



District Court Holds Tax Accrual Workpapers Are Protected by the Work Product Privilege

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Corporate taxpayers were handed an important victory recently when the U.S. District Court for the District of Rhode Island held in *United States v. Textron, Inc.*, D. R.I., No. 06-198T (Aug. 29, 2007), that tax accrual workpapers are protected by the work product privilege. The *Textron* decision confirms that a company’s analysis of soft spots in its tax returns is off-limits to the Internal Revenue Service under certain circumstances.

Background

A number of developments in recent years—including Sarbanes-Oxley, Financial Accounting Standards Board Interpretation No. 48 (“FIN 48”), and the government’s assault on tax shelters—have caused the status of tax accrual workpapers vis-à-vis the Internal Revenue Service (“IRS”) to take on heightened significance. For years, the IRS has exercised a policy of “restraint” in requesting a corporate taxpayer’s tax accrual workpapers as part of an audit. Taking the position that tax accrual workpapers are, for the most part, not protected by any privilege, the IRS has nonetheless established a policy of not requesting tax accrual workpapers as part of an audit except in unusual circumstances. See *generally*, Internal Revenue Manual section 4.10.20.

The IRS changed this policy in 2002 with respect to tax accrual workpapers related to “listed transactions” as defined at the time in Income Tax Regulations section 1.6011-4T(b)(2). In Announcement 2002-63, 2002-2 C.B. 72, the IRS announced that for returns filed on or after July 1, 2002, it would routinely request tax accrual workpapers related to a listed transaction that was disclosed pursuant to Income Tax Regulations section 1.6011-4T. In addition, the IRS indicated that, as a discretionary matter, it would request *all* of a taxpayer’s tax

accrual workpapers in the case of (1) a listed transaction that was not disclosed, (2) tax benefits claimed from multiple listed transactions on a return or (3) reported financial accounting irregularities in connection with disclosed listed transactions. *Textron* reflects the IRS’ first attempt to enforce a summons in connection with a request for tax accrual workpapers related to a listed transaction.

Summary of the *Textron* Decision

In 2001, Textron engaged in nine “sale-in, lease-out” (“SILO”) transactions, which were listed transactions. In connection with the audit of Textron, Inc.’s 1998-2001 returns, the IRS requested Textron’s “tax accrual workpapers.” In 2005, the IRS issued an administrative summons for “all of the Tax Accrual Workpapers” for Textron’s 2001 taxable year.¹ Textron’s tax accrual workpapers included a list of items that might be challenged by the IRS, litigation hazards assessments for such issues, and tax reserve amounts associated therewith along with notes and memoranda written by Textron’s in-house attorneys with some assistance from in-house accountants. Textron refused to produce the workpapers in part because, it argued, they were privileged.

The court analyzed each of the possible privileges that could apply. First, the court ruled that the attorney-client privilege applied because the tax accrual workpapers

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¹ The summons defined “Tax Accrual Workpapers” as “all accrual and other financial workpapers or documents created or assembled by the Taxpayer, or the Taxpayer’s independent auditor relating to any tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to any footnotes disclosing reserves or contingent liabilities on audited financial statements. They include, but are not limited to, any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes” This is essentially the definition contained in Internal Revenue Manual section 4.10.20.

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consisted of “nothing more than counsel’s opinions regarding items that might be challenged because they involve areas in which the law is uncertain and counsel’s assessment regarding Textron’s chances of prevailing in any ensuing litigation.”

Second, the court found that the tax practitioner-client privilege of section 7525 of the Internal Revenue Code applied to workpapers that reflected advice received from in-house accountants because Textron’s tax accountants performed “lawyers’ work” by participating in “advising Textron regarding its tax liability with respect to matters on which the law is uncertain and/or estimating the hazards of litigation percentages.” The court also found that the exception in section 7525(b) for communications “in connection with the promotion of” a tax shelter did not apply.

The court found that both of these privileges had been waived, however, when Textron provided its workpapers to its independent auditor, Ernst & Young (“E&Y”), notwithstanding the fact that E&Y agreed to keep the workpapers confidential.

