect the interests of their clients in litigation.⁹⁷

Further, opponents to discoverability argue that the supposed extension of the work-product doctrine is not an unfair broadening of Rule 26(b)(3). Instead, providing for protection of tax accrual workpapers embodies a fair legal principle that the privacy of lawyers should be protected in advocating for their clients; and, while it does limit the discoverability of some memoranda and workpapers, the work-product doctrine still allows for their discovery upon the demonstration of a substantial need.⁹⁸ As such, placing tax accrual workpapers under the work-product doctrine’s protective umbrella appropriately balances the interests of corporate counsel and the IRS’s need to ensure adequate reporting.⁹⁹

B. Quality of Legal Representation

Related to their concerns about preserving the adversarial system, opponents to discoverability also argue that allowing access to tax accrual workpapers threatens the ability of corporate attorneys to provide candid assessments of their clients’ legal positions.¹⁰⁰ As Judge Torruella articulated, “if attorneys who identify good faith questions and uncertainties in their clients’ tax returns know that putting such information in writing will result in discovery by the IRS, they will be more likely to avoid putting it in writing, thus diminishing the quality of representation.”¹⁰¹ Indeed, if corporate counsel knew that opposing counsel would evaluate her professional judgment with each written memorandum she produced, it is very likely that she would provide less detail in her documents so as to confer less benefit on her

96 *Hickman v. Taylor*, 329 U.S. 495, 511 (1947).

97 Brief for the Chamber of Commerce of the United States of America and Association of Corporate Counsel Supporting *Textron Inc.* and in Favor of Affirmance at 5, *United States v. Textron Inc.*, 557 F.3d 21 (2009) (No. 09-750) [hereinafter Brief for ACC].

98 *Id.*

99 Brief for the Committee on Taxation and Committee on Corporate Reporting of Financial Executives International as Amicus Curiae in Support of Appellee *Textron Inc.* Supporting Affirmance at 11, *United States v. Textron Inc.*, 577 F.3d 21 (2009) (No. 09-750) [hereinafter Brief for CCR].

100 *Id.* at 7.

101 *Textron*, 577 F.3d at 36–37 (Torruella, J., dissenting).

adversary.¹⁰² As such, the related tax reserve would be less substantiated than if the documents were not discoverable.¹⁰³

Proponents for discoverability reject this argument, asserting that securities laws require these workpapers to be created anyway in conjunction with the preparation of financial statements.¹⁰⁴ Tax accrual workpapers, they argue, support a corporation's financial disclosures in its financial statements, and if corporate counsel chose not to include its analysis of upcoming tax disputes, then the corporation's independent auditors could not issue a clean bill of health—an unqualified opinion that the financial statements are presented fairly in accordance with GAAP—that is required for all publicly traded entities.¹⁰⁵ As such, the standards to which independent auditors must adhere require that corporate counsel provide its assessment of potential tax litigation, whether or not the analysis constitutes privileged work product.¹⁰⁶ “Litigation does not trigger a corporate taxpayer's financial reporting obligations . . . [t]he disclosure requirements . . . force the corporate taxpayer to evaluate which tax positions might be challenged . . . [t]o that end, workpapers contain percentage determinations on the likelihood of success of prevailing on the merits of specific tax positions.”¹⁰⁷

102 *Id.* at 37. However, there are several ways in which an entity can improve its chances for succeeding on a work-product privilege claim against the IRS. One scholar suggests that ensuring that workpapers are prepared exclusively by licensed attorneys, including legal references to explain legal ambiguity, and avoiding the distribution of tax accrual workpapers to third parties, whenever possible, are three primary ways to increase the likelihood of sustaining a work-product privilege claim. Further, when providing workpapers to independent auditors, entities may consider preparing a separate set of documentation about the reserve that includes as little attorney analysis and opinion as possible. See Pease-Wingenter, *supra* note 15, at 353.

103 *Textron*, 577 F.3d at 37 (Torruella, J., dissenting).

104 *Id.* at 31–32 (majority opinion).

105 Ventry, *supra* note 55, at 883. Additionally, because the Supreme Court in *Arthur Young* held that there is no auditor-client privilege, “the auditor is ethically and professionally obligated to ascertain for himself as far as possible whether the corporation's contingent tax liabilities have been accurately stated.” *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984). Therefore, independent auditors are required to seek out the litigation analysis of tax disputes that the corporation seeks to protect.

