WE COULD TELL YOU, BUT THEN WE'D HAVE TO KILL YOU:
ETHICS AND PRIVILEGES IN THE ESTATE PLANNING CONTEXT

Presented by

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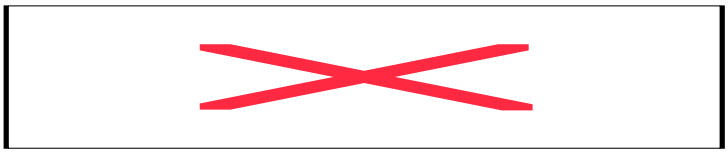
ABOUT THE SPEAKERS



CHARLES E. HODGES II

Charles E. Hodges II is a shareholder in the Tax Section of Chamberlain Hrdlicka's Atlanta Office, concentrating in civil and criminal federal tax controversies.

Mr. Hodges represents taxpayers against the IRS at all administrative and judicial levels from examination through court proceedings. Mr. Hodges has represented taxpayers in many different federal courts including: the United States Tax Court, the United States District Court for the Northern District of Georgia, the United States District Court for the Southern District of Mississippi, the United States District Court for the District of Arizona, the United States Court of Federal Claims, and the Court of Appeals for the Fifth and Eleventh Circuits. He is constantly involved in matters against the IRS and has yet to lose a trial against them. In all, he has been involved in cases in which taxpayers collected from the IRS over $1 million in attorneys' fees.

Mr. Hodges has been a key litigator in various cases earning him honors such as a "Leader in the Field" of Taxation by the *2005* and the *2006 Chambers USA—America's Leading Lawyers for Business* as well as a "Georgia Super Lawyers Rising Star" for 2005 and 2006. Some of his cases include:

> *Caracci v. Commissioner,* 456 F.3d 444 (5th Cir. 2006). The IRS sought over $250 million in excise taxes referred to as "intermediate sanctions" under I.R.C. § 4958 against three home-health care agencies and their owners in relation to the transfer of assets and liabilities when the agencies converted from tax-exempt to non-exempt status. The Federal Fifth Circuit Court of Appeals found taxpayers not liable for any excise tax liability. Complete taxpayer victory.
>
> *Estate of Lassiter v. Commissioner,* T.C. Memo 2000-324. The IRS attempted to collect over $11 million from the estate of a prominent land owner in Georgia and New York by challenging a disclaimer executed by the family members involving a pre-1982 will. The Tax Court found the disclaimer to be valid. Complete taxpayer victory.
>
> *International Capital Holding Corp. and Subsidiaries v. Commissioner,* T.C. Memo 2002-109. IRS challenged the deductibility of compensation paid between related companies under I.R.C. § 162. Court found company not liable for any additional income taxes. Complete taxpayer victory and IRS liable for attorneys' fees.
>
> *Trucks, Inc. v. United States*, 1:96-CV-800 (No. Dist. Ga. 2002). In a jury trial in the Federal District Court for the Northern District of Georgia (Atlanta), the IRS

attempted to collect millions from a large trucking company based on attack of their per diem plan for reimbursing drivers for over the road travel expenses. Court issued directed verdict to trucking company at the conclusion of the trial. IRS liable for attorneys' fees.

U.S. v. Jillson and Nixon, 99-2 U.S.T.C. ¶ 50,937 (DC-So. Fla. 1999). Rare taxpayer victory in summons enforcement case involving two executives of large installation company.

Full IRS concession of a $20 million civil fraud case docketed in the U.S. Tax Court against a large consolidated group based in the South.

Education
Clemson University (B.S., cum laude, 1992)
Mercer University (J.D. 1995)
University of Florida (LL.M., Taxation, 1996)

Affiliations
American Bar Association (Tax Section, and Real Property & Probate Section-Vice-Chair of Tax Litigation Committee)
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Atlanta Tax Forum
Lawyers Club of Atlanta

Publications
Mr. Hodges is a Columnist for the *Journal of Taxation* and has authored numerous tax articles for the *Journal of Taxation* and *Estate Planning* as well as has been cited in publications including the *Wall Street Journal's* Real Estate Journal.com, *Financial Advisor*, and *Atlanta Business Chronicle.*

Speaking Engagements
Mr. Hodges speaks regularly on tax issues and has given presentations for the American Bar Association, American Institute on Taxation, the Georgia Society of CPAs, Chattanooga Tax Practitioners, South Carolina Society of CPAs, Minnesota Society of CPAs, and Georgia continuing legal education seminars.

ABOUT THE SPEAKERS

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Stephanie Loomis-Price is an associate in the Tax Section of Baker Botts's Houston Office, concentrating in gift and estate tax litigation, fiduciary controversy, and estate administration.

Ms. Loomis-Price primarily handles federal gift and estate tax litigation, including disputes and litigation with the Internal Revenue Service, and fiduciary controversy work. She has assisted clients in numerous cases in the United States Tax Court, the United States Court of Federal Claims, and the United States Court of Appeals for the Fifth Circuit. Ms. Loomis-Price also counsels clients regarding estate administration. She currently serves as probate editor of the quarterly Real Estate, Probate and Trust Law Reporter published by the State Bar of Texas.

Prior to joining Baker Botts, Ms. Loomis-Price served as a law clerk to the Honorable Lawrence S. Margolis of the United States Court of Federal Claims in Washington, D.C. Some of her representative engagements includes–

- Charles T. McCord, Jr., and Mary S. McCord – successful defense of taxpayers in a case of first impression regarding the tax effect of gifts of limited partnership interests made by way of a dollar-based defined value formula (*Succession of McCord, et al. v. Commissioner*, 461 F.3d 614 (5th Cir. 2006))

- Estate of Wayne C. Bongard – successful defense of the estate against the IRS in a Tax Court case where the IRS sought to apply I.R.C. § 2036 to ignore the existence of a limited liability company for estate tax purposes (*Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005))

- Estates of Eugene and Allene R. Stone – successful defense of the estate against the IRS in Tax Court cases where the IRS sought to apply I.R.C. § 2036 to ignore the existence of five family limited partnerships (*Stone v. Commissioner*, 86 T.C.M. (CCH) 551 (2003))

- Estate of Joseph R. Coulter – successful defense of the estate against an IRS assertion of a $113 million estate tax deficiency in a Tax Court case involving the first-time application of I.R.C. § 2036(b) (T.C. Docket No. 17458-99)

- Estate of Beatrice Dunn – successful Fifth Circuit appeal and reversal of a Tax Court decision regarding the valuation of a closely held corporation (*Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002))

- Estate of Jimmie T. Drewry – successful representation against an IRS assertion of a $30 million estate tax deficiency in a Tax Court case involving recognition of private annuities and value of interests in a family limited partnership owning broadcast properties (T.C. Docket No. 10328-00)

- Estate of Helen Bolton Jameson – successful representation in a Fifth Circuit appeal involving an unrealized capital gains discount when valuing stock in a closely held C-corporation (*Jameson v. Commissioner*, 267 F.3d 366 (5th Cir. 2001))

Publications

- "Step Carefully to Avoid Pitfalls in Family Limited Partnerships," *Houston Business Journal*, April 2006
- Quarterly Probate Report, *Real Estate, Probate and Trust Law Reporter*, State Bar of Texas, January 2002 through current
- "Decision Making in the Law: What Constitutes a Good Decision–The Outcome or the Reasoning Behind It?" *Georgetown Journal of Legal Ethics*, Spring 1999

Speeches and Presentations

- "Dos and Don'ts of Family Limited Partnerships," American Bar Association Section of Real Property, Probate and Trust Law and the Center for Continuing Legal Education, National Teleconference, Houston, March 8, 2007
- "Fighting Legal Pitfalls With Family Limited Partnerships: A Practical Guide for Forming, Operating, and Defending FLPs," Business Valuation Resources National Teleconference, LLC, February 22, 2007
- "Family Limited Partnerships: A Practical Guide to Fighting Legal Pitfalls," American Bar Association Section of Real Property, Probate & Trust Law and the Center for Continuing Legal Education, Denver, October 21, 2006
- "Estate and Gift Tax Implications of FLPs," American Bar Association Section of Real Property, Probate and Trust Law and the Center for Continuing Education Legal National Teleconference, Houston, August 1, 2006
- "Family Limited Partnerships: A Practical Guide to Limiting Tribulations at Trial," Maryland State Bar Association, Gift and Estate Tax Study Group, Baltimore, February 9, 2006
- "Two Sides to Every Family Limited Partnership: A Practical Guide From Formation Through Audit," Houston Estate and Financial Forum, Houston, November 29, 2005 (with Paige Beach)
- "Shielding Your FLPs and FLLCs Against IRS Attack," Business Valuation Resources National Teleconference, June 1, 2005

- "Two Sides to Every Limited Partnership: A Guide to Family Limited Partnerships From Formation Through Audit," Bank of America 2nd Annual Wealth Symposium, Houston, May 4, 2005 (with Paige Beach)

- "Family Limited Partnerships: A Step-by-Step Guide to Limiting Tribulations at Trial," Estate Planning Council of Central Texas, Austin, March 22, 2005 (with Paige Beach)

- "Privileges in the Estate Planning Context," ALI-ABA Sophisticated Estate Planning Techniques, Boston, September 13, 2002

Education and Honors
J.D. (cum laude), Georgetown University Law Center, 1998
Managing Editor, Georgetown Journal of Legal Ethics
M.S., applied behavioral science, The Johns Hopkins University, 1996
B.A., international studies and Spanish, Austin College, 1989
Named a "Lawyer on the Fast Track" by H Texas, 2004
Named a "Texas Rising Star" by Texas Monthly and Law & Politics, 2006

Admissions and Affiliations
State Bar of Texas, Real Estate, Probate and Trust Law Section; Probate Editor of the quarterly Real Estate, Probate and Trust Law Reporter
United States Courts of Appeals for the Fifth and Eleventh Circuits
United States Court of Federal Claims
United States District Court for the Southern District of Texas
United States Tax Court
American Bar Association, Tax Section; Real Property, Probate and Trust Law Section; Tax Litigation and Controversy Committee, Chair
Houston Bar Association

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Ethics and Privileges in the Estate Planning Context

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We Could Tell You, But Then We'd Have To Kill You: Ethics and Privileges in the Estate Planning Context

Presented by

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"Nobody knows de trouble I've seen." G. Gershwin, *Porgy and Bess*.