Finally, the court addressed the work product privilege. In determining that the tax accrual workpapers had been prepared “in anticipation of litigation,” the court rejected the “primary purpose” test of the Fifth Circuit in favor of the “more inclusive ‘because of’” test that had been adopted by the First Circuit and several others. The court stated, “[I]t is clear that the opinions of Textron’s counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared at all ‘but for’ the fact that Textron anticipated the possibility of litigation with the IRS.” The court emphasized, “[E]ven if the workpapers were needed to satisfy E&Y that Textron’s reserves complied with GAAP, that would not alter the fact that the workpapers were prepared ‘because of’ anticipated litigation with the IRS.” The court also indicated that Textron’s anticipation of litigation was “well-founded” given its experience in past audit cycles.

Unlike the attorney-client and tax practitioner-client privileges, however, the court found that the work product privilege had not been waived because disclosure to the company’s independent auditors was not inconsistent with keeping the information from an adversary and, specifically, “did not substantially increase the IRS’ opportunity to obtain the information contained in them.” Finally, the court determined the IRS had failed to demonstrate “‘substantial need’ for ordinary work product, let alone the heightened burden applicable

to Textron’s tax accrual workpapers, which constitute opinion work product,” stating that such workpapers had “little bearing on the determination of Textron’s tax liability.”

Lessons Learned

There are a number of important points that can be derived from *Textron*, including the following:

- A document can be prepared in anticipation of litigation long before there is any actual threat of litigation. “In anticipation of litigation,” in at least the District Court of Rhode Island’s view, means in anticipation of *the possibility of* litigation.
- Workpapers should be as “lawyerly” as possible. Textron’s workpapers were prepared by lawyers or accountants subject to the attorney-client, tax practitioner-client privileges or work product privileges. The court distinguished *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984) in part on the basis that in that case, the workpapers were prepared by the taxpayer’s outside auditor. Moreover, the workpapers in question in *Textron* clearly reflected counsel’s assessment of litigation hazards.
- Although perhaps not helpful in claiming attorney-client or tax practitioner-client privilege, obtaining a written agreement from outside auditors to keep tax accrual workpapers confidential strengthens an argument that the work product privilege has not been waived.

Unanswered Questions

Although *Textron* has gone a long way in clarifying the privileges that may attach to tax accrual workpapers, corporate taxpayers likely will still find themselves grappling with the following issues.

- The boundaries of the attorney-client and tax practitioner-client privileges remain unclear where workpapers are not actually disclosed to the company’s auditors. Auditor requests for privileged opinions have become increasingly common in recent years, and taxpayers have struggled with ways to meet their auditor’s needs without turning over otherwise privileged materials. Notably, the *Textron* court found that the privilege was waived not because the workpapers were prepared in connection with a public reporting requirement but because the workpapers themselves were disclosed to the company’s auditors.

- As *Textron* was a pre-FIN 48 opinion, it is not clear what impact FIN 48 may have on the applicability of the work product doctrine to tax accrual workpapers. Not only have tax accrual workpapers taken on a heightened public reporting aspect as taxpayers attempt to comply with FIN 48's very detailed requirements, but the very fact that FIN 48 requires a greater level of certainty than previously required in a company's tax positions begs the question—is analysis supporting a position that meets the “more likely than not” standard less likely to be considered to be prepared in anticipation of litigation? Conservative taxpayers and those establishing small reserves may bear the greatest risk here.
- In a footnote, the court left open the question of whether tax accrual workpapers should be

disclosed to assist the IRS in making a penalty determination. Because the IRS had not even proposed a deficiency at the time of the summons, the court dismissed this argument as “premature, at best.”

Looking Ahead

We have not heard the last on the questions addressed by the *Textron* decision. IRS Chief Counsel Donald Korb has stated publicly that the government is unlikely to back down. Taxpayers, nevertheless, have acted quickly in responding to the *Textron* decision and are using the decision as a basis to withhold tax accrual workpapers that have been requested by the IRS in audits. Moreover, the IRS has suggested on more than one occasion that it may reconsider its policy of restraint with respect to

IRS Extends Deadline for Some, But Not All, Section 409A Document Compliance Amendments

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On September 10, 2007, the Internal Revenue Service issued [Notice 2007-78](#), which generally extends the deadline for making final plan amendments to comply with section 409A of the Internal Revenue Code (“Section 409A”) by one year, from January 1, 2008, to January 1, 2009. However, nonqualified deferred compensation plans, employment contracts and other arrangements will still need to be reviewed, and in some cases amended, by the end of 2007.

