SPECIAL REPORT: PRIVILEGE AND THE WORK PRODUCT DOCTRINE IN TAX CASES*

INTRODUCTION: On Thursday, March 25, 2004, from 1:00 – 2:00 p.m. EST, the Section together with ABA-CLE will sponsor another in its ***Tax Link Live*** Teleconference series. This special ethics teleconference will feature a discussion on ***"Privileges and Work Product in the Context of Tax Litigation: Lessons from the Trenches,"*** and will be led by Professor Martin J. McMahon, Jr. of the University of Florida College of Law and Steven S. Brown of Martin, Brown & Sullivan, Ltd., Chicago, IL, with Michael G. Yopp of Waller, Lansden, Dortch & Davis PLLC, Nashville, TN, serving as moderator. There will be ample opportunity for questions from those who are participating in the teleconference. For details on registering and obtaining CLE ethics credit, please see the box immediately following this report on page 13.

In this Special Report, Professor McMahon describes the current contours of the attorney-client and similar privileges as well as the work product doctrine and explains why they are at the forefront of current tax litigation. He also demonstrates why these developments have implications far beyond the tax shelter context in which some of the recent litigation has taken place and why these privileges and doctrines have to be considered at the time communications between tax advisors and clients are taking place and as documents are being drafted.

by Martin J. McMahon, Jr., Gainesville, FL

Over the past few years, the issue of the applicability of the attorney-client privilege, the related section 7525 tax practitioner-client privilege, and the work product doctrine have emerged as significant issues in tax litigation. For the most part, the recent cases have arisen in the context of marketed tax shelters and other aggressive tax planning transactions, but a few of the cases have arisen in more prosaic contexts. As a result of the recent firestorm of controversy in this area, tax practitioners are becoming increasingly conscious of the importance of raising privilege and work product doctrine claims when the Service seeks information about taxpayers' transactions pursuant to a summons or in the course of discovery.

The attorney-client privilege is a rule of evidence (and discovery) relating to a client's confidential communications to an attorney. (*See* Fed. R. Evid. 501; Fed. R. Civ. P. 26(b)(1) (both carving out privileged communications). In tax cases, privilege is governed by federal law. *E.g.*, *Johnston v. Commissioner*, 119 T.C. 27 (2002).) According to Wigmore's definition of the attorney-client privilege, "when *legal advice is sought*, from a professional legal adviser in that capacity, the *communications relating to that purpose, made in confidence, by the client*, are at his instance permanently protected, from the disclosure by himself or by the legal adviser, except the protection be waived." JOHN HENRY WIGMORE, 8 WIGMORE ON EVIDENCE § 2292 (McNaughton rev. 1961) (emphasis added). The attorney-client privilege exists for the purpose of encouraging full and truthful communication between an attorney and his client and "recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client." *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981). An attorney's advice to a client is privileged only to the extent that disclosure of that advice would disclose the client's confidential communications. *See, In American Standard, Inc. v. Pfizer Inc.*, 828 F.2d 734 (Fed. Cir. 1987). Significantly, the attorney-client privilege does *not* extend to communications between a taxpayer and an attorney relating to the preparation of a tax return. *See e.g., United States v. Frederick*, 182 F.3d 496, 502, *reh. denied* (7th Cir. 1999), *cert. denied*, 528 U.S. 1154 (2000), and cases cited therein.

If information is communicated to an attorney by someone other that the client or his agent, it is not generally privileged. *See, e.g., United States v. Threlkeld*, 241 F. Supp. 324, 326 (W.D. Tenn. 1965). However, under the *Kovel* doctrine, a client's communications to a third party, e.g., accountant, investment banker, etc., hired by the attorney, are privileged if the third party is necessary to interpret or translate the information for the attorney to enable the attorney to provide legal advice. *United States v. Kovel,* 296 F.2d 918 (2d Cir. 1961).