I. ANTICIPATE YOUR POTENTIAL AUDIENCE DURING PLANNING STAGE.

A. Preparation for the Transfer Tax Audit or Dispute Begins at the Estate Planning Level. The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer's file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work product privilege may not protect all contents in your file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help you state your case with the examiner or in litigation. With that goal in mind, as you are working on a client's estate plan, assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in tax litigation.

Preparation for the transfer tax audit or dispute truly begins at the estate planning level. When writing letters or internal memoranda, think about how that document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in tax litigation. Have you focused on all relevant reasons for the transaction or just the estate and gift tax savings that might be achieved through the transaction? Advise your client and the client's advisors, such as accountants or stockbrokers who are involved in the estate planning process, that their

correspondence and their files may also be subject to production in a tax audit or in litigation.

B. **Understand the IRS's Broad Subpoena Power.** The IRS has broad subpoena powers that can be used to subpoena documents or compel testimony from a taxpayer, the taxpayer's representative, or a third party. For the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax," the IRS is authorized (i) to examine any books, papers, records, or other data that may be relevant or material to such inquiry and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records, or other data. I.R.C. § 7602(a).

Subject to any applicable privileges, the IRS can summon the taxpayer, the taxpayer's attorney, the taxpayer's accountants, and other third parties to produce books, papers, records, or other data and to testify on matters relevant or material to the IRS's inquiry. This summons power includes lawyers, accountants, and others involved in the planning process. It also includes doctors or other health care providers. The range of discoverable documents is also very broad and generally includes all documents in any form (including, for example, computer files and emails).

To enforce a summons, the IRS must show that the summons: (1) was issued for a legitimate purpose; (2) seeks information relevant to that purpose; (3) seeks information that is not already within the IRS' possession; and (4) satisfies all administrative steps required by the United States Code. *United States v. Powell*, 379 U.S. 48, 57 58 (1964). However, the IRS's broad summons power remains subject to traditional privileges and limitations. *United States v. Euge*, 444 U.S. 707, 714 (1980). Thus, if the attorney client privilege attaches to documents requested by the IRS, the IRS has no right to issue a summons to compel their production.

C. **Put Your Client in a Position to Produce Correspondence or Documents in Your File if It Is in the Client's Best Interest to Do So.** The assertion of the privileges at the audit or tax court level lead to an inference that the taxpayer is hiding something. Arguing that a document should be shielded from discovery by an examining agent or district counsel because it is either subject to the attorney client privilege or was prepared in anticipation of litigation may have evidentiary implications. *See, e.g., Estate of Shoemaker v. Comm'r*, 47 T.C.M. (CCH) 1462, 1464 n.7 (1984) ("Prior to trial, respondent sought discovery of estate planning files of Mr. Parsons' law firm pertaining to decedent. The attorney-client privilege was asserted and sustained by us, although we invited attention to the possibility that an unfavorable inference could be drawn from this assertion of the privilege.").

In cases where the IRS questions motives or business purpose, the best evidence can come from the correspondence prepared in connection with the transaction at issue. Well-drafted contemporaneous correspondence outlining the business and financial reasons (*i.e.*, the nontax reasons) for the transaction being challenged, such as a buy-sell agreement or the creation of a family limited partnership or corporation, serve as wonderful evidence to rebut an argument from the IRS that an entity was created as "a device solely to avoid taxes" or lacks "business purpose." *See, e.g.*, *John J. Wells, Inc. v. Comm'r*, 47 T.C.M. (CCH) 1114, 1116 (1984). ("While obviously the true facts can never be known with complete certainty by an outsider. . . . We base our conclusion upon our view of the spoken testimony and how that testimony, coupled with the documentary evidence, comports with human experience.").

D. **Understand and Preserve All Privileges.** As noted above, the IRS's subpoena power is limited to nonprivileged material. Whether or not a privilege exists in the context of an IRS examination is a question of federal law. *Jaffee v. Redmond*, 518 U.S. 1 (1996); Fed. R. Evid. 501. There are three types of privileges that may apply to a lawyer's file and correspondence: (i) the attorney client privilege; (ii) the attorney work product privilege; and (iii) the tax practitioner's privilege. With respect to medical records, the doctor/patient privilege and psychotherapist/ patient privilege may also come into play. None of the privileges is as broad as most lawyers believe.

II. ATTORNEY-CLIENT COMMUNICATIONS AND WORK PRODUCT.

A. **Attorney-Client Privilege.** The attorney-client privilege exists for one reason and one reason only: to encourage the complete and truthful exchange of all sensitive information between a lawyer and his or her client, by ensuring that the confidential information will remain in confidence. Like the Fifth Amendment protection against compelled self-incrimination, the policy recognizes that encouraging complete and honest disclosures to the lawyer is more important than requiring lawyers to testify against their clients.

1. **Definition.** Professor Wigmore's definition of the attorney-client privilege is set forth in VIII Wigmore, Evidence § 2292:

a. where legal advice of any kind is sought;

b. from a professional legal adviser in his capacity as such;

c. the communications relating to that purpose;

d. made in confidence;

e. by the client;

f. are at his instance permanently protected;

g. from disclosure by himself or by the legal adviser; and

h. except the protection be waived.

2. **Two-Way Communications.** The privilege also works in the other direction: it protects communications *from* the lawyer *to* the client. *Alexander v. Fed. Bureau of Investigation*, 198 F.R.D. 306, 309 (D.D.C. 2000) ("The attorney-client privilege must protect 'a client's disclosures to an attorney,' and the federal courts extend the privilege also to an attorney's . . . communications to a client, to ensure against inadvertent disclosure, either directly or by implication, of information which the client has previously confided to the attorney's trust").

3. **Not Necessarily the Facts.** The privilege attaches to the communication and does not necessarily insulate the underlying facts against disclosure. *Rhone-Poulenc Rorer, Inc. v. Hone Indemnity Co.,* 32 F.3d 851, 862 (3rd Cir. 1994).

4. **Confidence.** Above all else, the communication must be made in confidence and intended to remain in confidence.

a. A communication between a client and a lawyer is *not* privileged if it is made "in the presence of a third party." *United States v. Evans,* 113 F.3d 1457, 1462 (7th Cir. 1997).

b. Specifically, no privilege attaches to any letter that shows a "cc" to someone outside the attorney-client relationship and adding a "cc" to a lawyer extends no privilege to a letter to a third-party. *Sprout-Bauer, Inc. v Beazer E., Inc.,* 174 F.R.D. 609, 633 (M.D. Pa. 1997) ("What would otherwise be routine, non-privileged communications . . . do not attain privileged status solely because . . . counsel is 'copied in' on correspondence or memoranda."; *United States v. Davis,* 636 F.2d 1028, 1041 (5th Cir. 1981) ("[D]ocuments created outside the attorney-client relationship should not be held privileged in the hands of the attorney unless otherwise privileged in the hands of the client . . . ").

5. **Bills and Invoices.** Danger arises from IRS agents routinely asking for invoices relating to all payables and the payables clerk inadvertently turning over the box with the attorney's invoices describing all manner of confidential information.

a. As a result of developments in the law driven by currency transaction reports, receipt and payment of a lawyer's bill are generally not privileged. *United States v. Ellis*, 90 F.3d 447, 450-51 (11th Cir. 1996) ("receipt of attorney's fees normally [is] not [a]

privileged matter"); *Chaudhry v. Gallerizzo,* 174 F.3d 394, 402 (4th Cir. 1999).

b. The descriptions in the invoices are, however, privileged – provided that privilege is not waived. *Clarke v. Am. Commerce Nat'l Bank,* 974 F.2d 127, 129 (9th Cir. 1992) ("[C]orrespondence, bills, ledgers, statements, and time records which also reveal the motive of the client in seeking representation, litigation strategy, or the specific nature of the services provided . . . fall within the privilege").

