AMERICAN BAR ASSOCIATION

Section of Real Property, Trust & Estate Law
19th Annual Spring Symposia

Washington, D.C.
May 1-2, 2008

Panel

"Grandma Died with a Cook Islands Trust: Now What?"

Curing Non-Compliance: Practical Factors to Consider

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I. Introduction

A. Root of the Problem: Tax Law Complexity

The rules that govern a taxpayer's obligation to file a tax return and pay taxes in the United States – principally the U.S. Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations and administrative practices and procedures thereunder[1]– are exceedingly complex. For the individual income tax return, the most widely filed return,[2] taxpayers and their representatives, including commercial tax preparation services, tax accountants and lawyers, annually spend enormous amounts of time collecting and compiling relevant financial information and determining how best to complete the return.[3] In addition, taxpayers and their representatives must determine which of a multitude of supporting schedules and tax information returns should be filed along with, or in addition to, the tax return.

There are a number of commercially available computer software programs to assist U.S. taxpayers with their tax returns.[4] Owing to the complexity of the tax laws, even professional tax preparers use computer programs (generally more sophisticated than those sold at retail) to assist taxpayers. However, even that doesn't always ensure that a tax return is completed correctly or filed timely. This is particularly true for U.S. taxpayers with income or assets outside the United States and foreign persons with U.S. income, assets or other connections. Even in an increasingly "global" economy, it probably is the case that many, if not most, professional tax

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[1] Unless otherwise noted, all section references herein are to the Code and the regulations thereunder.

[2] For 2005, the most recent year for which complete information is available, U.S. taxpayers filed 134,372,678 individual income tax returns on Form 1040 (including Forms 1040A and 1040EZ and electronic returns). IRS Statistics of Income Bulletin, available at www.irs.gov/taxstats.

[3] The Government is obliged to furnish an estimate of the time required to prepare tax and information returns. The instructions to the 2007 Form 1040, the return filed by most (the instructions say 69%) U.S. citizens and residents, estimate that an average of 33.5 hours is normally required to collect, compile and analyze the information necessary to complete and file the form (at an average cost of $267!). The instructions to the 2007 Form 1040NR, the basic income tax return filed by nonresident alien individuals and foreign trusts, estimate an average time of 29.5 hours (at an average cost of $204!).

[4] TurboTax,© produced by Intuit, Inc., and TaxCut,© produced by H&R Block,® are probably the leading brands available commercially, each promising the "maximum" refund available. In addition, the instructions to Form 1040 indicate that, if an individual has 2007 adjusted gross income of $54,000 or less, he is eligible to use Free File, a service offered by the Internal Revenue Service ("IRS") in partnership with the Free File Alliance, a group of tax preparation software companies.

advisors do not frequently see – and, therefore, are not thoroughly familiar with – many of the complex issues that can arise for U.S. taxpayers with foreign income and assets and foreign persons with U.S. income, assets and other connections. This is certainly true of the more exotic and arcane areas of, *e.g.*, foreign trusts, "controlled foreign corporations" and "passive foreign investment companies."

B. Dealing with "Unforeseen Circumstances"

As if the complexity of the Code's foreign tax provisions were not enough, taxpayers and their tax advisers are often faced with wholly unforeseen – and oftentimes "murky" – circumstances. These might range from the relatively innocuous receipt of a large foreign gift or bequest from a remote foreign relative to the more complex and troublesome inheritance of substantial foreign assets – previously unknown and of questionable origin – from a U.S. parent.

Dealing with such unforeseen circumstances can raise a host of questions and potentially complex tax issues for a U.S. tax practitioner. He generally will know who his client is (although even this can "shift" as he familiarizes himself with the circumstances). However, he must determine whether, and to what extent, his client is a potential taxpayer in connection with the circumstances. This will, of course, vary with the circumstances. Were the circumstances and the attendant tax issues completely unforeseen, or did the client have some knowledge of the circumstances? What was the level of the client's knowledge, and when and how did he acquire it? In particular, did the client have some responsibility in creating the circumstances giving rise to the potential tax issues?

As with any client matter, the U.S. practitioner has to gather the facts relevant to the determination and resolution of his client's potential tax issues, but he may have to go beyond the usual scope of such information-gathering to understand *all* of the surrounding circumstances, which may include facts remote in time and place from his client but that may have an indirect and substantial effect on the client's ultimate U.S. tax liability. How and when did the client's "unforeseen circumstances" come to exist? In particular, who put them in motion and with what? Frequently, events of which a client had no previous knowledge and for which he had no responsibility will dictate or, at least, influence the strategy that a U.S. practitioner employs to protect his client from unfortunate U.S. tax consequences.

