Tax Accrual Workpapers Redux

By Robin Greenhouse, Chad Nardiello, and Kevin Spencer


Robin Greenhouse


Chad Nardiello


Kevin Spencer

Robin Greenhouse and Kevin Spencer are partners, and Chad Nardiello is an associate, in the Washington office of McDermott, Will & Emery LLP, where they practice federal tax controversy and litigation.

Wells Fargo is embroiled in litigation with the IRS over the federal government's continuing efforts to obtain tax accrual workpapers. With a split in the circuits, the case may provide the vehicle for Supreme Court review.

On September 1, 2010, Wells Fargo & Co. asked a Minnesota federal district court to quash a summons issued by the IRS to Wells Fargo's independent auditor, KPMG LLP, seeking all tax accrual workpapers for tax years ending December 31, 2007, and December 31, 2008 (the KPMG summons).[1] The KPMG summons defines those documents as "any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes." On November 1, 2010, the government filed a response seeking to enforce the KPMG summons and asking for a hearing. In a related case, it asked the same court to enforce summonses issued directly to Wells Fargo seeking the same types of documents and corresponding witness testimony. The court consolidated the two cases and held a four-day evidentiary hearing beginning on July 25, 2011.

Wells Fargo's action to quash the KPMG summons is another recent effort by a large corporation to maintain the privileged nature of its tax accrual workpapers. Several other courts have reached different outcomes regarding whether tax accrual workpapers are protected by the work product doctrine. These workpapers often contain legal analyses, opinions, and discussion of the odds of success and merits of tax litigation regarding uncertain tax positions, and they support the creation and entry of tax reserves on a company's financial statements.[2]

Wells Fargo seeks to protect the tax accrual workpapers contained in its own files, as well as those in KPMG's possession. It is attempting to protect the following from disclosure: (1) memorandums based on advice of in-house tax controversy attorneys identifying and evaluating the legal merits of its UTPs and selecting a reserve percentage based on the likelihood of settlement; (2) meeting agendas and e-mails identifying and/or evaluating litigation risks associated with its UTPs, including the corresponding reserve percentage and correspondence regarding settlement negotiations with the IRS; and (3) spreadsheets, reports, and electronic data files identifying its UTPs, and/or evaluating appropriate legal tax reserve percentages and/or reserve amounts. Wells Fargo also seeks to protect the same sort of documents residing in KPMG's files, which Wells Fargo identifies as replications of some of the documents

[1] *Wells Fargo v. United States*, No. 10-mc-57 (D. Minn. 2010).

[2] As one federal district court has recognized, there is no "immutable definition" of the term "tax accrual workpapers," which means those documents will vary from corporation to corporation. *United States v. Textron*, 507 F. Supp.2d 138, 142 (D. R.I. 2007), *Doc 2007-20046*, *2007 TNT 169-1*. The Internal Revenue Manual defines the term as:

> those audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. These workpapers reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis.

IRM 4.10.20.2 (July 12, 2004).

described above and documents created by KPMG that reflect opinion work product of Wells Fargo.

Origins of the Work Product Doctrine

The work product doctrine finds its origins in the Supreme Court decision *Hickman v. Taylor*.[3] In *Hickman*, the Court granted protection from disclosure of materials prepared by a party ''in anticipation of litigation.'' *Hickman* involved summaries of witness statements gathered by an attorney in preparation of his case. The opposing party sought those statements and other related documents during discovery, which the attorney opposed. The *Hickman* Court determined that both tangible and intangible work product of an attorney, which can be found in ''interviews, statements, memoranda, correspondence, briefs, mental impressions, [and] personal beliefs,'' should be protected.[4]

In 1970 Rule 26(b)(3) was added to the Federal Rules of Civil Procedure (FRCP), which in its current form 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).'' It should be noted that Rule 26(b)(3) is both narrower and broader than the *Hickman* holding. It does not protect intangible work product, which is protected under *Hickman*, and does protect work product prepared by nonattorneys, which the *Hickman* Court did not address.