6. **Not Business Advice.** The attorney-client privilege only extends to communications relating to soliciting and receiving *legal* advice – as opposed to general business advice. *In re Grand Jury Subpoena Duces Tecum Dated Sept. 15, 1983,* 731 F.2d 1032, 1037 (2nd Cir. 1984) ("[T]he privilege is triggered only by a client's request for legal, as contrasted with business, advice."); *Olender v. United States*, 210 F.2d 795, 806-07 (9th Cir. 1954) (communications with lawyer who merely fills out form deeds and deposits the client's money at the bank not deemed to be confidential attorney-client communications).

7. **Dual Purpose?** What about dual purpose communications involving legal and business communications? The minority view is that any non-legal purpose precludes the privilege, but the better view looks to the dominant purpose. *See, e.g., Neuder v. Battelle Pac. Northwest Nat'l Lab.,* 194 F.R.D. 289, 292 (D.D.C. 2000) ("Where business and legal advice are intertwined, the legal advice must predominate for the communication to be protected."); *Pippenger v. Gruppe*, 883 F. Supp. 1201, 1207 (S.D. Ind. 1994) (holding conversation "conducted 'primarily for the purpose of securing legal opinions and legal services,' are not subject to discovery").

8. **Loan Officer/Lawyer.** A rebuttable presumption may arise where the lawyer works in the General Counsel's Office, as opposed to the finance department. *Boca Investerings P'ship v. United States,* 31 F. Supp. 2d 9, 11-12 (D.D.C. 1998) ("There is a presumption that a lawyer in the legal department or working for the general counsel is most often giving legal advice, while the opposite presumption applies to a lawyer . . . who works for the Financial Group or some other seemingly management or business die of the house").

9. **Tax Opinions.** Tax advice and tax opinions by counsel are generally privileged. *United States v. Tel. & Data Sys, Inc.*, 2002-2 U.S.T.C. ¶ 50,569 (D. Wis. 2002); *Wojdak v. First W. Gov't Sec.,* Civ. Action No. 83-1076, 1991 U.S. Dist. LEXIS 11482, *4-5 (E.D. Pa. Aug. 15, 1991) (draft tax opinions protected by attorney-client privilege because they "were for the purpose of giving legal advice to a client, and were expressly treated by the sender and the recipient as confidential").

10. **Generally Not Return Preparation.** On the other hand, tax return preparation by a lawyer is generally not privileged for several reasons:

a. **Not Legal Advice?** Some courts have held that the preparation of tax returns is not the rendering of legal advice. *See United States v. Davis*, 636 F.2d 1028 (5th Cir. Unit A), *cert. denied*, 454 U.S. 862 (1981); *United States v. Gurtner*, 474 F.2d 297 (9th Cir. 1973); *Canaday v. U.S.*, 354 F.2d 849 (8th Cir. 1966). *In re Grand Jury Investigation (Schroeder)*, 842 F.2d 1223 (11th Cir. 1987).

b. **Not Confidential?** Some courts acknowledge an element of legal advice in the preparation of a return, but deny privilege based on a lack of expectation of confidentiality or a waiver. *United States v. Lawless*, 709 F.2d 485 (7th Cir. 1983) (no expectation of confidentiality in information to be included on return); *Dorokee Co. v. U.S.*, 697 F.2d 277 (10th Cir. 1983); *United States v. Cote*, 456 F.2d 142 (8th Cir. 1972) (disclosure waives privilege not only as to disclosed data but also as to details underlying the information on the return); *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984) (waiver by inclusion on return).

c. **Contrary Position.** But *see Colton v. United States*, 306 F.2d 633, 637 (2nd Cir. 1962) ("There can, of course, be no question that the giving of tax advice and the preparation of tax returns * * * are basically matters sufficiently within the professional competence of an attorney to make them *prima facie* subject to the attorney-client privilege").

d. **Divorce Advice from Information Disclosed on Return.** Although the IRS has argued that information provided to an attorney for the purpose of preparing tax returns is outside the scope of the privilege, the Ninth Circuit has rejected this contention, holding that material provided in the context of return preparation may also have been for the rendition of legal advice and may be subject to the privilege. *United States v. Abrahams*, 905 F.2d 1276 (9th Cir. 1990); *see also, United States v. Bornstein*, 977 F.2d 112 (4th Cir. 1992).

11. **How Do You Talk to an Entity?** Special problems arise when the client is an entity.

a. When the client is a corporation, a divergence exists between federal law and the law of some states. Since the Supreme Court's holding in *Upjohn Co. v. United States*, 449 U.S. 383, 392-97 (1981), counsel's communications with *any* corporation employees (though not shareholders) may be privileged under federal law,

while some states still limit the privilege between counsel and the "control group" of employees.

b. Even communications between counsel and former employees of the corporate client are generally treated as privileged. *In re Allen*, 106 F.3d 582, 605-606 (4th Cir. 1997).

c. Also, communications between counsel for the corporate parent and counsel for the sub are generally privileged. *In re Westinghouse Elec. Corp. Uranium Contracts Litig.*, 76 F.R.D. 47, 58 (W.D. Pa. 1977).

d. Beware that disclosure of privileged corporation communications to shareholders may constitute a waiver. *Cf., Garner v. Wolfinbarger,* 430 F.2d 1093, 1103-1104 (5th Cir. 1970).

e. By contrast, communications with and disclosures to the *general* partners of a partnership client are generally privileged. *Abbott v. Equity Group*, 1988 WL 86 826 (E.D. La. 1988).

12. **Crime/Fraud Exception.** The privilege attaches to communications relating to completed crimes, but not ongoing or future crimes and frauds.

a. This "crime/fraud" exception to the privilege requires a *prima facie* showing (as opposed to mere suspicion) that (i) the client is in the process of planning or committing a crime or civil fraud, and (ii) the attorney-client communication furthers that crime or fraud, generally by giving direction to it. *In re Grand Jury Subpoena*, 223 F.3d 213, 217 (3rd Cir. 2000).

b. Note that the exception applies even if the lawyer doesn't know about the crime or fraud. *In re Grand Jury Proceedings,* 604 F.2d 798, 802 (3rd Cir. 1979).

c. In response to Enron, Worldcom, etc., the ABA House of Delegates recently voted to expand the ability (obligation?) of a lawyer to report his or her client's ongoing crimes or civil frauds, thereby expanding the effect of this exception.

13. **Beware Of Waiver.** Any action inconsistent with the maintenance of a privilege may constitute waiver and that waiver may extend to the entire subject matter. *Bernardo v. Commissioner,* 104 T.C. 677, 682 (1995), *citing In re Sealed Case*, 676 F.2d 793, 807 n. 44 (D.C. Cir. 1982).

a. At least in the Tax Court, the party asserting the privilege bears the burden of proving the negative that he has not waived it. *Hartz Mountain Indus. v. Commissioner*, 93 T.C. 521, 525 (1989).

b. Even though the privilege always belongs to the client and the lawyer is not free to waive it without client authorization, a third party is entitled to enforce a waiver based on the actions of that same lawyer as an agent with apparent authority. *Hartz, supra.*

c. Under the precedent of the D.C. Circuit – which governs evidentiary rulings in all Tax Court cases – even an INADVERTENT WAIVER by the lawyer (or the *Kovel* CPA) generally constitutes an enforceable waiver. *In re Sealed Case, supra.*

d. That waiver generally extends to the entire subject matter. *Bernardo, supra. But see, Long-Term Capital Holdings v. United States*, 2003 WL 1548 770 (D. Conn. 2003) (Disclosure of gist of "more-likely-than-not" tax opinion to auditors did not constitute wavier as to entire opinion).

e. Also beware of "witness waiver." Adverse parties are entitled to inspect anything shown to a witness at any time to refresh his recollection for the purpose of testifying. FED. R. EVID. 612; FED. R. CIV. P. 26; *Nutramax Labs., Inc. v. Twin Labs, Inc.*, 183 F.R.D. 458, 468-72 (D. Md. 1998); *Bailey v. Meister Brau, Inc.*, 57 F.R.D. 11, 13 (N.D. Ill. 1972); *In re Pioneer Hi-Bred Int'l Inc.,* 238 F.3d 1370, 1375 (Fed. Cir. 2001) ("[D]ocuments and information disclosed to a testifying expert in connection with his testimony are discoverable by the opposing party, whether or not the expert relies on the documents and information in preparing his report.").

f. The advice of counsel cannot be used as a sword and then cloaked with a privilege. *Columbia Pictures Television, Inc. v. Krypton Broad. of Birmingham, Inc.,* 259 F.3d 1186, 1196 (9th Cir. 2001) ("The privilege which protects attorney-client communications may not be used both as a 'sword and a shield' . . . Where a party raises a claim which in fairness requires disclosure of the protected communication, the privilege may be implicitly waived."); *In re G-I Holdings, Inc.,*218 FRD 428 (D.N.J. July 17, 2003) (Held privilege waived in its entirety by raising "reliance upon tax counsel" as "reasonable cause" penalty defense under I.R.C. § 6664).