106 *Textron*, 577 F.3d at 31–32.

107 Ventry, *supra* note 55, at 879–80. Professor Ventry also points out that tax accrual workpapers are also often created by non-lawyer tax practitioners, and “unprotected accounting documents do not magically become protected litigation documents by virtue of being created by a lawyer rather than an accountant.” *Id.* at 883.

However, discoverability opponents respond that the purpose of tax accrual workpapers is not so clear. Instead, the dual-purpose nature of tax accrual workpapers—both as an evaluation of litigation risks and as a means to provide the necessary supporting documentation to auditors—precludes any claim that they are solely a result of compliance with securities laws.¹⁰⁸ As the *Textron* dissent pointed out, while accounting standards do require some substantiation of the tax reserve numbers displayed on a corporation's financial statements, these standards do not require a set amount of detail for each UTP.¹⁰⁹ As a result, the amount of detail provided in these workpapers may vary depending on the needs of the independent auditor. Further, "the fact that accounting firms are required to review these workpapers as part of their own due diligence regarding the accuracy of the financial statements also does not change the character of the workpapers."¹¹⁰

C. Truthfulness in Financial Reporting

The *Textron* majority sums up its side of the third and final general policy debate succinctly: "tax collection is not a game."¹¹¹ In other words, the nature of tax collection, and the benefit to society produced through tax collection, mandates that the IRS should be able to discover a taxpayer's tax accrual documents.¹¹² The IRS is at a disadvantage in collecting taxes from entities which seek to obscure their true tax liability at every opportunity; for example, the documents at issue in *Textron* filled nine four-drawer file cabinets, and its consolidated tax return alone exceeded 4,000 pages and 190 different entities.¹¹³ Even after the IRS expended considerable effort to target

108 Michelle M. Henkel, *Textron Eviscerates the 60-Year-Old Work Product Privilege*, 125 TAX NOTES 237 (2009). In fact, the Second Circuit in *Adlman* expressly stated that risk assessments are "a classic example of work product." *United States v. Adlman*, 134 F.3d 1194, 1196–97 (1998). Therefore, work-product advocates argue that tax accrual workpapers, which assess the chance of success in litigation if an uncertain tax benefit is taken, are by their nature risk assessments and should be considered under the umbrella of the work-product doctrine. Henkel, *supra*; see also *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987) (reasoning that individual litigation reserve figures are protected from discovery under the work-product privilege, as they "reveal the mental impressions, thoughts, and conclusions of an attorney in evaluating a legal claim").

109 *Textron*, 577 F.3d at 37 (Torruella, J., dissenting).

110 Henkel, *supra* note 108.

111 *Textron*, 577 F.3d at 31.

112 *Id.*

113 Ventry, *supra* note 55, at 881. Professor Ventry contends that due to "funding and personnel deficiencies," it is not certain that IRS officials would have been able to

nine contested transactions, it could not fully understand those transactions without analyzing the supporting tax accrual workpapers.¹¹⁴ Access to these workpapers would help the IRS fully evaluate the taxable nature of the disputed transactions, as access would help “verify the accuracy and completeness of return positions, clarify turbid facts and data, reveal unidentified issues and positions, and expose information hidden from view on transaction documents.”¹¹⁵

Additionally, considering that taxpayer contributions are the means supporting the IRS’s efforts, the cat-and-mouse game that frequently occurs during IRS audits imposes a considerable cost on society. If the IRS were able to access a taxpaying entity’s tax accrual workpapers, this societal cost could be reduced through a more efficient tax audit and litigation process.¹¹⁶ Moreover, the motivating factor behind IRS audits is to uncover the *truth* regarding an entity’s tax liability.¹¹⁷ Even opponents to discoverability admit that “the integrity and fairness of our tax system relies in significant part on the willingness of all taxpayers to comply voluntarily with their tax reporting obligations.”¹¹⁸ Considering the serious informational disadvantage from which the IRS operates, its commendable goal should merit assistance in legally uncertain situations.