When applying the ''in anticipation of litigation'' standard, most courts apply what is referred to as the ''because of'' test, which focuses on whether ''in light of the nature of the document and the factual situation in a particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation.''[5] At least one circuit court has fashioned a more restrictive test, which requires that the ''primary motivating purpose'' behind the creation of a document be to aid in possible future litigation.[6]

Dual-Purpose Documents

Relevant to the *Wells Fargo* case is how courts deal with a dual-purpose document: one created for both litigation and non-litigation purposes. The Second Circuit decision in *United States v. Adlman*[7] illustrates the application of the work product doctrine to dual-purpose documents. In *Adlman*, an in-house tax attorney asked a tax adviser at Arthur Andersen LLP to prepare a memorandum to be used in assessing litigation risk associated with undertaking a proposed corporate transaction. The memorandum assessed the likelihood of success in litigation with the IRS. Applying the because of test, the Second Circuit held the document was protected. Moreover, the court reasoned that whether a document was prepared ''because of that expected litigation really turns on whether it would have been prepared irrespective of the expected litigation.''[8] Accordingly, the work product protection exists if the material also was created to assist in a business decision, provided that it would not have been created in the ordinary course of business. Of interest in the *Adlman* opinion is the hypothetical posed by the Second Circuit, in which a company's independent auditor, while preparing audited public financial statements, requests the preparation of a memorandum by the company's attorneys estimating the likelihood of success in litigation to assist in estimating what amount should be reserved for litigation losses. The Second Circuit cites that document, which is distinctively analogous to tax accrual workpapers, as protected by the work product doctrine espoused in *Hickman*.[9]

The Sixth Circuit, in *United States v. Roxworthy*,[10] also has analyzed the application of the work product doctrine to dual-purpose documents. In *Roxworthy*, the Sixth Circuit determined that the work product doctrine applied to a memorandum prepared by KPMG providing an analysis of the IRS litigation risks associated with a corporate restructuring transaction. The evidence demonstrated that the purpose of the document was twofold: 1) it helped the corporation determine whether to disclose the transaction on its tax return to avoid tax penalties, which is something a corporation does in the regular course of its business; and 2) it provided the corporation with an analysis of the anticipated IRS litigation risks attendant to the transaction and the likelihood of success. The Sixth Circuit said, ''A document can be created for both use in the ordinary course of business and in anticipation of litigation without losing its work-product privilege.''[11] Tax accrual workpapers are dual-purpose documents, and in the world of tax controversy and litigation, they are generally the most sensitive document in a corporate taxpayer's possession.

---

[3]329 U.S. 495 (1947).

[4]*Id.* at 511.

[5]*United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998), *Doc 98-7109*, *98 TNT 36-15* (citations omitted, emphasis in original).

[6]*See United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982).

[7]134 F.3d 1194.

[8]*Id.* at 1204.

[9]*Id.* at 1200.

[10]457 F.3d 590 (6th Cir. 2006), *Doc 2006-15129*, *2006 TNT 155-7*.

[11]*Id.* at 599.

Textron Lays the Backdrop

For almost 30 years, corporate America and the federal government have been battling over the disclosure of tax accrual workpapers.[12] The First Circuit is the most recent circuit court to hold that tax accrual workpapers are not protected by the work product doctrine.[13] Explaining its reasoning in part by highlighting the purpose for creation of the putatively protected documents, the court said that ''the Textron work papers were independently required by statutory and audit requirements and that the work product privilege does not apply.'' Although in defining the anticipation of litigation standard the court said that it was following the broader because of test — that is, whether the material ''can fairly be said to have been prepared or obtained *because of* the prospect of litigation'' — it arguably applied a more stringent test. Throughout the majority opinion, as noted by the dissent, the court refers to materials protected by the work product doctrine as those ''prepared for use in litigation.'' This test is seemingly more strict than the Fifth Circuit's primary motivating purpose test espoused in *El Paso Co.* In reconciling the prepared for use in litigation test with the in anticipation of litigation standard, the court said the codified phrase ''prepared in anticipation of litigation or for trial'' means ''only that the work might be done *for* litigation but *in advance of* its institution.''[14]