In determining how best to handle his client's situation, a U.S. tax practitioner has to be aware of a multitude of legal and ethical standards. What are client's obligations as a U.S. taxpayer to file a tax return? What are client's potential tax liabilities? What are the limitations periods applicable to the client's circumstances and issues? All of these factors may be affected by the client's knowledge and potential responsibility for the circumstances. A U.S. tax practitioner must also be aware of his own legal and ethical issues relating to his client's unforeseen circumstances and the issues arising therefrom. Does he have any potential liabilities?

Ultimately, a U.S. tax practitioner must devise a strategy to deal with, and hopefully resolve, his client's issues in the most tax-efficient manner possible (which might not always result in the client paying the lowest taxes possible). This might range from recommending that the client take relatively simple compliance steps to correct any prior tax "mis-steps." Or the practitioner might recommend that the client undertake "voluntary disclosure," which might be approached in different ways depending upon the potential seriousness of the client's tax issues and potential liability.

The balance of this paper will examine some of the principal legal and ethical considerations of which a U.S. tax practitioner must be aware in handling tax issues generally, and particularly in handling certain complex and frequently "unforeseen" cross-border U.S. tax issues for individual clients. Because of the nature of some of the considerations, it is fair to say that this undertaking frequently is more of an "art" than a "science."

II. Taxpayer Obligations and Liability

A. Taxation and Reporting of Income

The United States generally imposes an income tax filing requirement on all U.S. persons and certain foreign persons, including foreign entities with certain U.S. nexus. For all U.S. tax purposes, the Code defines a "U.S. person" to mean a citizen or resident of the United States, a domestic partnership, a domestic corporation, any estate other than a foreign estate and domestic trusts.[5] Unlike many countries in the world, the United States levies its income tax on its citizens and residents on a worldwide basis, regardless of where they live.[6] Therefore, a U.S. citizen residing overseas remains liable for U.S. income tax and reporting at all times.[7]

For U.S. income tax purposes, an individual is a "resident" of the United States if he either is a "lawful permanent resident" (*i.e.*, a U.S. "green card" holder) or satisfies a "substantial presence test."[8] A trust is "domestic" only if (i) a court within the United States is able to exercise "primary supervision" over the administration of the trust, and (ii) one or more U.S. persons has the authority to control *all* "substantial decisions" of the trust.[9] A trust which satisfies both requirements is generally treated as a U.S. person for U.S. federal income tax purposes; a trust not meeting both tests is treated as a foreign person.[10] A corporation or

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5 § 7701(a)(30).

6 Treas. Reg. § 1.1-1(b). Many countries tax their "residents" on worldwide income; indeed, "residence" is likely the international standard for taxing worldwide income. However, only a handful of countries tax their citizens and nationals on worldwide income.

7 U.S. citizens also are taxable on their worldwide property transfers under the gift, estate and generation-skipping transfer tax regimes. However, such transfer taxes generally are beyond the scope of this paper, which will focus principally on income tax issues.

8 Treas. Reg. § 1.1-1(a)(1). The "substantial presence test" measures the weighted average of days an alien is physically present in the United States over a three calendar year period. Specifically, if an individual is present in the United States for at least 31 days in the current year and the weighted average for the three year period totals 183 days or more, he generally will be treated as a U.S. resident as of the first day in the current year he is physically present in the United States. § 7701(b)(2)(A)(iii); Treas. Reg. § 301.7701(b)-4(a). The formula counts days present in the current year at full value, days present in the immediately preceding year at 1/3 value, and days present in the second preceding year at 1/6 value.

9 § 7701(a)(30)(E).

10 § 7701(a)(31).

partnership is generally treated as a U.S. person if it is created or organized in the United States or under the laws of the United States or any State thereof.[11]

1. U.S. Persons

Section 6012 contains the requirements for when an individual or entity is required to file a U.S. federal income tax return. An income tax return is generally required to be filed annually following the close of a taxpayer's "taxable year." The taxable year of individuals and trusts generally is the calendar year.[12] Corporations and other business entities generally can use a "fiscal year" other than the calendar year.[13] U.S. individuals generally file their returns on Form 1040; U.S. corporations on Form 1120; U.S. partnerships on Form 1065; and domestic trusts on Form 1041.

Further, U.S. persons generally are required to provide information regarding their interests in or transactions with certain foreign entities during the year, including controlled foreign corporations (Form 5471), passive foreign investment companies (Form 8621), foreign disregarded entities (Form 8858), controlled foreign partnerships (Form 8865), and certain foreign trusts (Form 3520). Moreover, U.S. persons are generally required to file a gift tax return on Form 709 to report any gifts they make during the year in excess of the annual exclusion amount.[14] They are also required to file a return on Form 3520 to report the receipt of certain large foreign gifts or bequests.[15]

In addition, each U.S. person having a financial interest in, or signature or other authority over, any foreign financial account with an aggregate value exceeding $10,000 at any time during the calendar year must annually report such account by filing Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts" ("FBAR"). The existence of such foreign accounts also must be identified on Schedule B of Form 1040 and, of course, the income from such accounts must be included on the U.S. person's income tax return.