With one limited exception, [Notice 2007-78](#) does not extend the current good faith compliance period or delay the deadline for taking other actions required to comply with Section 409A and the final Treasury Regulations under Section 409A that were published last April (the “Final Regulations”). See our May 2007 Tax Bulletin, [IRS Issues Final Regulation on Nonqualified Deferred Compensation](#), for a description of the Final Regulations.

Thus, most employers still will need to take actions by December 31, 2007, to ensure that their deferred compensation plans continue to comply after that date. For example, deferred compensation plans must still be operated in strict compliance with Section 409A and the Final Regulations beginning January 1, 2008, meaning that plan administrators must be familiar enough with the rules by then to apply them in practice.

Also, [Notice 2007-78](#) still requires the time and form of payment of any deferred compensation existing as of January 1, 2008, to be documented by then, although, as explained below, it does not require the documentation to be as detailed as it would have been under the Final Regulations.

[Notice 2007-78](#) also contains some other guidance that is not directly related to the delayed documentary compliance deadline.

Tasks Still Required to be Completed by December 31, 2007 Deadline

- Identify deferred compensation plans subject to Section 409A and the Final Regulations.
- Review all deferred compensation plans in order to operate them in strict compliance with Section 409A and the Final Regulations. Except for the

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rules in Section 409A(b) (dealing with offshore trusts and certain other funding arrangements), the Notice does not extend the current good faith compliance period or other transition relief beyond December 31, 2007.

- **Make any changes in the time and form of payment that would otherwise violate the anti-acceleration and subsequent deferral rules.** Notice 2007-78 does not extend the current transition rule allowing the time and form of payment to be changed without regard to the stricter Section 409A rules. For example, if the parties want to change the form of payment on separation from service from installments to a lump sum (which would otherwise violate the anti-acceleration rule), or change a specified payment date from July 1, 2008 to July 1, 2009 (which would otherwise violate the subsequent deferral rule), they must do so by December 31, 2007.
- **Make any changes in the time and form of payment necessary to avoid Section 409A entirely.** Notice 2007-78 states that no change in the time and form of payment after December 31, 2007, may result in an amount that was deferred as of December 31, 2007 qualifying for an exclusion from the definition of deferred compensation under the Final Regulations. This would include, for example, requiring a benefit to be paid soon enough after vesting to qualify for the short-term deferral exception.
- **Designate, in writing, a compliant time and form of payment for all deferred compensation (both mandatory and elective) that will not be paid by January 1, 2008.**

Notice 2007-78 contains several helpful rules for designating compliant times and forms of payment:

- Written plan provisions relating to the time and form of payment that do not comply with Section 409A and the Final Regulations may be disregarded, and do not have to be amended out of the plan or even overridden using “fail-safe” language. This rule applies to actual provisions that are inconsistent with Section 409A and the Final Regulations, such as a provision allowing a participant to obtain a distribution at any time subject to a 10 percent “haircut,” or at any time subject to the discretion of the employer. (It does not excuse the absence of provisions that are needed to comply with those rules, such as the compliant times and forms of payment themselves.) Of course, the inconsistent provisions may not be used in the

operation of the plan, and must be eliminated from the plan document by December 31, 2008.

