The Work-Product Doctrine and State Tax Accrual Workpapers

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This installment of A Pinch of SALT examines whether a corporate taxpayer’s state income tax accrual workpapers are protected by the work-product doctrine from discovery by state tax authorities. Tax authorities have asserted that tax accrual workpapers are not protected by the work-product doctrine because those documents have been created as part of the financial reporting process, not in anticipation of litigation. We believe that because there is an inherent anticipation of litigation in most analyses of uncertain tax positions, state income tax accrual workpapers often are protected by the work-product doctrine.

Before exploring the application of the work-product doctrine, a brief description of tax accrual workpapers is necessary. To appropriately account for potential liability, public companies’ financial statements are required to analyze income tax uncertainty. Financial Accounting Standards Board Interpretation No. 48 prescribes the appropriate standard for a company to use to account for uncertainty in income taxes. FIN 48 requires a company with an uncertain tax position (UTP) to perform a legal analysis of the tax technical merits to determine whether, in management’s judgment, the tax position is more likely than not to be sustained if challenged. The requirement is triggered by the company’s uncertainty regarding whether it will be able to sustain the tax position on the tax technical merits. For purposes of the analysis, FIN 48 requires a company to presume that the state tax authority has full knowledge of the tax position and that the issue is being resolved through the appeals and litigation process to the highest court.

Companies generally document that analysis in the form of a memorandum that provides an analysis of the technical merits of the tax position. It is that memorandum — referred to as a tax accrual workpaper — that causes tax practitioners the most concern. A taxpayer’s workpapers can contain language that, if disclosed to tax authorities, could be taken out of context and used to undermine the taxpayer’s position. Also, most companies keep an inventory of those UTP workpapers.

In Anticipation of Litigation

The fundamental reason for the work-product doctrine is to protect against an opposing attorney...

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1The work product doctrine as used in this article means the federal work product doctrine as codified in Fed. R. Civ. P. 26(b)(3), unless specified otherwise.
4Id.
5Whether such disclosure to a company’s independent financial statement auditor constitutes a waiver of the protection is beyond the scope of this article. However, nearly all courts have found that an independent financial statement auditor is not adverse to the company and, therefore, there is no waiver for purposes of the work-product doctrine. See United States v. MIT, 129 F.3d 681, 687 (1st Cir. 1997). (The [attorney-client] privilege . . . is designed to protect confidentiality, so that any disclosure outside the magic circle is inconsistent with the privilege; by contrast, work product protection is provided against “adversaries,” so only disclosing material in a way inconsistent with keeping it from an adversary waives work product protection.)
benefiting from counsel’s research, creativity, and analysis by allowing discovery of an attorney’s thoughts, opinions, and strategy. The work-product doctrine grew out of federal case law but has since been codified in the Federal Rules of Civil Procedure. The federal rule provides 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 or its representative (including the other party’s attorney, consultant, surety, indemnitor, insurer, or agent). The work-product doctrine provides protection for sensitive documentation created in anticipation of litigation:

To analyze whether a legal analysis of an uncertain tax position is prepared in anticipation of litigation, we have broken down the phrase into the two elements 1) in anticipation, and 2) litigation.

In Anticipation

How does a company determine whether it is anticipating litigation in order to qualify for the work-product doctrine? The federal courts have adopted two alternative tests to answer that question.

Most federal circuit courts apply a more liberal standard — the “because of” standard to determine whether a document is created in anticipation of litigation. The because-of standard provides that a document is created in anticipation of litigation when it is prepared because of potential or anticipated litigation. Further, and more importantly, a document is not precluded from satisfying the because-of standard because the documentation serves a dual purpose (for example, supporting financial statements and preparing for litigation).

A few federal circuit courts have applied a narrower, primary purpose standard. The primary purpose standard requires that the creation of the document be primarily motivated to assist in future litigation. That test is narrower than the because-of standard because it puts a focus on the most important purpose for the creation of the document.

Because there is an inherent anticipation of litigation in most analyses of uncertain tax positions, state income tax accrual workpapers often are protected by the work-product doctrine.

We submit that regardless of which standard is applied, there is an inherent anticipation of an audit when a taxpayer identifies an uncertain tax position. Further, it is the anticipation of an audit that compels the taxpayer to conduct and prepare the legal analysis of the technical merits of its tax position.

