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Tax Law

Alert

U.S. v. Deloitte: Tax Accrual Workpapers Can Contain Attorney Work Product

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On June 29, 2010, the U.S. Court of Appeals for the District of Columbia Circuit found that documents the government subpoenaed from Dow Chemical Company's independent auditors were protected from discovery under the work-product doctrine. *U.S. v. Deloitte, LLP*, 106 AFTR 2d 2010-5053.

The Current Debate

The question of whether tax accrual workpapers are protected from discovery under the work-product doctrine is being hotly debated among the U.S. Courts of Appeals and anxiously watched by corporate taxpayers. The IRS won a victory in *U.S. v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009), where the U.S. Court of Appeals for the First Circuit rejected the taxpayer's argument that its tax accrual workpapers were entitled to work-product protection. The IRS followed its victory in *Textron* with Announcement 2010-9 and Draft Schedule UTP, declaring its intent to require corporate taxpayers to disclose "Uncertain Tax Positions" on their tax returns. *Deloitte* may cause the IRS to reconsider Announcement 2010-9 and Draft Schedule UTP.

U.S. v. Deloitte

The discovery dispute in *Deloitte* arose from tax litigation between the IRS and Dow over Dow's tax treatment of two partnerships owned by Dow and two of its subsidiaries. During discovery, the government subpoenaed documents from Deloitte, Dow's independent auditor. Deloitte refused to produce three of the subpoenaed documents that Dow identified as attorney work product. In response, the government filed suit to compel production. Dow intervened to assert work-product protection.

The Subpoenaed Documents

The first document was a memorandum that Deloitte prepared to summarize a meeting between Dow employees, Deloitte employees, and Dow's outside counsel about the possibility of litigation over one of the partnerships and the proper accounting for any resulting tax liability ("Deloitte Memorandum"). The second document was a memorandum prepared by Dow's in-house accountant and in-house attorney, and the third document was a tax opinion prepared by Dow's outside counsel ("Dow Documents"). Dow disclosed the Dow Documents to Deloitte to allow Deloitte to review the adequacy of Dow's reserves for contingent tax liabilities on its financial statements.

The government argued that the Deloitte Memorandum was not attorney work product because it was created by Deloitte, not Dow or its counsel. Alternatively, the government argued that Dow waived work-product protection when it orally disclosed the information to Deloitte. The government then conceded that the Dow Documents were attorney work product, but argued that Dow waived work-product protection when it gave them to Deloitte.

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Deloitte's Authorship of the Memorandum does not Preclude it from Containing Attorney Work Product

The D.C. Circuit reasoned that "the question is not who created the document or how they related to the party asserting work-product protection, but whether the document contains the work product – the thoughts and opinions of counsel developed in anticipating of litigation." The Deloitte Memorandum recorded the thoughts of Dow's employees and outside counsel about anticipated tax litigation. Thus, the D.C. Circuit reasoned that Deloitte's authorship of the Deloitte Memorandum did not prevent it from containing Dow's work-product.

The government also argued that the Deloitte Memorandum was not work product because Deloitte prepared it during its financial statement audit and not in anticipation of litigation. The D.C. Circuit applied a test adopted by most circuits when determining whether a document was prepared in anticipation of litigation: "the question is whether the document was created '*because of*' the anticipated litigation." For the Deloitte Memorandum, the question was whether the memorandum "records information prepared by Dow or its representatives because of the prospect of litigation" even though the purpose of the document was related to the financial statement audit.

The D.C. Circuit found that the record was unclear whether all or part of the Deloitte Memorandum was work product. The D.C. Circuit remanded this question to the District Court to determine whether the Deloitte Memorandum was entirely work product or whether Dow should disclose a partial or redacted document to the government.

Disclosing the Work Product to Independent Auditors Did not Waive Work-Product Privilege

The D.C. Circuit noted that no U.S. Court of Appeals has addressed whether disclosing work product to an independent auditor waives work-product protection. Voluntary disclosure waives the attorney-client privilege, but it does not necessarily waive work-product protection because the two serve different purposes. Attorney-client privilege safeguards confidential communications, and voluntary disclosure is inconsistent with confidentiality.

