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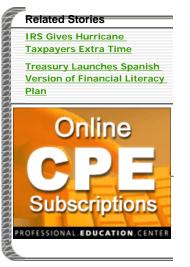
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Textron, IRS embroiled in tax battle over shelters

June 21, 2006 (Associated Press) — Textron Inc., an aerospace and defense contractor, is in an uphill legal battle with the Internal Revenue Service that could win U.S. corporations a significant new weapon in tax disputes.



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The conglomerate is resisting demands by the IRS for internal documents about its use of allegedly abusive tax shelters. Tax collectors have become more aggressive in recent years in demanding such records, and most companies comply. Textron is the first company that the federal government has taken to court over the issue, the IRS says. Legal experts say the IRS has the upper hand in the fight, but tax lawyers are watching to see if the case alters the balance of power in corporate tax disputes.

It's unclear how much money is at stake. Textron makes Cessna Aircraft, Bell Helicopters, golf carts, lawn mowers and other products. It had revenue of about \$10 billion in 2005, nearly a third of that from its Bell segment, which makes combat helicopters, armored vehicles, munitions and other defense products. Textron's stock, which closed Monday at \$86.67 on the New York Stock Exchange, has risen fairly steadily since the beginning of the Iraq war in early 2003, when it traded near \$30.

In 2001, Textron bought several telephone networks and a railroad system overseas and then leased them back to their owners, according to a Justice Department court filing. Such arrangements can produce big tax benefits because depreciation can be claimed on the assets to reduce taxable income.

Some leasing transactions that reduce taxes are legitimate, but the IRS has tried to crack down on aggressive ones it calls "sale in, lease out" deals. In 2004, Congress outlawed future so-called SILOs, and the IRS in 2005 said it would begin presuming that past SILO transactions violated tax laws. The IRS is currently trying to prove that assertion in cases involving Consolidated Edison

Co. of New York Inc., BB&T Corp. and Fifth Third Bancorp, which in suits against the government contend their deductions were proper.

The IRS says Textron entered into several deals that were SILOs, or "substantially similar" to SILOs. Toward that end, last year it demanded copies of the company's "tax-accrual work papers" for 2001.

Such documents generally include detailed analysis of tax-beneficial transactions that could be challenged by the IRS. If Textron thought there was a chance that the IRS would disallow a deduction, it would set aside - or "accrue" - a portion of the expected savings. The papers also could include analysis by lawyers of the transaction's legal weaknesses. Joseph Bankman, a Stanford University law professor who writes about tax shelters, calls such papers "the blueprint" for complicated tax transactions.

The Justice Department on behalf of the IRS says the dispute has its origins in nine SILO-like transactions, two involving cellphone-network equipment bought from and leased back to BT Cellnet Ltd. in the United Kingdom and Societe Francaise du Radiotelephone in France. The court documents don't say how much taxes Textron saved.

In a typical SILO, companies take advantage of depreciation that has no tax value to governments, foreign companies, or other entities that don't pay U.S. taxes. The authorities have gone after such agreements when they believe the buyer companies face no downside risk, suggesting that the deals were set up only to generate a tax break.

Textron acknowledges that tax considerations were a significant motivation for the transactions. But the company contends the deals were just a few of many leasing pacts its leasing unit does, were profitable even without the tax benefits and posed risks. (Chief Executive Lewis B. Campbell is a director of Dow Jones & Co., The Wall Street Journal's owner.)

When the IRS demanded Textron's accrual papers, it refused. In late April, the IRS and the Justice Department asked a federal court in Rhode Island, where Textron is based, to order the company to comply. It was the only time the government has taken such a step since the IRS in 2002 announced that it would start seeking such documents more often, says Deborah M. Nolan, commissioner of the IRS's Large and Mid-size Business Division. It is preparing similar moves against two other companies that have refused to turn over accrual papers.

Donald L. Korb, the IRS's chief counsel, said that companies shouldn't fear letting the IRS see such papers. "When I was in private practice before I took this job, I pointed out to clients that they should never be afraid of sitting in a room with IRS agents and discussing the strengths and weaknesses of their tax issues," he said. "If you think you're right, you ought to be willing to duke it out."

Norm Richter, Textron's vice president for taxes, said the company plans to argue in court that it is trying to protect privileged communications with its lawyers. "Just as the IRS relies on the law to keep communications with its attorneys confidential, the law also protects the confidential legal advice that citizens receive from their attorneys," he said in a written statement to the Journal.

To enable clients to be forthcoming with their lawyers so attorneys can give effective advice, lawyer-client communications generally are exempt from scrutiny by courtroom adversaries. The IRS, however, appears to have a legal precedent on its side. In 1984, the Supreme Court ruled that the IRS had a right to get tax-accrual documents in the U.S. v. Arthur Young & Co.

Fearing a corporate backlash that might turn Congress against the agency in such matters, the IRS announced after that decision that it would seek such papers only in limited instances. Between 1984 and 2002, the IRS requested them fewer than a dozen times, the IRS's Ms. Nolan estimates. But in 2002, the IRS announced a more aggressive policy for cases involving companies that used shelters it declared abusive. Since then, there have been 92 demands for such documents - 70 in the past year alone, Ms. Nolan said.

"There is pretty strong Supreme Court authority for the concept that the taxaccrual work papers are discoverable by the government," said William F. Nelson, a tax attorney at McKee Nelson LLP and a former IRS chief counsel. "But the question is whether the right to get tax-accrual work papers can be used to produce other information that might be subject to the attorney-client privilege."

The courts long have held that, in certain situations, the attorney-client privilege can't be invoked if the client shares the communications with outsiders. So if Textron showed documents prepared by its tax lawyers to outside auditors, its grounds could be shakier. Textron also could argue that the documents are covered by a privilege for documents produced by or for attorneys in anticipation of litigation.

Tax lawyers have expressed concerns that the IRS's position will prompt companies to stop sharing tax lawyers' analysis to outside accountants, leaving them with less information when auditing public companies for the protection of investors. The IRS's Mr. Korb calls that argument "a red herring." In the wake of recent scandals, accounting regulators are "not going to stand for" accountants blessing transactions without seeing all documentation.

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