B. **<u>Work Product Doctrine</u>.** The work product of an attorney prepared under the direction of an attorney or his staff in anticipation of litigation is protected from disclosure. *Hickman v. Taylor*, 329 U.S. 495 (1947); FED. R. CRIM. P. 16(b)(2); FED. R. CIV. P. 26(b)(3). In theory, the attorney work product doctrine is not a privilege, though some courts refer to it as one. Unlike the attorney-client privilege, its purpose does not lie in protecting confidential communications: its purpose is to encourage the lawyer to thoroughly prepare for trial though

investigation of the good and the bad, without fear of being forced to aid his adversary at the expense of his client. In addition to its focus upon anticipated litigation, this doctrine also differs from the attorney-client privilege in that its protection can be pierced (in very limited circumstances) through no fault of the lawyer or his client.

1. **Definition.** The doctrine is defined by the narrow scope of its exception in this passage from FED. R. CIV. P. 26(b)(3):

> A party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

2. **Scope.** Note that the protection extends beyond just the work prepared by the attorney to work prepared by the client, her employees, agents, etc. at the direction of the lawyer. *In re Perrigo Co.,* 128 F.3d 430, 437 (6th Cir. 1997).

3. **Two Types.** The rule contemplates two types of work product: factual and opinion work product.

a. Under unusual circumstances, factual work product is discoverable upon the special showing. *In re Allen*, 106 F.3d 582, 607 (4th Cir. 1997).

b. By comparison, opinion work product "'enjoys a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances.'" *Cox v. Adm'r United States Steel & Carnegie,* 17 F.3d 1386, 1422 (11th Cir. 1994), *modified on reh'g by* 30 F.3d 1347 (11th Cir. 1994).

4. **Anticipation of Litigation.** To qualify for the protection, it is not necessary that the litigation have already been filed or be certain. Statements of the required level of anticipation vary. *See, e.g., Energy Capital Corp. v. United States,* 45 Fed. Cl. 481, 485 (Fed. Cl. 2000)

("'Litigation must at least be a real possibility at the time of preparation . . . .'"); *A. Michael's Piano, Inc. v. Fed. Trade Comm.,* 18 F.3d 138, 146 (2nd Cir. 1994) (document must be created "'with an eye toward litigation'"); *Schiller v. N.L.R.B.,* 964 F.2d 1205, 1208 (D.C. Cir. 1992) (document must be created "in anticipation of foreseeable litigation"); *United States v. Rockwell Int'l,* 897 F.2d 1255, 1266 (3rd Cir. 1990) (document must be created "'because of the prospect of litigation'"); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.,* 709 F.2d 1009, 1119-20 (7th Cir. 1983) (party asserting the privilege must show that "'some articulable claim, likely to lead to litigation, [has] arisen'").

5. **What About Proposed Transactions?** The fact that the work product relates to a proposed transaction is just one factor that suggests it was not prepared in anticipation of litigation and is not, in and of itself, dispositive. *United States v. Adlman*, 68 F.3d 1495, 1501 (2nd Cir. 1995) (corporate officer obtained tax memorandum regarding proposed reorganization from accountant/lawyer at Arthur Andersen).

6. **Protection Not Absolute.** Work product is not absolutely immune from disclosure, and some work product may be obtained by an adverse party upon a showing of substantial need. *Upjohn Company v. United States*, 449 U.S. 383 (1981).

7. **Audit or Tax Return Work Papers Generally Not Protected.** Accountant's work papers and work product generally are not protected, and any immunity for the work product of an investigative accountant must be derived from the attorney's work product privilege. *United States v. Arthur Young & Company*, 465 U.S. 805 (1984).

8. **"Because Of" vs. Primary Purpose Test.** Litigation need not be imminent or even the primary reason the documents were prepared, for the work product doctrine to apply. As long as the facts demonstrate that the documents were prepared "because of" anticipated litigation, the doctrine attaches. *United States v. Adlman*, 134 F.3d 1194, 1203-1204 (2nd Cir. 1995); *Sundstrand Corp. v. Commissioner*, Mem. Sur. Order No. 26230-83, T.C.M. 1986-531 (April 24, 1987).

C. **The Physician-Patient Privilege.** IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce a summons issued under federal statutory authority, federal privilege rules generally apply. *See, e.g., United States v. Moore*, 970 F.2d 48, 50 (5th Cir. 1992).[1] The Fifth Circuit has held that

[1] When Congress adopted the final version of the new Federal Rules Evidence in 1975, it rejected the nine enunciated privileges in the proposed rules (which included a physician-patient privilege) in favor of a single rule authorizing federal courts to apply "common law principles – in the

there is no physician-patient privilege under federal law. *Id.* No other circuit has adopted the privilege. The Supreme Court has not yet directly addressed the issue.

However, in *Jaffee v. Redmond*, 518 U.S. 1 (1996), the Supreme Court addressed the question of whether federal courts should recognize a psychotherapist-patient privilege under Rule 501. In *Jaffee*, the Supreme Court held that confidential communications between a licensed psychotherapist and a patient in the course of diagnosis or treatment are protected from compelled disclosure under Rule 501. In reaching its holding, the Court noted that:

> Like the spousal and attorney-client privileges, the psychotherapist-patient privilege is "rooted in the imperative need for confidence and trust." *Trammel*, 445 U.S. at 51, 63 L. Ed. 2nd 186, 100 S.C. 906. Treatment by a physician for physical illness can often proceed successfully on basis of a physical examination, objective information supplied by the patient, and the results of diagnostic tests. Effective psychotherapy, by contrast, depends upon an atmosphere of confidence and trust in which the patient is willing to make a frank and complete disclosure of facts, emotions, memories and fears. Because of the sensitive nature of the problems for which individuals consult psychotherapists, disclosure of confidential communications made during counseling sessions may cause embarrassment or disgrace.

Id. at 10. While the *Jaffee* Court did not rule on the applicability of a physician-patient privilege, the cited language shows that medical records based primarily upon physical examination and other objective information supplied by the patient or that result from diagnostic tests may not be considered privileged.

III. PRIVILEGES IN THE APPRAISAL PROCESS.

A. The Attorney Should Hire the Appraiser. In the transfer tax area, valuation appraisals often serve as the basis for a taxpayer's position with respect to the value of transferred property. Working with appraisers is an everyday event for most transaction planning attorneys. On the other hand, working with appraisers can be something of a rarity for most clients, many of whom have dealt with appraisers only in the purchase of their home. In addition, many clients do not enjoy working with appraisers. Although they are necessary, they are also expensive and can slow transactions down.

In most cases, the attorney, not the client, should hire the appraiser for a planning transaction. The attorney can offer guidance both to the client and the appraiser

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light of reason and experience" in determining whether a privilege exists under the common law. The Senate Report accompanying the adoption of the Rules indicates that Rule 501 "should be understood as reflecting the view that the recognition of a privilege based on a confidential relationship . . . should be determined as a case by case basis." S. Rep. No. 93-1277, p. 13 (1974).

as to how similar transactions have been handled in the past by the IRS and the courts. Doing so will also provide the taxpayer with an argument that any unused reports or correspondence are privileged, as the appraisal was intended to assist the attorney in rendering legal advice. As noted above, this argument is not as strong in the "planning" stage. At the audit and litigation levels however, the attorney can argue that the documents are work product.

B. **Anything Committed to Writing May Be Discoverable.** Any document in the appraiser's file, including correspondence, notes, and drafts of an appraisal is subject to being discovered during the audit process or in subsequent litigation. Experienced appraisers should know this; however, it never hurts to remind them. Once again, consider who your audience may ultimately be and understand that the appraiser's file may be reviewed by the examining agent, appeals officer, district counsel, or the ultimate finder of fact in tax litigation.

C. **Discuss the Methodology and Results of the Appraiser's Work With the Appraiser Before the Appraiser Drafts the Report.** Hiring a qualified appraiser is only the first part of the job. Examine the underlying assumptions, analysis, and conclusions of the appraiser and ensure that they are logical. Appraisers can and do make mistakes. Discuss with the appraiser his or her methodology of his or her examination *before* the appraiser commits the findings to writing. This doesn't mean you should "coach" the appraiser or tell the appraiser the answer that you want; it does mean that you should satisfy yourself that the appraiser's assumptions and analysis are correct. If you have questions or concerns regarding the appraiser's assumptions or analysis, you should discuss those concerns with the appraiser before the appraiser begins drafting the report. If your concerns cannot be satisfied, consider choosing another appraiser. If you decide to engage a second appraiser *before* the first appraiser has reduced his findings to writing, there will be no documents from that appraiser to produce in response to an examining agent's request for "copies of all appraisals."

IV. THE NEW FEDERALLY AUTHORIZED TAX PRACTITIONER PRIVILEGE.

A. Prior Law: No Federal Privilege for Non-Attorneys.

1. **No Accountant-Client Privilege.** In *Couch v. United States*, 409 U.S. 322 (1973), the Supreme Court rejected the proposition that an accountant-client privilege shielded a CPA's tax return work papers from an IRS summons, saying that federal law recognizes no such privilege.