The work-product doctrine furthers the adversary process by protecting counsel's preparation from discovery. Voluntary disclosure is not inconsistent with the adversary process unless the disclosure is "inconsistent with the maintenance of secrecy from the disclosing party's adversary." Voluntary disclosure to an adversary or a conduit to an adversary waives work-product protection.

The D.C. Circuit found that Deloitte, as an independent auditor, could not be Dow's adversary. Under the AICPA Code of Professional Conduct, the threat of litigation would compromise Deloitte's independence. Deloitte would have to withdraw as Dow's auditor if its independence was compromised. The D.C. Circuit concluded that Dow anticipated a dispute with the IRS rather than with Deloitte, thus Deloitte was not a potential adversary with respect to the work product.

The D.C. Circuit also found that Deloitte was not a conduit to Dow's adversary. The D.C. Circuit examined whether Dow (i) had engaged in selective disclosure to at least one adversary or (ii) had a reasonable basis for believing that Deloitte would keep the work product confidential. Dow did not engage in selective disclosure by sharing the work product with Deloitte because Deloitte was not Dow's adversary. Dow had a reasonable expectation that Deloitte would keep the work product confidential because the AICPA Code of Professional Conduct required Deloitte to keep its clients' information confidential.

Contrasting Deloitte with Textron

In *Textron*, the First Circuit held that the IRS should have access to the taxpayer's tax accrual workpapers. The First Circuit rejected the taxpayer's argument that it prepared the workpapers in anticipation of litigation. The First Circuit found that the taxpayer prepared the workpapers to comply with securities laws and for financial accounting purposes in the ordinary course of its business rather than in anticipation of litigation. Thus, the First Circuit reasoned that the company could not avail itself of the work-product

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doctrine to avoid disclosing the workpapers to the IRS.

Textron did not convince the D.C. Circuit in *Deloitte*. The D.C. Circuit found that *Textron* turned on the particular documents at issue in the *Textron* litigation. In *Textron*, the First Circuit determined that the particular documents at issue were not work product, but the First Circuit did not exclude all documents prepared during the financial statement audit process from work-product protection. In *Deloitte*, the D.C. Circuit concluded that documents a taxpayer prepared during the financial statement audit process could serve multiple purposes, and could constitute work product prepared in anticipation of litigation.

Conclusion

Deloitte reveals several aspects of the work-product doctrine that corporate taxpayers should consider as they prepare their tax accrual workpapers and documents necessary for the financial statement audit process. A non-attorney, not acting under the attorney's instruction, can prepare a document that is protected work product if the document contains the attorney's analysis about anticipated litigation. A document can serve multiple purposes, including financial statement preparation, and still contain work product. Taxpayers can disclose their work product to their independent auditors without waiving work-product protection. The factual record must demonstrate that the protected document is in fact work product, which requires taxpayers to document the anticipated litigation when they create the document rather than waiting until litigation arises.

The D.C. Circuit and the First Circuit have now given taxpayers different answers to the same question of whether the work-product doctrine can protect tax accrual workpapers from disclosure to the IRS. Attempting to reconcile the two opinions, the D.C. Circuit explained that the documents the IRS sought to obtain in *Deloitte* were distinguishable from the documents the IRS sought to obtain in *Textron*. Tax practitioners are unlikely to accept that *Deloitte* and *Textron* are distinguishable. The unsettled landscape surrounding this important issue and the "split" between the D.C. Circuit and the First Circuit suggest that the case may be headed to the U.S. Supreme Court for resolution.

The Tax Practice Group at Williams Mullen will continue to follow developments in work-product protection of tax accrual workpapers after *Textron* and *Deloitte*. The Tax Practice Group is also following the IRS's proposed disclosure requirements for Uncertain Tax Positions on Draft Schedule UTP. We will provide timely alerts on these issues to our corporate clients.

Williams Mullen has previously reported on the issue of whether tax accrual workpapers are entitled to work-product protection. See Williams Mullen's related Tax Alerts.

Tax Accrual Workpapers: Is the IRS Jumping the Gun on Textron? February 2010

Supreme Court Declines to Review United States v. Textron June 2010

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