2. Foreign Persons

In contrast to U.S. persons subject to worldwide taxation and reporting, foreign persons are subject to U.S. income tax only on certain "fixed or determinable annual or

[11] § 7701(a)(4).
[12] §§ 441(b), 644(a).
[13] § 641(b), (e). However, § 898(c) generally requires a controlled foreign corporation ("CFC") to have the same taxable year as its U.S. majority shareholder (*i.e.*, U.S. person who owns more than 50% of the voting power or value of the corporation). The CFC can make an election to start its taxable year one month earlier than the taxable year of its U.S. majority shareholder. § 898(c)(1)(B). A foreign corporation is treated as a CFC if it is owned, or considered as owned, more than 50% (by vote or value) by U.S. persons who each own at least 10% of the voting power of the foreign corporation. § 957(c).
[14] The annual exclusion for gifts made in 2007 and 2008 is $12,000. The annual exclusion for gifts to an alien spouse made in 2007 is $125,000; for such gifts made in 2008, the exclusion is $128,000.
[15] § 6039F. Gifts or bequests from foreign individuals must be reported if they exceed $100,000 in a calendar year. Purported gifts from foreign corporations or partnerships must be reported if they exceed $10,000. *See* Notice 97-34, 1997-25 I.R.B. 22.

periodic gains, profits and income" ("FDAPI") from U.S. sources[16] and income that is "effectively connected" with a U.S. trade or business for the year ("effectively connected income" or "ECI").[17] To report U.S.-source FDAPI and/or effectively connected income, foreign individuals (including foreign trusts) are generally required to file a Form 1040NR,[18] and foreign corporations are generally required to annually file a Form 1120-F.

. 3. Foreign Trusts

A foreign trust that is not treated as "owned" by its grantor (*i.e.*, a foreign nongrantor trust) generally is treated as a separate taxpayer and taxed as a foreign individual.[19] Therefore, such a trust must file a Form 1040NR (modifying the form, as necessary, to conform to the trust accounting rules) to report its U.S.-source FDAPI and ECI, if any.[20] A foreign grantor trust generally also files a Form 1040NR, but attaches a statement indicating that the trust is a grantor trust and that all income, therefore, is taxable to the grantor and reportable on the grantor's Form 1040NR or Form 1040, whichever the case may be.

In addition, the Code imposes certain information reporting requirements on U.S. grantors and beneficiaries of foreign trusts, including the reporting of (i) the creation of, or transfer of property to, a foreign trust (*i.e.*, the U.S. transferor must notify the IRS of the transfer and provide the IRS with the identify of the trustees and beneficiaries),[21] (ii) ownership of a foreign grantor trust, and (iii) the receipt of a distribution of property from a foreign trust. Reporting is also required for any testamentary transfer of property to a foreign trust, as well as the death of a U.S. citizen or resident who was considered to own any portion of a foreign trust or in whose estate are included a foreign trust's assets.[22] In the case of testamentary transfers and the death of a U.S. owner of a foreign trust, notice must be furnished by the decedent's executor.[23]

B. Limitations Periods

In general, a limitations period (or statute of limitations) imposes a stated period of time during which civil or criminal proceedings against a person must be initiated. A person generally is immune to the prosecution of a civil or criminal claim once the period of limitations

16 Note that FDAPI does not generally include capital gains, unless such gains either are ECI or from the sale or exchange of a "U.S. real property interest." *See* § 897.

17 § 6012(a); Treas. Reg. § 1.6012-1(b)(1); *see also* Instructions to Form 1040NR.

18 Note that a foreign individual or trust having FDAPI whose U.S. tax liability is fully satisfied by withholding at source is not required to file an income tax return. However, a foreign person having any ECI generally is required to file a return, even if their tax liability is eliminated by the terms of an applicable income tax treaty.

19 § 641(b).

20 Treas. Reg. § 1.6012-1; *see also* Instructions to Form 1040NR.

21 § 6048(a). In Notice 97-34, *supra,* note 15, the IRS clarified section 6048(a)'s notice requirements. Form 3520, used to report transfers to foreign trusts, is filed with a U.S. transferor's annual income tax return.

22 § 6048(a)(3).