Under the *Textron* test, unless a document was prepared for use in potential litigation, the work product doctrine does not apply. This is a very function-oriented test; that is, protection hinges on why the document was prepared. Employing that test, the First Circuit reasoned that tax accrual workpapers are prepared in support of financial statement certification by independent auditors, not for use in potential litigation. As the government urged, the First Circuit focused on the function of the documents containing the work product material, as opposed to their content. Thus, from the court's perspective, unless the document is of the type for use in litigation, no work product protection exists.[15]

The *Textron* dissent took the majority to task for its reasoning. It argued that by adopting the more narrow and restrictive prepared for use in potential litigation standard, the majority abandoned precedent established in *Maine v. U.S. Department of Interior*.[16] The dissent said that in *Maine*, the First Circuit explicitly adopted the broader because of standard set forth by the Second Circuit in *Adlman* and that the *Textron* majority's decision was contrary to the policy analysis set forth in that case. Quoting *Adlman*, the *Textron* dissent said, ''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.'" In contrast to the majority, the *Textron* dissent focused on the purpose for creating the documents' contents, regardless of whether they were usable in litigation.

A Difference in Opinions

After the government's success in *Textron*, the pendulum swung in the other direction, courtesy of the D.C. Circuit. In *United States v. Deloitte LLP*,[17] the first issue the D.C. Circuit addressed was whether the work product doctrine could apply to a document prepared by individuals from Deloitte's audit team after discussions with the taxpayer's employees and outside counsel about prospective tax litigation. The court noted that FRCP Rule 26(b)(3) only partially codified the work product doctrine because it did not include ''intangible'' things of the type contemplated by the Court in *Hickman*. Accordingly, the *Deloitte* court explained that ''the question is not who created the document or how they are related to the party asserting work-product protection, but whether the document contains work product — the thoughts and opinions of counsel developed in anticipation of litigation.'' Thus, the *Deloitte* court focused on the content of the document, as opposed to who created it.

In rejecting the government's assertion that the function or purpose for preparation of a document controls, the court said that ''a document can contain protected work-product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation.'' Addressing an issue of first impression, the *Deloitte* court also determined that disclosing work product to the taxpayer's independent auditor did not constitute a waiver because Deloitte was neither a potential adversary nor a conduit to other adversaries. The court found that the taxpayer had a reasonable expectation of confidentiality in turning the documents over to its independent auditor

[12] *See United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

[13] *See United States v. Textron*, 577 F.3d 21 (1st Cir. 2009) (*en banc*), *Doc 2009-18383*, *2009 TNT 155-7*.

[14] *Id.* at 29 (emphasis in original).

[15] Textron petitioned the Supreme Court for review and was denied. *See Textron Inc. v. United States*, 130 S. Ct. 3320 (2010).

[16] 298 F.3d 60 (1st Cir. 2002).

[17] 610 F.3d 129 (D.C. Cir. 2010), *Doc 2010-14431*, *2010 TNT 125-11*.

because the latter had a contractual and ethical duty of confidentiality. The government did not seek Supreme Court review.

***Wells Fargo* Litigation**

The litigation in *Wells Fargo* is focused on whether the work product doctrine applies to dual-purpose documents prepared by taxpayers to support their Financial Accounting Standards Board Interpretation No. 48 tax reserves, which but for the anticipated litigation would not have been necessary.[18] The court also will confront tax accrual workpapers that were prepared by KPMG but contain opinion work product material of Wells Fargo's attorneys. Assuming work product protections apply, other questions include whether the government can overcome the privilege by making the required showing of need for ordinary work product and whether Wells Fargo has waived the protections by disclosing the documents to KPMG.