Discoverability opponents object to this line of thinking. “The scope of the work-product doctrine should not depend on what party is asserting it.”¹¹⁹ Instead, they point to the powerful tools the IRS already has at its disposal in collecting taxes—namely, the IRS summons (threatened or actual) and the ability to impose federal penalties.¹²⁰ With these weapons in its arsenal, the playing field on which the IRS and corporate taxpayers operate is much more level than discoverability proponents claim.¹²¹ Further, the IRS’s desire for more efficient investigations into UTPs—its admitted motivation in *Tex-*

find and evaluate the SILO transactions implicated in *Textron*. *Id.* While new efforts to make tax positions more transparent, such as the requirement to complete Schedule M-3 and Form 8271, assist in locating evasive tax shelters, the IRS cannot possibly examine and understand an entity’s tax positions from these forms alone. *Id.*

114 *Id.*

115 *See id.*

116 *See generally id.* (“[T]ax accrual workpapers help the IRS verify the accuracy and completeness of return positions, clarify turbid facts and data, reveal unidentified issues and positions, and expose information hidden from view on transaction documents.”).

117 *Textron*, 577 F.3d at 31.

118 Brief for CCR, *supra* note 99, at 14.

119 *Textron*, 577 F.3d at 37 (Torruella, J., dissenting).

120 Brief for CCR, *supra* note 99, at 14–15.

121 *Id.* at 15–16.

tron¹²²—should not deprive corporate attorneys of the privacy they need to support their clients.¹²³

IV. A CHANGING WORLD: IFRS AND THE DISCOVERABILITY OF TAX ACCRUAL WORKPAPERS

A. IAS 12 and the Move to IFRS

In November 2008, the SEC published a roadmap that could require all SEC-registered companies to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS) by 2014.¹²⁴ In moving to IFRS, the SEC seeks to create a uniform accounting standard that would help investors compare financial statements between U.S. and foreign companies.¹²⁵ Currently, IFRS are used instead of GAAP in over one hundred countries, but not in the United States.¹²⁶

With respect to income taxes, the implementation of IFRS—which is assisted by a convergence project between the FASB and the International Accounting Standards Board (IASB)—would likely mean that a new standard would displace FIN 48 as the authoritative standard in accounting for UTPs. Currently, the IASB's standard for accounting for income taxes, International Accounting Standard (IAS) 12, does not explicitly address accounting for UTPs.¹²⁷ In practice, IAS 12 companies generally record liabilities for UTPs that do not meet FIN 48's more-likely-than-not threshold by using either a probability-weighted-average approach or a single-best-estimate approach.¹²⁸

122 *Textron*, 577 F.3d at 36 (Torruella, J., dissenting).

123 Brief for ACC, *supra* note 97, at 15.

124 Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, 73 Fed. Reg. 70816 (proposed Nov. 21, 2008), *available at* <http://www.sec.gov/rules/proposed/2008/33-8982fr.pdf>. The Roadmap also provides that the SEC will decide in 2011 whether it will proceed with the timeline that has most U.S. companies transitioning to IFRS in 2014. *Id.* However, the recent financial crisis may push back the timeline to some extent, in an attempt to lessen the compliance burden on financially strapped businesses. James Dornbrook, *Accountants Hold Off on Switch to International Standards*, KAN. CITY BUS. J., Feb. 20, 2009, at 5, *available at* <http://kansascity.bizjournals.com/kansascity/stories/2009/02/23/story13.html>.

125 See Dornbrook, *supra* note 124.

126 Rolfes, *supra* note 16, § 1.10.

127 Tami Van Tassel et al., *Income Tax Accounting Under IFRS: Uncertain Tax Positions*, SEC. L. DAILY (June 4, 2009).

128 *Id.* "Under a single-best-estimate approach, highly certain tax positions may have resulted in a full benefit being recognized. Conversely, under a probability-weighted average approach, some level of reserve may be recorded." *Id.*