23 § 6048(a)(4). Most such transfers also give rise to the recognition of gain (but not loss) on assets deemed transferred to the foreign nongrantor trust. § 684.

has expired. In the context of tax law, periods of limitations generally serve as a legislative restraint on the Government's power to audit tax returns and initiate civil or criminal proceedings against a taxpayer with regard to a particular tax liability.[24]

1. Civil Proceedings

The IRS generally has three years from the date of the filing of an original return to audit the return and to assess any additional tax liabilities.[25] The period of limitation is extended to six years in the case of a substantial under-reporting of income (*i.e.*, a taxpayer fails to report more than 25% of the income shown on the return).[26] There is generally no limit for auditing and collecting taxes where a taxpayer files a false or fraudulent return.[27] However, the statute of limitations for initiating *criminal* proceedings generally is limited to six years. Since the period of limitations is measured from the date of the filing of the original tax return, neither the 3-year nor 6-year statute of limitations is applicable where a taxpayer has not filed a return.[28] Thus, a taxpayer sometimes is well-advised to file a return to start the applicable limitations period running.

Information returns (*e.g.*, Forms 3520, 5471, 8621, 8865) are generally subject to the same periods of limitations. Note, however, that a rule applicable to extending the applicable limitations period for certain information returns (including Forms 3520 and 5471) relating to foreign transfers can also have the effect of extending the applicable limitations period for any *assessment of tax* for any event or period to which the information appearing in the information return relates.[29]

2. Criminal Proceedings

The Code provides a 6-year limitations period for most criminal violations of the tax laws, including the following:

- Those Code sections in which defrauding or attempting to defraud the United States is an element of the offense;
- Willfully attempting in any manner to evade or defeat any tax or the payment thereof;[30]
- Willfully failing to collect or pay over tax;[31]

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24 Internal Revenue Manual ("IRM") 9.1.3.6. Note that a limitations period can also run against a taxpayer wishing, *e.g.*, to amend a tax return or obtain a tax refund.
25 § 6501(a).
26 § 6501(e)(1)(A).
27 § 6501(c)(1).
28 § 6501(c)(3).
29 § 6501(c)(8).
30 § 7201.
31 § 7202.

- Willfully aiding, assisting, counseling, procuring or advising the preparation or presentation of a false return or other document;[32]

- Willfully failing to timely pay any tax or make any return (other than declaration of estimated tax, partnership returns or other information returns);[33]

- Willfully making and subscribing a false return under penalty of perjury;[34]

- Willfully delivering or disclosing to the IRS a fraudulent return, statement or other document;[35]

- Corruptly or forcibly attempting to interfere with the administration of the Internal Revenue laws;[36] and

- Conspiracy in connection with an attempt to defeat or evade any tax or the payment thereof.[37]

C. <u>Obligation to File Amended Returns</u>

Generally, all income tax returns and information returns are signed by a taxpayer under penalties of perjury. Thus, a taxpayer, by signing Form 1040, effectively certifies under penalties of perjury that he has examined the return and its accompanying schedules and statements, and, *to the best of his knowledge*, all of the information contained therein is true, correct and complete.[38]

Nothing contained in the Code or regulations expressly requires a taxpayer to file an amended return to reflect changes in facts or circumstances that have arisen since the filing of the original return *or that were originally different than the taxpayer believed them to be.*

III. <u>Taxpayer Liability for Actions of Other Taxpayers</u>

A. <u>Spouses—Joint Tax Returns</u>

Married couples often choose to file a joint tax return because of certain benefits this filing status allows. In general, both taxpayers filing a joint tax return are jointly and severally liable for the tax and any interest or penalties due on the joint return. This means that one spouse may be held responsible for all the tax, interest and penalties due, even if all the income was

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32 § 7206(2).
33 § 7203. Note that failure to file a return is considered a criminal misdemeanor, as is filing a false return. The balance of the tax crimes are considered felonies.
34 § 7206(1).
35 § 7207.
36 § 7212(a).
37 IRM 9.1.3.6.
38 18 U.S.C.§ 371. *See* Form 1040.

earned by the other spouse. This joint and several liability remains intact even if the couple later divorces.[39]

However, a taxpayer may seek relief from this liability by requesting "innocent spouse relief" from the IRS by filing Form 8857. By requesting innocent spouse relief, a taxpayer may be relieved of responsibility for paying tax, interest, and penalties if his or her spouse (or former spouse) improperly reported items or omitted items on their joint ax return.

B. Transferee Liability

Section 6901(a)(1)(A) allows the IRS to assess a tax liability against any third party that is a gratuitous "transferee of property" from a taxpayer liable for an unpaid income tax. This "transferee liability" arises when a taxpayer who is liable for taxes (whether that liability has been assessed or not) transfers assets to a third party without receiving fair market value consideration. In such a case, section 6901(c)(1) gives the IRS an additional one year from the end of the limitation period against the original transferor-taxpayer to assess the transferee liability against that third party (*i.e.*, the transferee). Note that section 6901 applies to beneficiaries of a decedent's estate.[40]

Since transferee liability is based on the liability of the original taxpayer, it is not necessary for the IRS to assess the liability against the original taxpayer before assessing it against the transferee.[41] However, if the transfer occurs after the end of the statute of limitations against the original taxpayer, and the IRS has not made a timely assessment against the original taxpayer, the IRS cannot then assess the liability on the transferee.[42] That is, once the original statute of limitations has expired against the transferor, a taxpayer's liability is eliminated for all practical purposes.