2. **Work Papers Also Not Protected.** Thus, the IRS may inspect an independent auditor's confidential tax-accrual work papers. An independent auditor plays a quasi-public role, rather than an advocacy rule, that is at variance with absolute confidentiality. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). (Before the Supreme Court rendered its opinion, the IRS revised the Internal Revenue Manual to provide that tax-accrual work papers could be summoned only in unusual

circumstances and only after the revenue agent had failed to obtain the requested information from the taxpayer. Internal Revenue Manual 4024.4. The Supreme Court was aware of the change. 465 U.S. at 821, n.17.

a. *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), was decided two years prior to *Arthur Young*. El Paso argued that because in-house counsel performed the tax-return review along with the help of the company's in-house accounting staff, the resulting work papers were privileged. The Government countered that the work papers embodied financial and business guidance, not tax advice. The Fifth Circuit held that whatever privilege may have existed was waived when El Paso shared the contents of the work papers with its independent auditors, but *in dictum* said that "[t]he line between accounting work and legal work in the giving of tax advice is extremely difficult to draw," and said it "would be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of litigation on it are not legal advice." 682 F.2d at 539.

b. *United States v. Rockwell Int'l, Inc.*, 897 F.2d 1255 (3rd Cir. 1990). The IRS demanded Rockwell's in-house tax-accrual work papers, contained in a reserve file maintained by a Rockwell staff attorney. While rejecting the district court's position that such work papers were unprivileged, the court of appeals remanded the case for findings on four issues: Did the contents of the file constitute legal advice? Who prepared the work papers? Who controlled the file? Were the contents of the file disclosed to any third parties? The case was resolved by agreement on remand, so there is no subsequent opinion.

c. In *United States v. Hankins*, 631 F.2d 360 (5th Cir. 1980), the Fifth Circuit reversed criminal and civil contempt citations against an attorney who refused to answer questions concerning his review of the taxpayer's books and records in connection with an IRS criminal investigation of the taxpayer. The nature of the service being rendered -- to identify and quantify the extent of the client's potential exposure during the adjudicative or administrative phase of a tax controversy -- is privileged.

B. Code Section 7525.

1. Protection of Certain Communications. Section 7525(a)(1) extends the same common law protection of confidentiality to a communication between a taxpayer and any "federally authorized tax practitioner" that would have been privileged if it were a communication between a taxpayer and an attorney.

2. **Matters Covered.** The new privilege may be asserted only in:

   a. Non-criminal tax matters before the Internal Revenue Service; and

   b. Any non-criminal tax proceeding in federal court brought by or against the United States.

3. **Definitions.**

   a. **Federally Authorized Tax Practitioner.** The term "federally authorized tax practitioner" means any individual who is authorized to practice before the IRS if such practice is subject to federal regulation under 31 U.S.C. § 330. In other words, the phrase includes CPAs, enrolled agents, and enrolled actuaries.

   b. **Tax Advice.** The term "tax advice" means any advice given within the scope of the individual's authority to practice before the IRS. In other words, it includes tax advice and tax representation.

   c. **Exception for Tax Shelters.** The privilege does not apply to written communications between tax practitioners and directors, shareholders, officers, employees, agents, or representatives of a corporation in connection with the promotion of the direct or indirect participation in any corporate tax shelter as defined in Section 6662(d)(2)(C)(iii).

   d. **Effective Date.** The privilege may be asserted only as to communications made on or after July 22, 1998.

4. **Obvious Limitations of Section 7525.**

   a. **Uncovered Return Preparers.** By its terms, new Section 7525 is applicable only to communications between a taxpayer and a "federally authorized tax practitioner." This phrase includes CPAs, enrolled agents, and enrolled actuaries. Other accountants, bookkeepers, and possibly agents of otherwise qualified federally authorized tax practitioners do not appear to be included.

   b. **State, Local & Foreign Tax Matters.** The phrase "tax advice" is defined with reference to practice before the Internal Revenue Service or in a proceeding before a federal court.

      (i) **Query:** Are state and foreign tax matters automatically excluded by this definition?

      (ii) The new provisions apparently do not cover state court foreclosure actions where one issue might be the priority of the federal tax lien.

c. **Scope.** The extension of privilege to "any non-criminal tax proceeding in Federal Court brought by or against the United States" in Section 7525(a)(2)(B) was inserted by the Senate (or the conference committee) and was designed to be broader than the House version, which had only covered tax litigation.

(i) **Non-Criminal.** The statute is specifically inapplicable in criminal proceedings before the Internal Revenue Service and in criminal proceedings in a Federal Court. NOTE THAT TODAY'S PRIVILEGED COMMUNICATION LOSES ITS SECTION 7525 PRIVILEGE BY THE IRS COMMENCING A CRIMINAL INVESTIGATION TOMORROW.

(ii) **Bankruptcy Covered?** Bankruptcy is not a non-criminal federal court matter "by or against the United States" until an adversary proceeding is filed.

(iii) **All Bankruptcy Covered?** Does the new provision cover all bankruptcy cases in which the United States is a party, or just cases in which a determination of tax liability is involved?

d. **Tax Shelters.** The statute carves out written communications between practitioners and representatives of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter.

(i) **Ambiguous At Best.** Although reference is made to Section 6662, the definition of tax shelter in that section is far from precise.

(ii) **Legal Advice Still Privileged as to Shelters.** The tax shelter exception originally was designed to remove privilege from attorneys who advised regarding tax shelters as well. In the conference committee bill, lawyers were carved out of the exception. Senate judiciary committee chair Orrin Hatch and House judiciary committee chair Henry Hyde pressured the conference committee to drop all references to the attorney-client privilege in the corporate tax shelter exception.

e. **Tax Return Preparation Not Covered.** The privilege for tax advice is the same as if the professional were an attorney. This means, among other things, that the privilege does not ordinarily attach to the preparation of tax returns or to other areas where a

communication would not be privileged even if made to an attorney.

5. **Tax Shelter Litigation.** The district court for the District of Columbia has also issued several important decisions in the tax shelter litigation involving KPMG. In *United States v. KPMG*, 237 F. Supp. 2d 35 (D. D.C. 2002), citing *Frederick*, the court determined that the Section 7525 privilege did not extend to KMPG opinion letters issued to its client because such letters were prepared in connection of preparing a tax return. In a subsequent decision, the court determined that some of the documents KPMG claimed to be protected by Section 7525 were in fact so protected. *United States v. KPMG*, 2003-2 USTC ¶50,691 (D. D.C. 2003). *See also United States v. BDO Seidman, LLP*, 225 F. Supp. 2d 918 (N.D. Il. 2002), *aff'd*, 337 F.3d 802 (7th Cir. 2003) (name of clients not privileged under Section 7525); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (accounting firm's advice not privileged because such accounting firm's communications with company were not delivered to facilitate communications between company and its attorney).

V. **THE *KOVEL* ACCOUNTANT: SOLUTION?** Because of the narrow limits of the new tax practitioner privilege, the attorney, not the taxpayer, should consider engaging the accountant in order to make certain that the accountant's work product will remain confidential. Moreover, if the tax case becomes a criminal matter or if non-IRS matters arise, the communications will not remain privileged unless the attorney has hired the accountant.

A. **The *Kovel* Case.** Communications made to an accountant who is assisting an attorney *in providing legal service* (not accounting service) to a client are within the attorney-client privilege. *United States v. Kovel*, 296 F.2d 918, 921 (2nd Cir. 1961); *United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972); *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002).

B. ***Kovel* Engagement Agreement.** A written engagement letter is essential. The letter should include:

1. **Control.** That the accountant is engaged by the attorney and working under the attorney's direction.

2. **Negate Pure Return Preparation.** That the work is for the purpose of rendering legal advice, not simply for the preparation of tax returns. For example, the accountant is assisting the attorney in determining whether delinquent federal income tax returns should be prepared and filed and what positions to take on them.

3. **Ownership.** That the work product of the accountant belongs to the attorney.

4. **Purpose.** That any communications to the accountant are made solely for the purposes of enabling the attorney to provide legal advice subject to the attorney-client privilege.

5. **Payment.** Provisions for payment to the accountant.

VI. **THE EFFECT OF ASSERTING THE PRIVILEGE ON THE BURDEN OF PROOF IN DISPUTED CASES.** In certain cases, the taxpayer can shift the burden of proof in transfer tax cases from the taxpayer to the government in the Tax Court. *See* I.R.C. § 7491. Section 7491 provides:

> (a) burden shifts where taxpayer produces credible evidence.–
>
> (1) GENERAL RULE.–If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.
>
> (2) limitations.–
>
> (A) the taxpayer has complied with the requirements under this title to substantiate any item;
>
> (B) the taxpayer ***has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews***; and
>
> (C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).
>
> Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent's death and before the applicable date (as defined in section 645(b)(2)).
>
> (3) COORDINATION.– Paragraph (1) shall not apply to any issue if any other provisions of this title provides for a specific burden of proof with respect to such issue.

I.R.C. § 7491 (emphasis added).

To shift the burden of proof, the taxpayer must have complied with the substantiation requirements and kept the required records. In addition, the taxpayer must have cooperated with "reasonable requests" by the IRS for "witnesses, information, documents, meetings, and interviews" and must present "credible evidence" in court on the factual issue before the burden shifts. If the taxpayer asserts the privilege in response to an IRS request for information, the IRS will obviously argue that the taxpayer has not cooperated fully enough in providing information and should not be able to shift the

burden of proof. The question yet to be addressed by the courts is whether a request that seeks privileged information can ever be "reasonable."