- Payment events must include one or more of the payment events permitted by Section 409A and the Final Regulations. Impermissible payment events need not be formally deleted until next year; rather they can be ignored under the rule in the preceding paragraph as long as they are not used in operation, but any permissible payment events that the parties want to include should be included at this time. For example, if the parties would like to provide that a distribution will be made upon the occurrence of an unforeseeable emergency, and the plan does not currently provide for such a distribution, it should be added by December 31, 2007. Adding or deleting payment events when the plan is retroactively amended by December 31, 2008, could violate the anti-acceleration and subsequent deferral rules.
- General terms like “termination of employment” or “change in control” may be used to describe payment events instead of defined terms that track the exact wording and requirements in the Final Regulations. Of course, the defined terms must be used in the actual operation of the plan. Also, if a term is applied in a particular way in operation to a particular individual’s deferred compensation, the plan is deemed to have adopted that operation as its definition and it will need to be included in the plan document when retroactively amended by the end of 2008. For example, the Final Regulations treat an employee as having separated from service if the level of his anticipated future services is reduced to less than 20 percent of his previous level, but allow a plan to designate a different percentage between 20 percent and 50 percent for this purpose. If an employee’s level of services is reduced to 25 percent of his previous level, and the plan does not treat him as having separated from service, the plan may not treat a reduction to 25 percent as a separation from service and the plan when it is retroactively amended must be consistent with the plan’s operation during 2008.
- The time and form of payment must be “objectively determinable.” This is roughly the same as the standard in the Final Regulations, and it is not clear whether the IRS intended to provide any additional flexibility (except in the case of tax gross-up payments, where a limited exception is provided). Thus, consistent with the Final Regulations, if the parties do not want to require a payment to be made exactly when a payment event such as separation from service occurs, they should require it to be made at some time during a calendar year or portion of a calendar year, or a period of no more than 90 days, that can be objectively determined when the separation from service occurs, *e.g.*, the calendar year following separation from service, or the 90-day

period beginning on the first day of the month following separation from service. Also, if a period of no more than 90 days that overlaps two calendar years is used, the employee may not be allowed to control in which calendar year the payment is made.

- **Notice 2007-78** does, however, allow an objectively determinable time and form of payment to be replaced with another objectively determinable time and form of payment when the plan is retroactively amended by December 31, 2008, as long as the change does not affect the year in which the payment will be made (or, if a period of no more than 90 days that overlaps two calendar years is used, the employee could not control in which calendar year the payment was made). For example, a provision calling for an immediate lump sum payment when an employee dies may be changed to a provision calling for a lump sum payment by the end of the year in which the employee dies.
- The time and form of payment requirements do not have to be added to the particular plans to which they apply during 2007. Instead, they may be contained in an omnibus document that specifically identifies the particular plans or simply describes them in such a way that they can be identified and the amounts deferred under them can be objectively determined. For example, the document could contain lists of the times and forms of payment for Plan X, the times and forms of payment for Plan Y, and the times and forms of payment for all other deferred compensation plans maintained by the same employer. With respect to elective deferrals, the election form setting forth the time and form of payment of the deferrals should suffice.

Notice 2007-78 also makes it clear that the designation can be made at a later date, *i.e.*, after December 31, 2007, if that is permitted by the Final Regulations, for example, under the special rules for performance-based pay and the so-called “13-month rule” for certain unvested awards.

- **Designate, in writing, a series of installment payments as separate payments if that is what the parties intend.** This option is potentially very valuable. For example, it can be essential in order to meet the special “2 times” exemption for involuntary separations, where the form of payment is installment payments, or in order to be able to combine the short-term deferral exemption with the “2 times” exemption (*i.e.*, all installments paid before March 15 count towards short-term deferral exemption and installments after March 15 count towards the “2 times” exemption. (However, note there may be detrimental results

if the plan permits subsequent deferral elections to change the form of payment from installments to a lump sum as the effective date for the new lump sum distribution cannot begin until five years after the date of the last installment under the original schedule.) **Notice 2007-78** specifically states that the installment payments will be treated as a single payment unless this change is made.

- **If a deferred compensation plan or arrangement provides for a payment on a “good reason” termination event that the parties would like to comply with the definition of “good reason” added in the Final Regulations, an amendment to the definition to comply with the Final Regulations can be made but only if the individual is not yet vested in the payments and the amendment is made by the end of 2007.** This might be desirable, for example, so that the termination is considered involuntary and payment can fit within the “2 times” exemption for separation pay, or so that the payment is considered subject to a substantial risk of forfeiture and can fit within the short-term deferral exemption.
 - **Notice 2007-78** states that this can be done even though a payment that is subject to a weak “good reason” requirement could be considered payable in 2007, and thus arguably ineligible for the existing transition rule allowing the time and form of payment to be changed without regard to the anti-acceleration and subsequent deferral rules.
 - **Notice 2007-78**, however, states that if the existing “good reason” requirements are too weak for the payment to be considered subject to a substantial risk of forfeiture, then the change cannot cause the payment to be subject to a substantial risk of forfeiture, meaning that the short-term deferral exception will not be available. This will limit many plans’ ability to rely on the short-term deferral exception using the new definition of “good reason” in the Final Regulations, since before the definition was added practices varied considerably and many definitions were weaker than the one in the regulations.