When defining the anticipation of litigation standard, the Eighth Circuit (the circuit to which the Wells Fargo action is appealable) has adopted the because of test.[19] This is the same broad test applied in a majority of circuits, including the one in which *Deloitte* was decided. Eighth Circuit law also dictates that for an adversary to obtain ordinary work product (such as raw factual information), it must demonstrate a substantial need for the information. To obtain opinion work product, however, it must demonstrate ''rare and extraordinary circumstances.''[20]

Regarding the privileged nature of the tax accrual workpapers, the government's primary position is that they were prepared in the ordinary course of business as part of Wells Fargo's obligations under regulatory requirements and not in anticipation of litigation. The government argues that the D.C. Circuit's *Deloitte* opinion, which protects portions of documents prepared for a business purpose that include work product material, is contradictory to Eighth Circuit law. Citing *Simon v. G.D. Searle & Co.*,[21] the government asserts that the work product doctrine does not protect any portion of a document prepared in the ordinary course of business, even if the document contains some work product material. Recognizing that the court in *G.D. Searle* stated that it would protect documents prepared in the ordinary course of business to the extent they ''reveal the mental impressions, thoughts, and conclusions of an attorney,'' the government argues that that dictum provides no refuge to Wells Fargo.[22] The *G.D. Searle* court was referring to the potentiality of work product material created by attorneys that was then revealed in summarizing documents created by non-attorneys. The government asserts that that differs from *Wells Fargo*, in which non-attorneys were the drafters of the original analyses, with attorneys having only ''input in the process.'' The government also asserts that the prospect of litigation was ''too remote'' to invoke the protections because the procedural events of having to create tax reserves (in some cases, pre-return filing) and being under IRS examination are not ''tantamount to anticipated litigation.'' For those reasons, the government argues that it is entitled to all the summoned documents in KPMG's possession.

If the court determines that the work product doctrine applies, the government argues in the alternative that such protection is vitiated because the IRS has shown a substantial need and that the documents cannot be obtained from another source. In arguing that it has overcome the protections for work product, the government cites a district court decision standing for the proposition that a different and far less stringent standard applies when the IRS is exercising its statutory summons power.[23] Although not stated expressly, in this context it appears the government is only seeking to overcome the protections for ordinary work product material, not opinion work product material.

The government also argues that even if the tax accrual workpapers are protected, Wells Fargo has waived the work product privilege by providing the documents to KPMG's audit team. Citing *In re Chrysler Motors Corp. Overnight Evaluation Program Litigation*[24] and other cases, the government asserts that disclosure of documents to an adversary or potential adversary, even in relation to a different action, waives the work product protections. The government rejects the D.C. Circuit's reasoning in *Deloitte* that disclosure of tax accrual workpapers to an independent auditor does not waive the work product protections, arguing that Wells Fargo waived the protections because KPMG performs a different role that includes obligations to creditors and the public and that any perceived obligations of

[18] *See, e.g., Regions Financial Corp. v. United States*, 101 A.F.T.R.2d (RIA) 2179 (N.D. Ala. 2008), *Doc 2008-10349*, *2008 TNT 92-64*.

[19] *See Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th Cir. 1987); *see also PepsiCo Inc. v. Baird, Kurtz & Dobson LLP*, 305 F.3d 813 (8th Cir. 2002).

[20] *Baker v. General Motors Corp.*, 209 F.3d 1051 (8th Cir. 2000) (''opinion work product enjoys almost absolute immunity'').

[21] 816 F.2d 397.

[22] *Id.* at 401.

[23] *Iowa Protection & Advocacy Services Inc. v. Rasmussen*, 521 F. Supp.2d 895, 909-910 (S.D. Iowa 2002).

[24] 860 F.2d 844 (8th Cir. 1988).

confidentiality do not prohibit KPMG from becoming an adversary or a conduit to other adversaries.