However, the Tax Court recently determined that a taxpayer did not fail to reasonably cooperate simply because it filed a motion to quash a summons that the IRS had issued to obtain certain documents during discovery. The court found that the taxpayer "had a good faith belief that some of the documents respondent sought were irrelevant, sealed, or contained sensitive . . . business information and filed a motion to quash the summons to protect its rights. Once the court denied the estate's motion to quash, the estate provided the documents respondent requested. Respondent has not argued that respondent's investigation was impaired by any lack of documentation." *Estate of Kohler v. Comm'r.*, T.C. Memo 2006-152 (July 25, 2006).

VII. PROTECTING PROVISIONS IN LIGHT OF I.R.C. § 6662 ACCURACY-RELATED PENALTIES. Privileges are important but, depending upon the case and how helpful or damaging the content of the communications may be, they may not be as important as defeating penalties through a "reliance upon tax profession" argument under the Section 6664 "reasonable cause" defense. Think very hard about if, when, and how you waive the privilege – especially as to the tax opinion which provides the agent with a road map.

At least in theory, a taxpayer ought to be able to get an answer to a debatable question without threat of penalties. The primary threat arises from the § 6662 "Accuracy-Related Penalty" which draws a distinction between non-shelter issues and shelter issues (*i.e.,* transactions with a significant purpose of tax avoidance). No § 6662 penalty applies to non-shelter issues as long as the taxpayer meets either prong of a disjunctive test: substantial authority or adequate disclosure. In comparison, no § 6662 penalty should apply to a shelter transaction if the taxpayer meets both elements of a conjunctive test: substantial authority *and* reasonable belief that the position taken will "more likely than not" prevail. For transactions entered into on or after January 1, 2003, the disclosure regulations seek to inject "adequate disclosure" as a third conjunctive element for shelters, but the validity of engrafting that additional requirement onto the statutory scheme Congress so carefully structured is debatable. Proposed Regulation § 1.6664-4(c)(1)(i) and (c)(2).

The "reasonable cause"/"good faith" provisions of § 6664 trump all of § 6662 penalties – as they should. In many quarters, the Service is attempting to write the most common form of "reasonable cause" – reliance upon knowledgeable persons – out of the statute and out of the business world of ordinary care.

A. Privilege versus Penalty. Ironically, the price of asserting the privilege in particular cases may be the loss of other rights that would otherwise be available to the taxpayer or to the tax preparer. For instance, claiming the privilege may prevent taxpayers from showing that they have had substantial authority for a return position to avoid an accuracy related penalty, or prevent tax preparers from protecting themselves from tax preparer penalties.

Specifically, I.R.C. § 6662(a) imposes an accuracy related penalty in an amount equal to 20% of the portion of any underpayment to which the section applies. The section applies to, among other items, the portion of an underpayment attributable to negligence or disregard of rules or regulations. I.R.C. § 6662(b)(1). Negligence has been defined as the lack of due care or failure to do what a reasonable and ordinary prudent person would do under the circumstances. *Neely v. Comm'r*, 85 T.C. 934, 947 (1985). Negligence includes the failure to make a reasonable attempt to comply with the Internal Revenue Code. I.R.C. § 6662(c).

One defense to an underpayment penalty is that the underpayment of tax was made in good faith and due to reasonable cause. Whether an underpayment of tax is made in good faith and due to reasonable cause will depend upon the facts and circumstances of each case. Treas. Reg. 1.6664 4(b). However, reliance on the advice of professional accountants or attorneys in preparing tax returns constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. *Id. See, e.g., Schauerhamer v. Comm'r*, 73 T.C.M. (CCH) 2855 (1997). In order to demonstrate reasonable reliance, the taxpayer may need to disclose what might otherwise be privileged information. Accordingly, each case should be looked at on its own merits to determine whether or not the client will benefit by disclosure.

As a general matter, if the transaction is not a tax shelter under section 6662, the taxpayer may avoid understatement penalties if it has substantial authority for its position. It is not necessary to have a legal opinion per se as long as it is possible to demonstrate the existence of substantial authority.

If it is a tax shelter, then the taxpayer must have reasonable cause for its position and have taken such position in good faith. I.R.C. § 6662(d)(2)(B); I.R.C. § 6664(c). Until recently, most believed that a more likely than not opinion from a law firm would satisfy this standard. Care needs to be taken on the accuracy of the factual representations and the structure of the opinion to ensure that reliance on such opinion would constitute reasonable cause. See Circular 230; Treas. Reg. § 1.6664-4. Also, while so called "short form" opinions may provide more comfort with respect to privilege concerns, they also may provide less comfort with respect to penalty concerns.

Reasonable cause may also exist, even though an outside legal opinion was not obtained, based on an analysis of the legal issues by employees of a company. To the extent in-house company lawyers review the tax issues, communications with such lawyers may also be privileged but it is important to demonstrate that such company lawyers, among other requirements, were acting in their legal and not business capacities. *See generally Upjohn v. United States*, 449 U.S. 383 (1981).

If a taxpayer relies on the opinion of counsel to avoid penalties, the taxpayer must produce such opinion and thereby waive its privilege, which could be interpreted as a broad subject matter waiver. *In re G-I Holdings, supra*. If the opinion was

procured only to avoid penalties, there is the further risk that such opinion did not enjoy a privileged status in the first instance.

The Section 7525 privilege does not apply to tax shelters, which would probably include listed transactions. Also, the IRS's current practice is to ask for audit work papers only if the transaction is a listed transaction. Ann. 2002-63. In terms of avoiding penalties, the taxpayer must have disclosed the listed transaction on its tax return pursuant to the reportable transaction regulations in order to rely upon the reasonable cause defense. Treas. Reg. § 1.6664-4(d). Finally, producing an opinion to avoid penalties will waive the privilege. *In re G-I Holdings, surpa*. It is also possible that obtaining an opinion solely to avoid penalties will also waive the privilege.

In *Johnston v. Comm'r*, 119 T.C. 27 (2002), the Tax Court held that the taxpayer impliedly waived the attorney client privilege by raising a claim that could be effectively disproven only through discovery of privileged information. The Johnstons rebutted fraud penalties with the defense of reasonable reliance on qualified experts in preparing income tax returns. Relying on *Hearn v. Rhay*, 68 F.R.D. 574, 581 (E.D. Wash. 1975), the *Johnston* court acknowledged four approaches[2] to implied waiver analysis, and focused on the three factors of the *Hearn* test to determine whether the privilege had been impliedly waived: (1) assertion of the privilege must be the result of an affirmative act – in other words, the privilege is implicated in the context of an affirmative defense; (2) as a result, the privileged information has been put at issue by the person asserting the privilege by making it relevant to the case; and (3) upholding the privilege would deny the opposing party access to information vital to his defense (sometimes termed a "sword and shield" approach). For a discussion of the "sword and shield" analysis, *see Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992).

B. **I.R.C. § 6662 Accuracy-Related Penalty.** Section 6662 consolidates several accuracy-related penalties formerly found in I.R.C. §§ 6659, 6660, and 6661. Generally, § 6662(a) imposes a 20% penalty on the portion of an underpayment attributable to any of the following types of conduct:

1. Negligence or disregard of rules and regulations;

a. **Negligence.** Any failure to make a reasonable attempt to comply with the Internal Revenue Code § 6662(c). Negligence has also been defined by the Tax Court as a lack of due care or failure to do what a reasonable person would do under the same circumstances.

[2] The other three approaches were: (1) the automatic waiver rule – whereby a party automatically waives the privilege by asserting a claim or defense to which otherwise privileged material is relevant; (2) a balancing test – weighing the need for discovery against the underlying rationale for the privilege; and (3) a more protective waive theory whereby the privilege is waived only if the party directly injects an attorney communication into issue.

See Antonides v. Commissioner, 91 T.C. 686, 699 (1986), *aff'd,* 893 F.2d 656 (4th Cir. 1990).

b. **Disregard.** Includes any careless, reckless, or intentional disregard. I.R.C. § 6662(c).

2. Substantial understatement of income tax;

3. Substantial valuation misstatement (includes "basis"?);

4. Substantial overstatement of pension liabilities; or

5. Substantial estate or gift valuation understatement.

C. **Defenses Against Accuracy-Related Penalties Under § 6662.** The 20- to 40-percent penalty under § 6662 is eliminated if the taxpayer had substantial authority for the item in question or if there was adequate disclosure and a reasonable basis for the reporting position. *See* I.R.C. § 6662(d)(2)(B). Nirvana lies in § 6664(c) if there is "good faith" and "reasonable cause" in undertaking the transaction. Did the taxpayer proceed in "good faith" with "reasonable cause" for taking a position on the return, for failing to report an item of income, or for valuing an asset as reported on a return? If that cause was reasonable from the perspective of ordinary care, the penalties should be eliminated. Since the § 6664(c) relief is comprehensive, the focus in this outline will be on that exception to the penalty.