On March 31, 2009, as part of the aforementioned international convergence project, the IASB released an initial proposal, or exposure draft, to replace IAS 12.¹²⁹ Among other proposals, the exposure draft mandated that uncertain tax positions be measured at the probability-weighted average of all possible outcomes.¹³⁰ Therefore, under the proposed standard, “whatever the probability of a tax position not being upheld, a reserve equal to that probability must be created on the books.”¹³¹ In other words, whereas under FIN 48 a tax benefit is only recognized for positions that are more-likely-than-not to survive an IRS challenge, under the proposed international standard, a tax benefit is to be recognized based on the probability of success, regardless of whether it met a stated recognition threshold.¹³² For example, assume Company *X* has three potential tax liabilities, each valued in full at \$1,000,000. Position *A* has a 10% chance of being upheld if challenged, while positions *B* and *C* have a 49% and a 95% chance, respectively. Under FIN 48, GAAP taxpayers could record the liability in full for positions *A* and *B*, but would record no tax reserve for position *C*. IFRS taxpayers, on the other hand, record a liability for all three positions, including those that probably would not succeed upon challenge (*A* and *B*). Indeed, IFRS taxpayers even record a tax liability of \$50,000 for position *C*, which has essentially no chance of being overturned upon IRS challenge.

129 See Press Release, Int’l Accounting Standards Bd., IASB Seeks Comments on a Proposed Standard on Income Tax Accounting (Mar. 31, 2009), available at <http://www.iasb.org/News/Press+Releases/IASB+seeks+comments+on+a+proposed+new+standard+on+income+tax+accounting.htm>.

130 Exposure Draft, Int’l Accounting Standards Bd., ED 2009/2, Income Tax (Mar. 31, 2009).

131 Van Tassel et al., *supra* note 127. “For instance, a 60 percent chance of a position not being sustained would trigger the creation of a reserve equal to 60 percent of the value of the asserted benefit to cover the eventuality of it being disallowed.” *Id.* Like the guidance under FIN 48, companies using the new standard would assume that the relevant tax authorities would be able to review the reported tax information and have full knowledge of all pertinent records, and cannot take into account that a particular tax position will go undetected. *Id.*

132 *Id.*

TABLE 1. ANALYSIS OF TAX RESERVES UNDER FIN 48 AND IAS 12

Position	Amount of Tax Position	Likelihood of Success	Contingent Liability Reserve Recorded	
			GAAP (FIN 48)	IFRS (IAS 12)
A	\$1,000,000	10%	\$1,000,000	\$900,000
B	\$1,000,000	49%	\$1,000,000	\$510,000
C	\$1,000,000	95%	\$0	\$50,000
Totals*			\$2,000,000	\$1,460,000

* The totals in this example do not carry much meaning in and of themselves, because the accounting method that results in a higher recorded tax liability depends on the nature of the UTPs on a corporation's books. For example, assuming a corporation has multiple UTPs, each valued at the same amount, then the corporation would record a higher tax reserve under FIN 48 only if the majority of its positions had less than a 50% chance of success, as in this example. Alternatively, assuming the same facts, if the majority of a corporation's positions were more-likely-than-not to succeed (50.01% to 100%), then the corporation would record a higher tax reserve under IAS 12. Because amounts or "values" of various uncertain tax positions typically differ in magnitude, this example oversimplifies reality. However, this example illustrates how material differences can result when accounting for uncertain positions under the FIN 48 standard and a probability-weighted average standard.

The IASB's proposed IFRS standard garnered some support from the international tax community, but also met its fair share of criticism, contributing to the IASB's decision to drop the proposed standard from its June 2011 convergence schedule.¹³³ The most commonly invoked criticism concerned the time and cost associated with the transition from the FIN 48 standard to the IASB's proposed standard.¹³⁴ Critics harped on the time needed to retrain personnel and the burden of evaluating and assessing the probability of every UTP—across every jurisdiction, no less.¹³⁵ In particular, many commenting firms—including some of the big four accounting firms—noted that the proposed tax standard did not square with the expected outcome of most tax disputes.¹³⁶ These critics asserted that a probability-weighted-average approach does not reflect the true

133 Thomas Jaworski, *Latest FASB, IASB Convergence Plan Excludes Recent Income Tax Proposal*, 125 TAX NOTES 661 (2009). The IASB will pursue further limited improvements to IAS 12, potentially with the intent to attempt convergence with U.S. GAAP in the future. See also Press Release, Int'l Accounting Standards Bd., FASB and IASB Reaffirm Commitment to Memorandum of Understanding (Nov. 5, 2009), available at <http://www.iasb.org/News/Press+Releases/IASB+and+FASB+Reaffirm+Commitment+to+Memorandum+of+Understanding.htm>.

134 Thomas Jaworski, *IASB's Tax Uncertainties Method Portrayed as Burdensome in Public Comments*, TAX NOTES, Aug. 12, 2009.