Wells Fargo vigorously objects to the government's attempts to obtain its workpapers, whether from itself or KPMG. It explains that its tax accrual workpapers are, by their very nature, prepared in anticipation of litigation because they are created "because of the prospect of litigation." Wells Fargo states that but for the anticipated litigation with the IRS over its UTPs, it would have no need to create the workpapers containing its attorneys' legal analyses and settlement positions. The company also points out that allowing the government to obtain the information is incompatible with the policies of the work product doctrine: protecting an attorney's litigation preparation, encouraging candid advice to clients, and maintaining the integrity of the settlement process. Citing *G.D. Searle*, Wells Fargo asserts that Eighth Circuit law protects materials generated because of the prospect of litigation even if they were included in a document created for a purpose other than litigation. For support, Wells Fargo looks to several opinions from the D.C., Second, and Sixth circuits. In addition, arguing that Eighth Circuit law contains no requirement that litigation be imminent, and because of its tax litigation history and current audit status, Wells Fargo also rejects the government's assertion that a dispute with the IRS over its UTPs is too remote to garner protection. Further, Wells Fargo cites Eighth Circuit law, as well as law from multiple other circuits, in support of the proposition that IRS administrative proceedings are sufficiently adversarial to be considered litigation for purposes of the work product doctrine.

Addressing the government's claim that it can overcome the protections of the work product doctrine, Wells Fargo asserts that the government has failed to meet the required showing of substantial need, which would only entitle the government to ordinary work product, because it has relied on conclusory assertions without any concrete evidence. In addition, Wells Fargo argues that there is no effort on the part of the government to meet the Eighth Circuit's rare or extraordinary circumstances standard so that it could obtain opinion work product. Wells Fargo also notes that the government's attempt to apply a less stringent standard for obtaining work product material in the context of an IRS summons is without legal authority and contrary to Supreme Court precedent.

Regarding the government's waiver argument, Wells Fargo cites the more recent Eighth Circuit opinion of *Pittman v. Frazier*[25] to support its argument that a waiver occurs only when the party who made the disclosure does so "with an actual intention that an opposing party may see the documents." Wells Fargo asserts that no waiver occurred because the disclosure to KPMG was not to an adversary, nor is there any evidence that it intended that KPMG would share the documents with an adversary. Rather, Wells Fargo relied on KPMG's legal and ethical obligations to maintain confidentiality. Pointing out that the D.C. Circuit's test for waiver from *Deloitte* is broader than the Eighth Circuit's test, Wells Fargo takes the position that even under the *Deloitte* test, it still has not waived the protections by making the disclosure. To counter the government's attempts to contrast *Deloitte* with Eighth Circuit case law, Wells Fargo notes that the Eighth Circuit's *Chrysler* case (on which the government relies) dealt with disclosure of work product to a current litigation adversary during settlement negotiations, which is different from disclosure to an independent auditor that has legal and ethical duties to maintain confidentiality. Wells Fargo also explains that an auditor's obligations under 15 U.S.C. section 78j-1 to "report illegal acts it detects during its audit" does not make the auditor a conduit to the government.

Although summons enforcement proceedings are intended to be summary in nature, the court permitted each party to take three depositions and held a four-day evidentiary hearing during the last week of July. Additional briefing is expected in September and October. Considering the importance of the issue and its potentially broad implications beyond tax accrual workpapers to a vast array of other types of dual-purpose documents, large corporations and their legal and tax representatives are waiting with great anticipation for the trial court's decision — and unquestionably as it is appealed to the Eighth Circuit (and potentially beyond).

The Upshot

Should the matter find its way to the Supreme Court, the decision will have implications far beyond tax accrual workpapers. Taken outside the tax world, a holding against Wells Fargo could force litigants to disclose litigation strategies related to any type of anticipated litigation if the material appears in a dual-purpose document. On the other hand, a decision in Wells Fargo's favor would encourage full disclosure to a company's independent auditors, which benefits the investing public at large. With the split in the circuits and the wide-ranging impact of the issue, Supreme Court review seems likely and welcomed.

[25]129 F.3d 983, 988 (8th Cir. 1997).