As explained above, § 6662 applies its 20-percent penalty for varying degrees and types of inaccurate reporting including negligence, disregard of rules and regulations, and substantial understatement of tax. Importantly, the penalties cannot be stacked. Thus, even if all three types of proscribed conduct apply to one understatement, the maximum penalty is still 20 percent (or 40 percent in the case of a gross valuation understatement). Treas. Reg. § 1.6662-2(c). Again, the common defense for abatement or elimination of the penalty is "reasonable cause." The determination of reasonable cause and good faith is made on a case-by-case basis, taking into account all the facts and circumstances. Treas. Reg. § 1.6664-4(b)(1). The penalty applies only if a return is filed. I.R.C. § 6664(b).

1. **"You Never Really Told Me Why You Think I Was Negligent."**

a. Under I.R.C. § 7491(c), the IRS bears the burden of production of the evidence in any court proceeding (generally after July 22, 1998) with respect to the "liability of any individual for any penalty . . ."

b. Under I.R.C. § 7522(a), IRS notices "shall describe the basis for . . . additions to the tax [*i.e.*, penalties]." The failure of a deficiency notice (and maybe an FPAA) to meet this standard may

result in the overall burden of proof being shifted to the Service. *Shea v. Commissioner,* 112 T.C. 183, 195-196 (1999).

c. *Fisher v. Commissioner*, 45 F.3d 396 (10th Cir. 1995). Commissioner did not provide adequate explanation regarding refusal to waive penalties under old § 6661(c). "It is an elementary principle of administrative law that an administrative agency must provide reasons for its decisions." *Fisher*, 45 F.3d at 397 citing *SEC v. Chenery Corp.*, 318 U.S. 63 S.Ct. 454, 462 (1943). To emphasize this point the Court also stated that, "[t]he IRS cannot make taxpayers haul it into Tax Court to ascertain that it has ruled on a lawful request or to discover what the rationale for its decision is." *Id.*

d. *Osteen v. Commissioner,* 62 F.3d 356 (11th Cir. 1995). Penalty reversed because of multitude of conflicting standards for requisite profit motive in hobby loss cases, the taxpayer satisfied the more liberal standard, and the Tax Court failed to enunciate a clear standard for imposition of the penalty.

2. "<u>I Followed Nattie Bumpo Through the Wilderness</u>."

a. *U.S. v. Boyle*, 469 U.S. 241, 251 (1985) contains the clearest language on the ability of a citizen to demonstrate ordinary care through reliance upon a tax practitioner or other expert. The leading case on shifting responsibility away from the taxpayer to a tax advisor. Contrary to the conventional reading of *Boyle* by the IRS to the effect that under many circumstances the taxpayer cannot rely upon the professional advisor, the Supreme Court stated:

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. [emphasis in the original].

b. *Streber v. Commissioner*, 138 F.3d 216, 222 (5th Cir. 1998). Two young women, ages 20 and 25, received $1 million each from their father due to the collection of an installment note. They went to a tax attorney to determine how the money should be reported.

Relying on the attorney's advice, they reported the money as a gift from their father. The Fifth Circuit reversed the Tax Court and held that they should not be subject to negligence penalties. The Fifth Circuit made several statements which should help future taxpayers.

(i) If ignorance is bliss, 'tis folly to be wise. Taxpayer's subjective characteristics can be considered in evaluating the reliance on a tax professional. *Streber*, 138 F.3d at 219 ("Given their level of understanding in these matters, the appellants took the appropriate steps to secure legal advice from attorney Edwin Hunter to ensure that their tax returns for the upcoming year complied with the law"). In "penalty audits" in connection with one tax shelter, the IRS initially took the position that if the taxpayer was unsophisticated in the type of transaction undertaken, then the transaction must have been undertaken solely for tax purposes. Later the IRS shifted and took the position that the less sophisticated the taxpayer, the greater the likelihood that a penalty would not be asserted.

(ii) The taxpayer does not have to challenge the professional's opinion. *Streber*, 138 F.3d at 219 ("Due care does not require young, unsophisticated individuals to independently examine their tax liabilities after taking the reasonably prudent step of securing advice from a tax attorney").

(iii) A taxpayer may rely on any one of several bona fide alternatives in determining how to report a transaction. *Streber*, 138 F.3d at 221. *See also, Reser v. Commissioner*, 112 F.3d 1258, 1271-1272 (5th Cir. 1997).

c. *Betson v. Commissioner*, 802 F.2d 365 (9th Cir. 1986). Court reversed as to negligence penalty as taxpayer had reasonably relied on accountant's advice regarding ordinary and necessary business deductions.

d. *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990). Citing *Boyle*, the Fifth Circuit reversed the Tax Court for failure to hold that IRS had abused its discretion in applying penalties against investors in an energy tax shelter where the unsophisticated taxpayer relied upon advice of accountants and attorney.

e. *Wright v. Commissioner*, T.C. Memo 1994-288. Negligence penalty avoided due to reasonable reliance on certified financial planner despite investment in tax shelter with no business purpose. *See also, Daoust v. Commissioner*, T.C. Memo 1994-203; *Buehler*

Lumber Co., Inc. v. United States, 94-2 U.S.T.C. ¶ 50,488 (D.C. Pa. 1994).

f. *Bradley v. Commissioner*, T.C. Memo 1995-169. Mistake by accountant nonetheless absolves taxpayers of negligence penalty.

g. *Bellour v. Commissioner*, T.C. Memo 1995-284. Reasonable reliance on CPA and complexity of issues (*i.e.,* § 1244 stock) prevent application of penalty. *See also, State Police Assn. of Massachusetts v. Commissioner*, T.C. Memo 1996-407, *aff'd on other issues*, 97-2 U.S.T.C. ¶ 50,627 (1st Cir. 1997) (exempt status); *Froehlich v. Commissioner*, T.C. Memo 1996-487 (guarantees); *Goudas v. Commissioner*, T.C. Memo 1996-555 (partnership gain).

h. But *see Catalono v. C.I.R.*, 240 F.3d 842 (9th Cir. 2001). Taxpayer assertion that he relied on advice of his accountant did not establish defense to imposition of accuracy-related penalties, where taxpayer provided no evidence of the professional qualifications of accountant or purported expertise, or evidence suggesting the nature of advice.

3. "<u>But My Reliance on My Tax Advisor Was Exceedingly Reasonable</u>."

a. *Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 211 (3rd Cir. 2002). Taxpayer's reliance on advice from an insurance agent who stood to benefit financially from the taxpayer's participation in a Voluntary Employees Beneficiary Program, rather than a competent, independent tax professional, was no defense to accuracy-related negligence penalties (*i.e.,* the insurance agent suffered from a conflict of interest). The IRS takes the position that this case supports its position that an opinion from a promoter, no matter how reputable, may not provide penalty protection. It is difficult to see how reliance on advice from an insurance agent selling policies equates to reliance on a tax opinion from an established, well-respected tax firm. Judge Laro acknowledged in this decision that the penalty was sustained (at least in part) because reliance was on an insurance agent rather than an independent tax professional, stating that any prudent taxpayer would have asked a tax professional to opine on the tax consequences of the transaction.

b. "Reliance on professional advice, standing alone, is not an absolute defense to negligence, but rather a factor to be considered. First, it must be established that the reliance was reasonable." *Freytag v. Commissioner*, 89 T.C. 849, 888 (1987), *aff'd*, 904 F.2d 1011 (5th Cir.1990). The IRS relies upon this decision, as well as other

decisions, for the proposition that no penalty protection is afforded by an opinion if the tax results of the transaction are "too good to be true." In affirming the *Neonatology Associates* opinion, Judge Greenberg of the Third Circuit stated that: "When, as here, a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril." But given the complexity of the Code and the transactions that have passed muster in the courts or even with the Internal Revenue Service (*see, e.g.,* the Viacom "sale" of a subsidiary without the payment of any tax), how can lay persons judge what is "too good to be true" under the Code?

c. Use of appraisal valuing property 91 times more than purchase price two years earlier found to be unreasonable. *Von Zelff v. United States,* 96-2 U.S.T.C. ¶ 50,626 (7th Cir. 1996).

d. Reliance on advice of corporate president who had been indicted on more than 40 counts of financial crimes not reasonable. Also, not smart.

e. In *Addington v. Commissioner*, 205 F.3d 54 (2nd Cir. 2000), the taxpayer relied upon a lawyer who drafted the offering materials and opined on the transaction. The Second Circuit held that it was unreasonable to rely upon that adviser because the adviser clearly had a conflict of interest.

f. In *Nicole Rose Corp. v. Commissioner*, 117 T.C. 328 (2001, *aff'd per curium*) 320 F.3d 282 (2nd Cir. 2002), Tax Court Judge Swifts specifically stated that the participation of highly-paid professionals would not prevent penalties where the taxpayer participated in an obvious scheme where there was no business purpose and no economic substance.