135 See *id.* (describing the reaction of PricewaterhouseCoopers LLP to the proposed standard, as put forth in its comment letter dated August 3, 2009).

136 See *id.*

measurement of UTPs, in part because taking a UTP can only result in one of two outcomes: success in defending the position taken or reversal of the position in defeat.¹³⁷ Additionally, other firms expressed concern about the reliability of estimates used to support the computation of UTPs, considering the lack of a minimum recognition threshold.¹³⁸ Because of these concerns, many commentators advised against the proposed probability-weighted-average approach and instead recommended an expected value model.¹³⁹ Without a converged income tax standard from the FASB and IASB, the SEC may consider adopting IAS 12 as part of its IFRS implementation plan. Further, if adopted, IAS 12 would probably require U.S. corporate taxpayers to record liabilities for uncertain tax positions using the probability-weighted average approach anyway.¹⁴⁰

B. *Textron and the IFRS Standard*

In addition to its effects on the tax accounting world, a probability-weighted-average approach, when viewed in conjunction with the *Textron* decision, could have some serious legal ramifications for corporate tax departments. In fact, these ramifications are already being realized thanks to the IRS's recent announcement regarding tax accrual workpapers. IRS Announcement 2010-75, released in September 2010, proscribes new regulations that require certain large corporate taxpayers to rank uncertain tax positions (based on size) on a new Schedule UTP accompanying their tax returns, and to specifically designate uncertain tax positions that account for more than 10% of its aggregate amount of the reserves for all positions reported on Schedule UTP.¹⁴¹ While the total dollar amount of the tax reserve

137 See *id.* (quoting Deloitte Touche Tohmatsu International's Ken Wild, who argues that the probability-weighted approach produces an "outcome in respect of each item that rarely represents any particular expected outcomes," and the sum of the estimates under the approach would "rarely represent the overall outcome that the entity may expect in relation to the tax return as a whole").

138 *Id.*

139 *Id.* It should be noted that an expected value model for valuing uncertain tax positions may differ somewhat from the FIN 48 approach. Some commentators advocated a valuation model similar to another international standard, IAS 37, "Provisions, Contingent Liabilities, and Contingent Assets." *Id.* An application of the IAS 37 model of valuation would reflect the best estimate of amounts that could be required to settle current tax and deferred tax assets and liabilities. This would differ somewhat from FIN 48, as FIN 48 states that tax positions should be recorded at their full value if they meet the more-likely-than-not threshold.

140 Van Tassel et al., *supra* note 127.

141 IRS Announcement 2010-75, 2010-41, I.R.B. 428-29. For the 2010 tax year, the disclosure requirement applies to corporations with more than \$100 million in assets.

need not be disclosed, the corporate taxpayer will need to provide a “concise description” of the relevant facts of each uncertain tax position.¹⁴² In addition, the IRS reaffirmed, if not expanded, its policy of restraint regarding tax accrual workpapers, stating that, during the examination phase, it would not argue that a disclosure to a corporation’s independent auditors constitutes a privilege waiver.¹⁴³ Announcement 2010-75 covers both GAAP- and IFRS-reporting entities, meaning that certain IFRS-reporting entities could feel the consequences of the intersection between IAS 12, *Textron*, and Announcement 2010-75 as early as the 2010 tax year.¹⁴⁴ Therefore, IFRS-reporting entities, under IAS 12, could ultimately experience *Textron*’s influence through two interrelated tax requirements: the substantiation of probability estimates and the preparation (and potential availability) of the related tax work papers.

First, the major dilemma confronting IFRS-reporting entities is how to substantiate the probability estimates assigned to UTPs. Under GAAP and FIN 48, taxpaying entities estimate whether a UTP is “more-likely-than-not” based on related, previously litigated tax cases and their own experience with IRS auditors.¹⁴⁵ Under the “more-likely-than-not” standard, FIN 48 entities have an established procedure in place to estimate the probability of tax positions that are 50% or less likely to be upheld in the event of litigation. However, if the SEC adopts a probability-weighted-average standard, FIN 48 entities will not have procedures for estimating UTPs that are “more-likely-than-not” to be upheld—those that fall between 50.01% and 100% in the probable estimate scale. Because of the lack of expertise in estimating those positions, entities would be at most *speculating* as to what percentage should be applied to tax positions in the 50.01% to 100% range. These speculated probability percentages will not have much meaning or substance behind them, and any inquiry into the reasonableness of the estimates will likely bear little fruit. For that reason, tax

That asset threshold will decrease to \$50 million in the 2012 tax year and \$10 million by the 2014 tax year. *Id.* at 428.