FIN 48 provides that a taxpayer must analyze such uncertainty to determine whether it is able to meet the recognition threshold in order to be permitted to recognize any benefit of the uncertain tax position in its financial statements. A taxpayer is at risk of losing the benefit of the tax position only if the tax authority challenges that tax position. Therefore, uncertainty in income taxes arises as a result of the company determining that a tax authority would challenge a tax position. To further illustrate the point, if a state tax authority has an administrative practice not to challenge a particular tax position, even though that position doesn’t satisfy the letter of the law, a taxpayer may use the administrative practice to resolve that uncertainty and recognize the benefit of that tax position. Therefore, a taxpayer is required to account for that uncertainty only if the state tax authority would challenge the tax position.

In fact, FASB pronouncements provide that although tax accrual workpapers are necessary for financial reporting purposes, the reason for those accruals is to represent the uncertainty stemming from potential litigation. FIN 48 provides that the

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10Id.
8Unlike the attorney-client privilege, the work-product doctrine is not an absolute privilege and may be defeated if the requesting party is able to demonstrate a substantial need for the materials, the court must protect against the disclosure of the “mental impressions, conclusions, opinions, or legal theories.” Fed. R. Civ. P. 26(b)(3)(B).
9Maine v. Dept. of Interior, 298 F.3d 60 (1st Cir. 2002); United States v. Adlman, 134 F. 3d 1194 (2nd Cir. 1998); In re Grand Jury Proceedings, 604 F.2d 798 (3rd Cir. 1979); National Union Fire Ins. Co. v. Murray Sheet Metal Co., Inc., 967 F.2d 880 (4th Cir. 1992); United States v. Roxworthy 457 F.3d 590 (6th Cir., Aug. 10, 2006); Binks Mfg. Co. v. National Presto Indus., Inc., 709 F.2d 1109 (7th Cir. 1983); Simon v. G.D. Searle & Co., 816 F.2d 397 (8th Cir. 1987), cert. denied, 484 U.S. 917 (1987); In re Grand Jury Subpoena (Mark Torf/Torf Environmental Management), 357 F.3d 900, (9th Cir. 2004).
11United States v. Davis, 636 F.2d 1028 (5th Cir. Unit A), cert. denied, 454 U.S. 862 (1981); United States v. Pennington (In re Newton), 718 F.2d 1015 (11th Cir. 1983).
12FIN 48 (June 2006).
reason for requiring reserves and reserve reporting is the uncertainty and likelihood of litigation that surrounds uncertain tax positions. In the “Reason for Issuing This Interpretation” section of FIN 48, FASB indicates that the establishment of reserves is tied directly to whether that position will be sustained upon audit. Therefore, the premise underlying the accounting of uncertainty in income taxes is that there is a risk of losing the benefit of a tax position through litigation.

The purpose for creating a document that provides an analysis of the technical merits of the tax position is to account for a potential or anticipated audit. Further, the creation of the document is arguably primarily motivated to assist in future litigation. Therefore, workpapers prepared to support the company’s uncertain tax position for financial accounting purposes are created in anticipation of litigation.

**It is the anticipation of an audit that compels the taxpayer to conduct and prepare the legal analysis of the technical merits of its tax position.**

For litigation to be anticipated, it is not necessary that some type of action or audit has begun.13 In fact, case law indicates that a lawsuit need not have been filed for the anticipation requirement to be satisfied. For workpapers to be protected by the work-product doctrine, the critical element is that there is a subjective anticipation that an adversarial proceeding may commence.

**Litigation**

What constitutes litigation? Does an audit by a tax authority constitute litigation?

What constitutes litigation will vary, but at its core the work-product doctrine is intended to encompass proceedings that are adversarial in nature.14 In fact, it is well settled that the proceedings for which documents are prepared need not take place in a court of record, as long as the proceeding is adversarial in nature.15 The critical element in determining whether an audit constitutes litigation is analyzing whether a state tax authority is adversarial when it is conducting an audit.

We believe that the state tax audit process is adversarial by its nature because the tax authority’s examination of a company’s filing is aimed at identifying any instance in which a taxpayer has not complied with the tax law. Indeed, tax practitioners take great pains at the audit and protest level to carefully review documentation before it is provided to a tax authority. And any documentation disclosed to a tax authority at the examination level may be used by the tax authority throughout the controversy — including later judicial appeals. As a result, if an examination by a tax authority was determined not to constitute litigation, the work-product doctrine would lose any applicability in the tax litigation context because the tax authority could render the work-product doctrine meaningless by requesting all documentation during the examination.

Therefore, the adversarial nature of the tax audit process is sufficient to constitute litigation for purposes of determining whether the work-product doctrine applies.

**Recent Cases**

Two recent cases illustrate the application of the work-product doctrine to protect tax accrual workpapers from disclosure.16 The IRS has applied a “policy of restraint” regarding requesting corporate taxpayers’ tax accrual workpapers, except for in unusual circumstances. Recently the IRS indicated that the participation in one or more listed or reportable transactions will constitute an “unusual circumstance” for purposes of determining whether to request tax accrual workpapers.17 The district court in each case determines that the work-product doctrine applies to protect that documentation from disclosure and each of the cases is on appeal to its circuit court.