4. "<u>Reasonable Men and Women Can Disagree on Unresolved Issues Without Name Calling</u>."

a. If the taxpayer underpays his tax liability based upon a mistake of law or fact made in good faith and on reasonable grounds, the negligence penalty will not be applied. *Geary v. Commissioner*, 235 F.3d 1207 (9th Cir. 2000).

b. Genuine, albeit mistaken, belief is consistent with good faith and should at least negate "willful" penalties*, U.S. v. Cheek*, 882 F.2d 1263 (7th Cir. 1989); *U.S. v. Dahlstrom*, 713 F.2d 1423 (9th Cir. 1983); *U.S. v. Garber*, 607 F.2d 92 (5th Cir. 1979); *Scott v. Commissioner*, 61 T.C. 659 (1974).

c. In *Larotonda v. Commissioner*, 89 T.C. 287 (1987), the taxpayer avoided penalties even though the taxpayer failed to report as income a distribution from a Keogh fund. The Court found the taxpayer's position that an involuntary assignment was not a taxable distribution to be erroneous but reasonable.

5. "<u>It May Be a Sham, But It's a Reasonable Sham</u>."

a. In the economic sham case most often relied upon by the IRS, *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the Tax Court found for the Service that the transaction lacked economic substance, but the Service apparently did not propose any penalties. The economic substance determination by the Tax Court was affirmed by the Third Circuit, but with one of the three judges dissenting. *See ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Cir. 1998). What may be deemed a sham by one judge may be viewed as a reliance upon the clear language of the Code by another judge.

b. In *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), the Service challenged the loss recognition reported by banks when they exchange portfolios of mortgages that were large enough to have very similar risk factors and equal in value. The Court found that the banks properly recognized their losses because the exchange properties did embody legally different entitlements. One might have described this as a sham in substance, but not the Supreme Court.

c. Reasonable reliance on advice of attorney, tax accountant, and vice-president of finance of taxpayer's employer was found to be reasonable cause, even though investment was held to be a sham. *Durrett v. Commissioner*, 71 F.3d 515 (5th Cir. 1996). *See also, Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995) (reasonable cause where taxpayer relied on opinion of tax expert that deduction for loss was a "good faith, supportable position").

6. "<u>Hey, I Relied Upon You, IRS</u>!" If a taxpayer can demonstrate that during prior audits and inquiries a particular reporting position was known to the IRS and the IRS failed to act on it, this is tantamount to giving the taxpayer erroneous advice. The IRS may not be bound by this advice insofar as making adjustments, but it should relieve the taxpayer of any penalties based on a reasonable belief. *Gerli & Co. v. Commissioner*, 668 F.2d 691 (2nd Cir. 1982); *Hugh Smith, Inc. v. Commissioner*, 8 T.C. 660 (1947); *Sheehy v. Commissioner*, T.C. Memo 1996-334; *Haynes v. Commissioner*, T.C. Memo 1990-135; *Brown v. Commissioner*, T.C. Memo 1989-89. Significant concessions by the IRS may help avoid penalty. *Culmo v. Commissioner*, T.C. Memo 1991-441.

7. **"<u>You Confused Me</u>."** In *Lemery v. Commissioner*, 54 T.C. 480 (1970), the Tax Court held that a taxpayer was subject to tax on certain foreign income. However, the Court refused to apply a substantial understatement penalty finding that the IRS's guidance on the issue, "created such confusion and uncertainty on the question of this petitioner's residence that we cannot say his actions were due to 'negligence or intentional disregard of rules and regulations.'"

8. **"<u>My Software Ate My Homework</u>."** *Reynolds v. Commissioner*, 296 F.3d 607 (7th Cir. 2002). Taxpayers must demonstrate that reliance on commercial software caused them to make substantive errors in their tax preparation in order to avoid accuracy-related penalties. However, reliance may not be enough. In *Reynolds*, the taxpayer was an attorney, a CPA, and a retired IRS Agent. Due to his experience in tax, the Court held that the accuracy-related penalties were warranted.

9. **"<u>If My Authority is Substantial, Surely It Constitutes Reasonable Cause</u>."** Substantial authority is an absolute defense to non-corporate tax shelter transactions under § 6662 and may constitute reasonable cause for shelter transactions.

a. In order to satisfy the substantial authority standard the taxpayer bears the burden of showing that the weight of authorities is substantial in relation to those supporting a contrary position. *Antonides v. Commissioner*, 91 T.C. 686, 702 (1988).

b. Importantly, more than one position may have substantial authority. Treas. Reg. § 1.6661-3(b). "Thus, that a taxpayer's treatment of an item is later judged to be incorrect does not mandate the imposition of a penalty for understatement." *Dunnegan v. Commissioner*, 96-1 USTC ¶50, 234 (3rd Cir. 1996).

c. In *Dunnegan*, the Third Circuit upheld the Tax Court's determination that the taxpayer was liable for additional taxes due to an erroneous position taken under § 1034. On appeal, the taxpayer argued that he should not be liable for substantial understatement penalties because his position was reasonable given that the issue involved was novel and there was a paucity of information available. In reversing the Tax Court on the application of penalties, the Third Circuit held that the Tax Court erred when it applied the penalty because (i) the taxpayer had made a reasoned (even though erroneous) construction of the statute, and (ii) although the taxpayer did not have any other authority, neither did the government.

d. All relevant authorities must be taken into account. Under Treas. Reg. § 1.6662-4(d)(3)(iii) they include:

(i) The Code and other statutory provisions;

(ii) Proposed, temporary and final regulations;

(iii) Court cases;

(iv) Tax treaties, related regulations, and Treasury official explanation of treaties;

(v) Revenue rulings and procedures;

(vi) Private Letter Rulings;

(vii) Technical Advice memoranda;

(viii) Actions on Decisions;

(ix) General Counsel Memoranda issued after March 12, 1981;

(x) Information or press releases, notices, and other similar documents published in the I.R.B.; and

(xi) Committee Reports and Blue Books; (*See*, H.Rep. No. 247, 101st Cong. 1st §§ 280-281).

Just as important, the IRS does *not* consider "substantial authority" to include: treatises; legal periodicals; and legal opinions rendered by tax professionals which is of particular importance in tax shelter cases, since many taxpayers relied on the opinion of accounting firms in pursuance of a transaction. These sources may, however, constitute reasonable cause.

e. Substantial FACTUAL Authority. *Osteen v. Commissioner*, 62 F.3d 356 (11th Cir. 1995). Eleventh Circuit affirmed Tax Court holding of no profit intent under § 183 but reversed as to substantial understatement penalties under § 6661. The Court found that the taxpayers had substantial authority. Importantly, the Eleventh Circuit found there to be substantial authority if the factual evidence tends to support a previously stated standard. In such a situation, "there is substantial authority from a factual standpoint for the taxpayer's position." *Osteen*, 62 F.3d at 359.

10. **Flashing the IRS.** Adequate disclosure of an item's tax treatment will avoid the substantial understatement penalty for non-shelter transactions and should demonstrate good faith for shelter transactions. Generally, disclosures will be effective if complete, and item-specific of a position with a "Reasonable Basis." Note that the "Reasonable Basis" standard replaced the former "Not Frivolous" standard in the 1993 Tax Act. The disclosure must be "full and substantive," and "clearly identified as being

made to avoid imposition of the accuracy-related penalty." Notice 90-20, 1990-10 I.R.B. 17 (Mar. 5, 1990). *See also* Rev. Proc. 92-23, updating Rev. Proc. 91-19, 1991-CB 523. Importantly, disclosure will not cure a negligence penalty.

11. **Waiver: The Pre-Cursor to Section 6664.** The IRS was directed to waive penalties under old § 6661 if the taxpayer's position was based on reasonable cause and the taxpayer acted in good faith. Case law indicates that it is possible to challenge the IRS with precedent citing the proposition that failure to waive penalties is an "abuse of discretion."

a. *Shelton v. Commissioner*, 105 T.C. 114 (1995) (abuse of discretion not to waive substantial understatement penalty where taxpayer reasonably relied on CPA's advice); *See also, Estate of Owen v. Commissioner*, 104 T.C. 498 (1995) (applying abuse of discretion standard under pre-1990 law whether "respondent exercised discretion arbitrarily, capriciously, or without sound basis in fact").

b. *Norgaard v. Commissioner*, 939 F.2d 874 (9th Cir. 1991). Court held IRS abused its discretion in failing to waive penalties for understatement of income even though taxpayer had failed to substantiate wagering losses.

c. *Vorsheck v. Commissioner*, 933 F.2d 757 (9th Cir. 1991). Ninth Circuit held that Tax Court was unreasonable in not waiving negligence and overstatement penalties. Ninth Circuit found that the taxpayers were acting as ordinary prudent persons in the circumstances, and they were entitled to a good faith reliance on their tax adviser.

d. *Lyon v. Commissioner*, T.C. Memo. 1991-84. Tax Court held IRS abused discretion in refusing to waive substantial understatement penalty even though taxpayer understated income by $250,000. Court found that taxpayers made good faith effort to properly report income.

12. **Defenses to a Substantial Valuation Overstatement Penalty.**

a. Good faith, reliance on reasonable cause in the form of a qualified appraisal.

b. Prove no net tax distortion.

c. Establish good faith, reasonable cause by reliance on "qualified appraisal by qualified appraiser," and "good faith investigation of the value of contributed property." *DHL Corp. and Subs. v. Commissioner*, 285 F.3d 1210 (9th Cir. 2002). Taxpayer acted in good faith in requesting and relying on financial advisor's comfort

letter as to taxpayer's valuation of a trademark, precluding valuation misstatement penalty.

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