V. Practitioner Obligations and Potential Liabilities

A. Attorney-Client and Work Product Privileges

The attorney-client privilege is a Common Law doctrine protecting the confidentiality of communications between attorneys and their clients. The attorney-client privilege is intended to promote open and honest communications between attorneys and their clients, thereby serving the greater public interest of compliance and administration of law.[43]

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39 This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns.

40 However, note that section 6324(b) creates a 10-year "lien" against a beneficiary who receives and uses property of the estate when the estate has not paid the estate tax. The lien may be foreclosed on at any time during the 10 year period by the IRS to collect the unpaid estate tax, irrespective of the limitation period for transferee liability. § 6324(a)(2).

41 *See, e.g.*, *Commissioner v. Kuckenberg*, 309 F.2d 202, 206 (9th Cir. 1962); *O'Neal v. Commissioner*, 102 T.C. 666 (1994).

42 *See Diamond Gardner v. Commissioner*, 38 T.C. 875, 881 (1962).

43 *See, e.g.*, *Upjohn v. United States*, 449 U.S. 383, 389 (1981); *Fisher v. United States*, 425 U.S. 391, 403 (1976).

The attorney-client privilege generally prohibits an attorney from disclosing information relating to the representation of a client, unless the client gives informed consent or disclosure is otherwise required or permitted.[44] The specific elements and limitations of the privilege are generally defined by the courts and ethics committees of State bars. Accordingly, the scope of the privilege can vary from one jurisdiction to the next, and practitioners must understand the privilege as it applies in the jurisdiction in which they practice. Difficulties can arise where an attorney is subject to the differing rules of several jurisdictions in connection with the same client or transaction (*e.g.*, a U.S. lawyer practicing in London as a foreign lawyer). In such a case, a client is likely to be entitled only to the protection of the privilege having the more limited scope.

Where applicable, the attorney-client privilege is absolute and affords complete protection to communications between attorneys and clients. It preserves the confidentiality of the information in all contexts, criminal, civil or otherwise. Because of its extensive application, the attorney-client privilege is narrowly construed to apply only to confidential disclosures by a client to an attorney made in order to obtain legal assistance.[45] In particular, in order to assert a claim of attorney-client privilege, several U.S.-based courts have held that the following essential elements must be present: (i) when legal advice is sought, (ii) from a professional legal adviser in his capacity as such, (iii) the communications relating to that purpose, (iv) made in confidence, (v) by the client, (vi) are at his instance permanently protected, (vii) from disclosures by himself or by the legal adviser, (viii) except when the privilege is waived.[46]

Since the attorney-client privilege is intended to protect only those communications by a client to an attorney that were intended to be confidential, the privilege generally will not protect from disclosure statements made by a client to his attorney in the presence of a third party who is not an agent of either the client or attorney.[47] Thus, in the event that a client discloses information in the presence of a third party, the attorney-client privilege generally is considered waived. In addition, the person invoking the attorney-client privilege must prove that he is a client or that he affirmatively sought to become a client (*i.e.*, the privilege belongs to the client).[48] Communications from a client that neither reflect the attorney's thinking nor are made for the purpose of eliciting the attorney's professional advice or other legal assistance are not privileged. Further, an attorney may be permitted to disclose confidential information to prevent death or substantial bodily harm or to prevent the client from committing a crime or fraud, among other reasons.[49]

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44 *See, e.g.*, Rule 1.6(a) of the American Bar Association's Model Rules of Professional Conduct (2007 ed.) ("ABA Model Rules").

45 *See Fisher v. United States*, 425 U.S. at 403.

46 *See, e.g.*, *United States v. Evans*, 113 F.3d 1457, 1461 (7th Cir. 1997), *citing* 8 John Henry Wigmore, *Evidence in Trials at Common Law* (McNaughton rev. 1961) § 2290; *In re Fischel*, 557 F.2d 209, 211 (9th Cir. 1977); *Diversified Group, Inc. v. Daugerdas*, 217 F.R.D. 152, 161 (S.D. NY 2003).

47 *See United States v. Evans*, 113 F. 3d at 1461.

48 *See Evans*, 113 F.3d at 1465; *United States v. Keplinger*, 776 F.2d 678, 701 (7th Cir. 1985); *In re Grand Jury Subpoena Duces Tecum*, 112 F.3d 910, 923 (8th Cir. 1997).