142 *Id.* at 429. Initially, the IRS proposed that corporations would be required to detail the rationale and nature of uncertainty for each uncertain tax position, but that requirement was eliminated in the final rule. See IRS Announcement 2010-9, 2010-7, I.R.B. 408.

143 IRS Announcement 2010-76, 2010-41, I.R.B. 432-33. However, the IRS remained silent as to whether that policy of restraint would also apply in any resulting litigation.

144 IRS Announcement 2010-75, 2010-41, I.R.B. 428.

145 See *supra* Part I.A.

departments may be forced to seek out supporting opinions from outside tax counsel as a means of verifying their own estimates.

Further, the difficulty in assessing the probability for “all possible outcomes” also weighs against the reliability of the probability estimates. As many argued in their comment letters to the IASB’s proposed tax standard, the Internal Revenue Code contains considerable “gray” areas, which makes the analysis of tax uncertainties inherently difficult, regardless of the applicable tax standard. However, where FIN 48 limits the inquiry to tax positions with a less than or equal to a 50% chance of success, a probability-weighted-average tax standard requires the assessment of *every* UTP. In order to comply with that standard, then, entities must devote significant monetary resources to correctly assess the UTPs that are more-likely-than-not to succeed upon challenge anyway. Such an effort consumes corporate time and assets, and weighs against the acceptance of the proposed standard in its current form.¹⁴⁶ Moreover, after the Sarbanes-Oxley Act of 2002,¹⁴⁷ management is required to certify that the financial statements, including the estimates that drive the numbers produced within those financial statements, are presented fairly. Under a probability-weighted-average standard, then, management must also certify that the probabilities articulated in its calculation of tax liability are fair. Management will most likely have a difficult time certifying, under the penalty of perjury, financial statements that contain material tax position estimates with very little substance behind them.

Second, and relatedly, corporate tax departments will have to increase their workpaper documentation under a probability-weighted average standard in order to withstand scrutiny from independent auditors. As discussed earlier, the concern in *Textron* hinged on IRS access to documentation behind tax positions that are believed to meet the “more-likely-than-not” standard, which would give the IRS

146 In its comment letter to IASB dated July 24, 2009, Mayer Brown LLP, a United States law firm, made a similar argument to IASB regarding estimating low-probability tax positions under the proposed IFRS standard:

[I]n practice it may be extremely difficult to even identify all possible outcomes. Moreover, many such outcomes will, at most, be remote contingencies not likely to have a material effect on an entity’s overall assessment of its tax position. However, under the proposed standard, it appears that it will be necessary to assess the consequences of each of these outcomes.

MAYER BROWN LLP, COMMENTS ON EXPOSURE DRAFT 2009/2 (INCOME TAX) (July 24, 2009), [hereinafter MAYER BROWN COMMENTS], available at <http://www.iasb.org/Current+Projects/IASB+Projects/Income+Taxes/Exposure+Draft+and+Comment+Letters/Comment+Letters/Comment+Letters.htm>.

147 Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

a “roadmap” in potential litigation. The proposed IFRS standard exacerbates this concern. Under a probability-weighted-average standard, the IRS would enjoy potential access to analysis of *each and every tax position* an entity takes. With this newly acquired breadth of documentation, the IRS may undertake more aggressive strategies to dispute estimates of tax positions.¹⁴⁸ At the very least, the IRS could obtain additional information, providing the government with an unfair advantage in future adversarial litigation.¹⁴⁹

However, these corporate concerns do not necessarily outweigh the benefits achieved from applying *Textron* to corporations using the probability-weighted-average standard for UTPs. First, as Professor Ventry argues, the IRS is at an extreme disadvantage when collecting tax revenues; for example, IRS auditors had to dig through nine four-drawer file cabinets and a consolidated tax return totaling 4,000 pages in order to find the supporting tax accrual workpapers for only nine transactions.¹⁵⁰ Therefore, the IRS’s ability to get a “roadmap” for weak spots on an entity’s tax return could actually level the playing field between the IRS and corporate taxpayers.¹⁵¹ Second, the IRS’s efficiency gains in audits and litigation will reduce the cost of their monitoring efforts, allowing taxpayer dollars to be shifted to other needs. In other words, because both the IRS and the corporate taxpayer will have complete access to information regarding the corpora-