Tasks for 2008

- **Operate all deferred compensation plans and arrangements in strict compliance with Section 409A and the Final Regulations.** As noted above, **Notice 2007-78** generally does not extend the current good faith compliance period or other transition relief beyond December 31, 2007.
 - For example, the parties may not change the time and form of payment of deferred compensation except

to the extent permitted by the anti-acceleration and subsequent deferral rules or the special rules in [Notice 2007-78](#) described above.

- While a plan does not have to be amended by December 31, 2007, to say how “specified employees” are defined, the rule prohibiting such employees from receiving distributions less than six months after they separate from service must be applied consistently as if a definition had been adopted.
- **Keep close track of how each deferred compensation plan and arrangement is operated.** Once certain rules are adopted in operation, they are effectively treated as part of the plan and cannot be changed except to the extent permitted by Section 409A and the Final Regulations. These rules will have to be incorporated into the plan when the plan is retroactively amended by December 31, 2008, to comply with Section 409A and the Final Regulations.
- **Designate, in writing, a compliant time and form of payment for all deferred compensation effectively deferred after December 31, 2007,** unless the Final Regulations allow the designation to be made at a later date.

Tasks Required to be Completed by December 31, 2008 Deadline

- **Amend each deferred compensation plan and arrangement retroactive to January 1, 2008, to comply with Section 409A and the Final Regulations.** [Notice 2007-78](#) specifically states that the amendments must “accurately reflect the operation of the plan on and after January 1, 2008, through the date of the amendment, including the terms and conditions under which any initial deferral elections or subsequent deferral elections were permitted, and how the operation of such plan met the requirements of the § 409A guidance on and after January 1, 2008, through the date of the amendment.” By contrast, actions taken before January 1, 2008 that do not affect later periods still generally do not have to be incorporated in the plan document. The preamble to the Final Regulations states that amendments “are not required to reflect any amendments made or actions taken under the transition rules to the extent such amendments or actions do not affect the plan’s compliance with section 409A and these regulations for periods on or after January 1, 2008.”

Other Guidance under [Notice 2007-78](#)

- The Treasury Department and the IRS anticipate creating a limited voluntary compliance program similar to the voluntary correction program for tax-qualified plans that will permit taxpayers to correct certain unintentional operational violations of Section 409A and thus limit the amount of additional taxes and penalties due under Section 409A.
- The transition relief from Section 409A(b) that was provided in [Notice 2006-33](#) will not be extended after December 31, 2007. [Notice 2007-78](#), however, states that until further guidance is issued, taxpayers may still rely on a reasonable, good faith interpretation of Section 409A(b) to determine whether their arrangements are subject to that section. Section 409A(b)(1) and (2) generally treat assets set aside in or transferred to offshore trusts, and assets subject to restrictions based on the employer’s financial health, as transfers of property which are required to be included in income under section 83, and subjects them to additional taxes and interest like those imposed on deferred compensation arrangements that do not comply with Section 409A(a). (Section 409A(b)(3) was added in 2006 to extend this rule to certain transfers and arrangements arising while the employer has an underfunded defined benefit plan or is in bankruptcy.) [Notice 2006-33](#) provided that assets set aside, transferred or restricted on or before March 21, 2006, could avoid that treatment under Section 409A(b)(1) and (2) if the plan was conformed with the requirements of section 409A(b) and any applicable guidance on or before December 31, 2007. This rule will lapse after December 31, 2007.
- Until further guidance, the *de minimis* cashout rule that allows remaining installments under an installment payment or annuity provision to be distributed when the present value of the remaining payments falls below the predetermined threshold may be applied, instead, when installments commence, as long as, among other things, the cashout threshold is fixed at the time the payment event is designated. This approach is simpler and more consistent with practices under tax-qualified plans than the existing rule.

Material Available On-Line

The following material is available with the indicated file sizes:

- [Notice 2007-78](#) [68K].
- Our May 2007 Tax Bulletin, *IRS Issues Final Regulation on Nonqualified Deferred Compensation*, in turn containing links to the text of the final regulations, the regulations as proposed in October 2005, various IRS notices and section 409A and its legislative history [26K].

Important Notice to Readers

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