49 In particular, according to Rule 1.6(b) of the ABA Model Rules, an attorney may be permitted to disclose otherwise confidential information (1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably

In addition to the attorney-client privilege, the "work product" privilege may apply to protect the confidence of communications between attorneys and clients.[50] Unlike the attorney-client privilege, however, the work product privilege is not an absolute privilege and can be overcome by a court of competent jurisdiction. In particular, although the work product privilege generally applies to protect confidential information between attorneys and clients, if the opposing party (*e.g.*, the IRS or Department of Justice) can show a compelling need for the information, a court can order the information to be disclosed.[51] The work product privilege generally applies if the work is performed in anticipation of litigation (*i.e.*, possibility of litigation, rather than certainty of litigation).

B. Limitation on Tax-Related Communications

Although tax engagements and tax-related communications between attorneys and clients are generally protected by the same set of privileges as communications between attorneys and clients generally, no privilege extends to protect communications related to the preparation of a client's tax return by an attorney. The general rule is that where a client transmits information so that it might be used to prepare his tax return, such transmission generally defeats any expectation of confidentiality. That is, the attorney-client privilege and work product privilege protect only those communications that are legal in nature, such as those made to enable the preparation of a brief or opinion letter, and generally do not extend to protect communications related to the preparation of a client's tax returns.[52] Thus, for example, while advice relating to the tax consequences of a proposed transaction, when rendered by an attorney, is generally considered legal advice protected by the privileges, such information generally will not be protected from disclosure if it is ultimately used to prepare the client's tax return.[53]

In addition, there is no Common Law accountant's or tax preparer's confidentiality privilege similar to the attorney-client privilege or work product privilege.[54] Indeed, the

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certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; (4) to secure legal advice about the lawyer's compliance with other rules of professional conduct; (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or (6) to comply with other law or a court order.

50 *See Hickman v. Taylor*, 329 U.S. 495 (1947).

51 Fed. R. Civ. Proc. 26(b)(3); *see also Hartz Mountain Industries, Inc. v. Commissioner*, 93 T.C. 521 (1989).

52 *See United States v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999); *In re Grand Jury Subpoena Duces Tecum*, 731 F.2d 1032, 1037 (2d Cir. 1984) (advice rendered by an attorney concerning the tax consequences of alternative employee compensation plans is considered legal advice); *Matter of Federated Dep't Stores, Inc.*, 170 B.R. 331, 354 (S.D. Ohio 1994) (tax planning advice rendered by an attorney is legal advice); *see also In the Matter of Grand Jury Proceedings*, 220 F.3d 568, 571 (7th Cir. 2000).

53 *See Frederick,* 182 F.3d at 500.

54 However, note that section 7525, as enacted by the *Restructuring and Reform Act of 1998* (Pub. L. No. 205-206), provides a limited confidentiality privilege to federally authorized tax practitioners (*e.g.*, certified public accountants) with respect to tax advice in noncriminal tax matters ("section 7525 privilege"). The section 7525 privilege has significant limitations, including the limitation that it applies only to noncriminal tax matters before the IRS and the federal courts. In addition, the section 7525 privilege does not extend to written communications in connection with the promotion of the direct or indirect participation of all tax shelters, whether entered into by corporations, partnerships, individuals, tax- exempt entities and any other entities. § 7525(b).

rationale for not extending these privileges to tax preparation work appears to be that, since there is no Common Law tax preparer's privilege, a taxpayer must not be permitted to hire an attorney to do the work that an accountant or the taxpayer himself normally would do, in order to obtain greater protection than a taxpayer who did not use an attorney as his tax preparer would be entitled to.[55]

This limitation on the application of the confidentiality privileges can pose a significant problem for clients with potential criminal tax exposure, since such clients often need both legal and accounting expertise to manage their risk. For example, in order to make a "voluntary disclosure," a client must properly report his or her liability on an amended or delinquent return, which would generally require a tax preparer's general and accounting expertise. One method of resolving this problem is by using a "*Kovel* agreement" to engage an independent accountant to perform the necessary tax preparation work.

C. Kovel Agreements

The *Kovel* agreement derives its name from the Second Circuit case of *United States v. Kovel*,[56] the leading case that originally recognized the attorney-client privilege when an accountant is engaged to assist in providing legal services to a client. The basic premise of the *Kovel* arrangement is that the accountant so engaged is acting as an "agent" of the attorney for the purpose of assisting with the provision of legal advice and, therefore, information transmitted to the accountant must fall under the protection of the attorney-client privilege.[57]

Although oral agreement may be permitted by law, as a practical matter, practitioners should document a *Kovel* arrangement in writing, specifically defining the scope of the accounting services to be provided and responsibilities to be managed by the accountant or accounting firm in the engagement. An accountant or accounting firm engaged under the *Kovel* agreement is generally considered to work directly for the attorney as an independent contractor and is considered to work only indirectly for the client as part of the legal team rendering legal services to the attorney's client, even if the accountant's fees are paid directly by the client.