148 With respect to FIN 48, the IRS has announced a “policy of restraint,” which it adheres to by only pursuing certain “transactions,” such as the SILO transaction in *Textron*. Internal Revenue Service, FIN 48 and Tax Accrual Workpaper (TAW) Policy Update, I.R.S. LMSB Mem. 04-0507-044 (May 10, 2007), available at <http://www.irs.gov/businesses/corporations/article/0,,id=171447,00.html>. However, the “policy of restraint” is not a statutory mandate and may be altered at any time. Some argue that the IRS’s policy of restraint has become less restrained since 2007. Ron Buch, *The Touch and Feel of Work-Product*, TAX NOTES TODAY, Aug. 31, 2009, at n.4.

149 Mayer Brown LLP made a similar point in its previously noted comment letter, but instead focused on how such disclosure to the IRS would affect an entity’s future assessment of probability:

[The proposed standard] may increase the likelihood of seemingly remote outcomes because tax authorities will be put on notice of an entity’s lawyers’ assessment of litigation strategies, which could then change tax authorities’ strategy. Furthermore, if tax authorities become aware of the number of different ways that a taxpayer believes a position may affect others, taxpayers may find it more difficult to reach resolution because tax authorities may feel compelled to examine many or all of the overlapping issues prior to resolving any of them.

MAYER BROWN COMMENTS, *supra* note 146.

150 See *supra* note 113 and accompanying text.

151 Ventry, *supra* note 55, at 881 (citing “funding and personnel deficiencies” that plague the IRS’s regulatory efforts).

tion's UTPs, settlements in tax litigation will probably increase, as there will be no cat-and-mouse game to be played.¹⁵²

The legal consequences of moving to an international standard are broad, and the *Textron* decision exacerbates the potential difficulties. While the complexity in estimating the probability of uncertain tax positions below the more-likely-than-not standard (i.e., under 50%) may befuddle corporate tax departments in the short term, the *Textron* line of thinking will allow the IRS full access to those complex estimates, and the opportunity, if it wishes, to challenge those estimates on a regular basis. For this reason, the clash between the IFRS and *Textron* may yield an unfavorable result for many corporate entities, and possible efficiency gains for the IRS and taxpayers.

CONCLUSION

The issue of protecting tax accrual workpapers is not a recent debate, and the First Circuit's opinion in *Textron* is just the latest installment in the series. The *Textron* majority dealt a significant blow to work product advocates by narrowly applying the "because of" test and concluding that the work-product doctrine does not prevent the IRS from accessing tax accrual work-paper documentation. In the short-term, the *Textron* opinion encouraged the IRS to promulgate Announcement 2010-75 and 2010-76, but in the long term, the decision raises some serious concerns as the SEC considers the transition to international accounting standards. In particular, if U.S. companies are required to move to an international probability-weighted standard for reporting uncertain tax positions, the *Textron* decision will lead to additional challenges for tax-reporting entities, not the least of which are the difficulty in accurately assessing estimates of success between 50.01% and 100% and the broad disclosure to the IRS of its uncertain tax positions. This potential framework could not only undermine the reliability of financial reporting, but also the value of the adversarial system. However, these concerns do not necessarily outweigh the societal gains achieved from the *Textron* decision. Broad disclosure of tax accrual workpapers may level the playing field between the IRS and corporate taxpayers, allowing for more complete, timely, and accurate tax assessments. Additionally, if all tax accrual information is disclosed, the efficiency of both IRS audits and any resulting litigation could be improved, reducing the societal cost of tax administration.

152 See *supra* note 116 and accompanying text.

As situations like that presented in *Textron* come to the forefront, we must ask ourselves: are we comfortable with the potential effects of the *Textron* standard in a world governed by international tax accounting standards? Additionally, who should resolve such questions—Congress, the courts, or administrative agencies like the IRS and SEC? The answers to these questions may provide the first clues as to how *Textron* will influence the corporate tax world—both now and in the years ahead.