**Textron**

In *United States v. Textron*, the IRS challenged the applicability of the work-product doctrine to protect tax accrual workpapers. The First Circuit has applied the because-of standard to determine whether the documents were created in anticipation of litigation for purposes of the work-product doctrine.

The IRS requested Textron’s workpapers and Textron refused the request, asserting that such information and documentation was privileged under the work-product doctrine. At trial, Textron’s vice president of tax testified that Textron’s ultimate purpose in preparing its tax accrual workpapers (which included a “hazards of litigation” analysis with various percentages assigned to particular issues) was to adequately reserve for any potential disputes or

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14Id.

15Id.


17IRS Announcement 84-46, 1984-18 IRB 18; IRM 4.10.20.3(2).
litigation. The IRS responded that the documentation was not protected under the work-product doctrine because Textron prepared the workpapers in the ordinary course of business because it needed the tax accrual workpapers to satisfy its independent auditor for financial statement purposes.

State taxing authorities should follow the lead of the IRS and request tax accrual workpapers only in unusual situations.

In holding for Textron, the court found that had Textron not anticipated a dispute with the IRS, it would have had no reason to prepare the tax accrual workpapers. The court found unconvincing the IRS’s argument that Textron prepared the workpapers in the ordinary course of business because it needed the tax accrual workpapers in order to satisfy its independent auditor for financial statement purposes. Rather, the court determined that were it not for pending or threatened litigation, Textron would have had no need to advise or report to the independent auditors concerning their analyses.

The IRS has appealed the district court decision to the First Circuit; it was argued on September 5.\(^{18}\)

Regions

In parallel litigation in the Eleventh Circuit, the IRS argued that the work-product doctrine did not protect tax accrual workpapers under the primary purpose standard.

During the 2002 and 2003 tax years, Regions Financial Corp., a southeastern banking operation, engaged in two federal listed transactions. The IRS served a summons on Ernst & Young LLP, Regions’ outside auditor, requesting information related to the relevant tax years. After reviewing the documentation requested, Regions instructed E&Y to withhold 20 documents. Later E&Y provided 260,000 pages of documentation to the IRS. All 20 withheld documents related to a transaction entered into by Regions in 2000. Regions’ general counsel sequestered four of those documents that “express opinions, evaluate legal theories, and analyze possible IRS attacks on Regions’ tax reporting of the transaction.” The other 16 documents explain, discuss, or quote these four documents and consist of e-mail, memoranda, and other less formal documents.

The IRS argued that under the primary motivating purpose test, the documentation at issue would not qualify for protection because the documents were produced so that Regions could create a sufficient and accurate tax reserve for contingent liabilities to satisfy the requirements of its independent auditor. Essentially, the IRS argued that Regions would have prepared its tax accrual workpapers in the absence of the prospect of litigation. Regions countered that argument by asserting that it would not have contingent liabilities at all if it did not think it would be sued by the Service over the tax consequences of the transaction.

The court was persuaded by Regions’ argument and held that, absent the prospect of litigation, those documents would never have been prepared. The court was not troubled by the fact that the prospect of litigation was uncertain at the time that the working paper was prepared and cited the well-settled principle that litigation need not be imminent for the work-product doctrine to apply “as long as the primary motivating purpose behind the creation of the document was to aid in possible future litigation.” (Emphasis in original.) Indeed, the court thought it was clear that Regions was motivated by the prospect of litigation when it sought outside legal opinions. That Regions undertook the time and expense of consulting an outside legal firm indicated that it believed litigation to be likely and the court found Regions’ subjective belief objectively reasonable. Further, the court rejected the IRS’s claim that if Regions prepared the documentation for any other purpose than in anticipation of litigation (such as to satisfy financial auditors), the documentation should not be protected.

Regions is now being briefed at the Eleventh Circuit Court of Appeals.\(^{19}\)

Conclusion

The work-product doctrine will often protect state income tax workpapers from discovery by state taxing authorities. Litigation concerning the application of the work product doctrine as applied to tax accrual workpapers is still in its infancy. However, this litigation so far indicates that workpapers prepared by outside law firms qualify for protection. Regardless, state taxing authorities should follow the lead of the IRS and request tax accrual workpapers only in unusual situations.

\(^{18}\)U.S. v. Textron, Docket 07-2631 (1st Cir. Ct.)

\(^{19}\)Regions Financial Corp. v. U.S., Docket 08-13866 (11th Cir. Ct.)