D. New Standards of Conduct for Tax Return Preparers

Effective generally for tax returns *prepared* after May 25, 2007, the *Small Business and Work Opportunity Tax Act of 2007* (the "2007 Act"),[58] amended several provisions of the Code to (i) extend the application of the income tax return preparer penalties to all tax return preparers, (ii) alter the standards of conduct which must be met by tax preparers to avoid imposition of penalties, and (iii) increase the applicable penalties. The Treasury Department and IRS intend to

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55 *See United States v. Arthur Young & Co.,* 465 U.S. 805, 817-19, 79 L. Ed. 2d 826, 104 S. Ct. 1495 (1984); *Couch v. United States,* 409 U.S. 322, 335, 34 L. Ed. 2d 548, 93 S. Ct. 611 (1973); *United States v. Frederick,* 182 F.3d 496, 500 (7th Cir. 1999), *cert. denied,* 145 L. Ed. 2d 1070, 120 S. Ct. 1157 (2000).

56 296 F.2d 918, 922 (2d Cir. 1961).

57 ."What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal* advice *from the lawyer*." *Kovel,* 296 F.2d at 922; *see also United States v. Brown,* 478 F.2d 1038, 1040 (7th Cir. 1973).

58 Pub. L. No. 110-28.

issue regulations to implement the changes under the 2007 Act and, on December 31, 2007, released Notice 2008-13[59] to be used as interim guidance by tax return preparers.

Although the 2007 Act extends the return preparer penalties to preparers of all tax returns and not just to preparers of income tax returns, Notice 2008-13 clarifies that preparers of many information returns will not be subject to the new penalty provision unless they willfully understate tax or act in reckless or intentional disregard of the law. The Notice further explains the application of the new rules to specific returns—*e.g.*, the preparer of a Form 1065 may be deemed to be the preparer of any of the partners' individual income tax returns (*i.e.*, Form 1040), if the items on the partnership return constitute a substantial portion of each partner's income tax return.

Regarding the standard of a tax return preparer's conduct with respect to undisclosed positions on a tax return, the 2007 Act replaces the former "realistic possibility standard"[60] with a requirement that the preparer have a reasonable belief that the tax treatment of the position would "more likely than not" be sustained on the merits.[61] Where the taxpayer discloses the position on the tax return, the 2007 Act requires only a "reasonable basis"[62] for the tax treatment of the position taken on the return[63] Notice 2008-13 explains that preparers can generally rely on taxpayer representations in preparing returns and can also generally rely on representations of third parties, unless the preparer has reason to know they are incorrect.

V. <u>Managing Potential Tax Exposure</u>

A. <u>Voluntary Disclosure</u>

Clients with potential criminal tax exposure might be able to avoid criminal liability by making a so-called "voluntary disclosure." Criminal tax exposure arises when a taxpayer either has filed a fraudulent return (false as to the amount of tax reported or false as to some material item required to be disclosed on the return) or has failed to file a return timely. However, this is particularly problematic for a taxpayer who has knowingly (or, perhaps, even unknowingly) committed tax fraud in the past and now wants to become U.S. tax compliant. For such taxpayer, filing a timely current return alone, in order to come back into the "system," might raise questions regarding a prior failure to file. Further, filing an accurate current return might tend to identify omitted income or incorrect fact statements on prior returns.

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59 2008-3 I.R.B. 282 (Jan. 22, 2008).

60 In practice, the "realistic possibility" standard generally means that the tax position has at least a one-in-three chance of success if challenged by the IRS.

61 The "more likely than not" standard generally means that the return preparer believes, in good faith, that there is a greater than 50% likelihood that the tax treatment of an item will be upheld if challenged by the IRS. *See* Notice 2008-13.

62 The "reasonable basis" standard generally means that the tax position has at least a 25% chance of success if challenged by the IRS.

63 This is the same standard to which a taxpayer preparing his own return is held. Holding the taxpayer and return preparer to differing standards is problematic, and the Treasury Department is apparently investigating ways to eliminate the difference. It may well be that this can only be accomplished by further legislation.

The traditional method of commencing a voluntary disclosure, in order to avoid potential criminal liability, is to file an amended return or delinquent return (as appropriate) before the IRS or another Government agency has opened an inquiry regarding a taxpayer's prior returns (or lack thereof). Filing an amended or delinquent return does not undo the crime, and making a voluntary disclosure does not guarantee immunity from criminal prosecution. However, as a matter of internal practice, the IRS generally will give consideration to a taxpayer's voluntary disclosure, along with all other relevant factors, in determining whether criminal prosecution will be recommended for the taxpayer.[64] In addition, given that the IRS has limited investigative resources, it obviously is in the Government's self-interest to encourage taxpayers who owe additional tax to file amended or delinquent returns. Accordingly, voluntary disclosure might be a viable option, with significantly less exposure for criminal liability, for taxpayers seeking to correct past mistakes.

All components of a voluntary disclosure must be truthful. A voluntary disclosure occurs when the communication is truthful, timely and complete, and when, in addition: (i) the taxpayer shows a willingness to cooperate (and does, in fact, cooperate) with the IRS in determining his correct tax liability, and (ii) the taxpayer makes good faith arrangements with the IRS to pay, in full, the tax, interest, and any penalties determined by the IRS to be applicable.[65] Generally, in practice, no favorable consideration will be given to a partial voluntary disclosure that is followed by a claim of the Fifth Amendment, a refusal to cooperate in an audit, or a refusal to give financial information relevant to a claim of inability to pay.

A voluntary disclosure is considered timely when it is received by the IRS before the IRS has initiated or notified the taxpayer of a civil examination or criminal investigation and before the IRS has acquired information, either directly or from a third party, regarding the taxpayer's noncompliance.[66] A noncompliant taxpayer should not overlook the possibility of making a voluntary disclosure merely because he no longer has the records from which to calculate his tax liability. What is required is a taxpayer's best estimates based on all available information, not precision. However, a taxpayer whose return contains "best estimates" rather than precise information should indicate on the face of the amended or delinquent return that the figures are the taxpayer's estimates and also include the methods used to calculate the estimates.

B. New Informer Rules

Although some individuals may consider it "offensive," the other side of the coin relative to voluntary disclosure is the IRS informer program. A taxpayer who knows or suspects that another taxpayer is not complying with the tax laws can report such activity to the IRS on Form 3949-A. Alternatively, a taxpayer can also send a letter to the IRS, providing identifying information regarding the taxpayer suspected of noncompliance (name, address and taxpayer identification number, if known), the years that might be involved and estimated dollar amounts of the any unreported income. The informer-taxpayer is not required to disclose his identity, which can, with the assistance of the IRS, generally be kept confidential.

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64 IRM 9.5.11.9.

65 *Id.*

66 IRM 9.5.11.9.

Informer cases typically take several years to develop. While many, if not most, never lead to any action taken by the Government, due to, *e.g.*, lack of any real basis for the claims or an inability to obtain necessary evidence (or even jurisdiction of the taxpayer), others may go to a grand jury and result in prosecution. The IRS may provide a reward for the information, ranging from 1% to 15% of the amount recovered by the IRS (but not more than $10 million).[67] To make a claim for a reward, an informant must file Form 211, which asks the informant to provide an estimate of the potential tax liability, the pertinent facts in the case, and an explanation of how the informant obtained the information.[68]

In addition, in December 2006, the IRS created the "Whistleblower Office" to receive and process information that helps uncover tax cheating by employers and company officials and to provide appropriate rewards to "whistleblowers." The Whistleblower Office processes tips received from individuals who spot tax problems or suspicious activity in their workplace. To make a claim for a reward, a "whistleblower" must also file Form 211.[69]

A "whistleblower" may be eligible for a monetary award if the total amount in dispute (the tax, plus penalties, interest, additions to tax, and additional amounts) exceeds $2 million for any taxable year, if the taxpayer is a company; if the taxpayer is an individual, the individual's gross income must exceed $200,000 for any taxable year in question. Awards are generally paid in proportion to the value of information furnished. However, as a general matter, the amount of award will be at least 15%, but no more than 30%, of the collected proceeds in cases in which the IRS determines that the information submitted by the informant substantially contributed to the collection of tax. The award percentage may be reduced in some circumstances.[70]

VI. <u>Conclusion</u>

There are numerous complex U.S. tax provisions potentially relevant to cross-border fact patterns that can give rise to "unforeseen circumstances" and challenging tax issues for unsuspecting (and occasionally not so unsuspecting) persons who are or may become U.S. taxpayers. The possibilities for such problems are virtually limitless. Certainly, in trying to understand and resolve such issues, it is important that U.S. tax practitioners understand the nuances of the substantive tax provisions that apply. At the same time, it is also important for them to recognize that taking remedial actions to try to bring a taxpayer back into compliance with U.S. tax rules inevitably involves more than just the substantive tax rules. Close attention must also be paid to the equally numerous and complex procedural rules contained in the Code as well as to certain fundamental rules and principles of legal and professional practice.

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67 § 7623(a) authorizes the IRS to pay such sums as are necessary to detect tax underpayments and bring persons guilty of violating the tax laws to trial. *See* IRS Publication 733, *Rewards for Information Provided by Individuals to the Internal Revenue Service* (Rev. Oct. 2004).

68 Form 211, *Application for Reward for Original Information*.

69 *See id.*

70 *See generally* § 7623(b).