If the communications are disclosed to a third party, the privilege generally has been waived. *In re Sealed*, 676 F.2d 793 (D.C. Cir. 1982). In tax cases involving the assertion of penalties (e.g., section 6662 accuracy related penalties), raising reliance on the advice of an attorney as a defense to penalties results in a waiver of the attorney-client privilege. *Johnston v. Commissioner*, 119 T.C. 27 (2002) (civil fraud penalty). In some instances a waiver may be limited. In *Long-Term Capital Holdings v. United States*, 90 A.F.T.R.2d 2002–7446 (D. Conn. 2002), *on further proceedings*, 91 A.F.T.R.2d 2003–1139 (D. Conn. 2003), the taxpayer obtained a tax opinion from King & Spalding relating to certain aspects of a transaction.

* A few portions of this Article have been adapted from various CLE outlines prepared by the author and Professor Ira B. Shepard, University of Houston Law Center, over the past ten years.

Without specifically disclosing the opinion letter itself, the taxpayer revealed to its tax accountant that it had a "more likely than not" opinion with respect to the allowability of a deduction as a result of the transaction. The disclosure of the existence of the opinion, and that it was a "more likely than not" opinion with respect to allowance of deduction, disclosed the gist of opinion, and such disclosure was a waiver of those portions of the opinion letter reflecting the matter actually disclosed, but not of the entire subject matter.

There is no accountant-client privilege under federal common law. *Cavallaro v. United States*, 284 F.3d 236 (2002); *Couch v. United States*, 409 U.S. 322, 335 (1973). This rule has been modified by section 7525, which creates a limited privilege for non-attorney tax practitioners by extending the common law attorney-client privilege to "tax advice" for taxpayer communications with a "federally authorized tax practitioner." The section 7525 privilege does not apply, however, to tax advice regarding "corporate tax shelters." The section 7525 privilege may be asserted only in noncriminal tax matters before the Service and in noncriminal tax proceedings "brought by or against the United States" in federal court.

The identity of a client, or the fact that a given individual has become a client are matters that an attorney normally may not refuse to disclose. *See, e.g., Colton v. United States*, 306 F.2d 633(2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963). In a few instances, however, a client's identity may be privileged. In *Baird v. Koerner*, 270 F.2d 623, 632 (9th Cir. 1960), the Ninth Circuit allowed the attorney-client privilege to be claimed where the client's identity might have been "the link that could form the chain of testimony necessary to convict an individual of a federal crime." Client identity also was protected by the Seventh Circuit in *Tillotson v. Boughner*, 350 F.2d 663 (7th Cir. 1965), on the grounds that the government already knew so much about the transaction that revealing the client's identity would be tantamount to revealing the client's privileged communication to the attorney.

Client identity privilege has been asserted in several recent high profile cases involving tax shelters, but these claims have not been sustained. The most notable of these cases is *United States v. BDO Seidman*, 337 F.3d 802 (7th Cir. 2003), *motion to stay mandate denied* by 345 F.3d 465 (7th Cir. 2003), in which the Seventh Circuit affirmed a district court's determination that tax shelter investors failed to establish that a confidential communication would be disclosed if their identities were revealed. Disclosure of their identities would disclose to the Service only that they had participated in one of the tax shelters described in the summonses, but no confidential communication could be inferred from that information alone. The court distinguished *Tillotson* and similar cases, as situations in which "the Government already knew much about the substance of the communications between the attorney and his unidentified client," from the *BDO Seidman* case, where "the IRS knows relatively little about the interactions between BDO and [the investors], the nature of their relationship, or the substance of their conversations." Furthermore, in a sweeping conclusion, the court held that the tax shelter disclosure rules of section 6112 virtually preclude assertions of identity privilege by tax shelter investors.

Client identity privilege claims also were rejected in *Doe #1 v. Wachovia Corporation*, 268 F.Supp. 2d 627 (W.D. N.C. 2003). The Service served an administrative summons on Wachovia, which had marketed the tax shelter investments, seeking investor lists, documents, and other information relating to potentially abusive tax shelters pursuant to the regulations under section 6112. Investors intervened, arguing that disclosure of their names would disclose privileged information provided by them to KPMG (section 7525 privilege) and to Jenkens & Gilchrist (J & G) (attorney-client privilege), both of which had participated in designing the transactions or had provided opinions regarding the transactions. The court found that there was no attorney-client relationship between the investors and J & G. There was no evidence that any investor "ever had so much as a conversation with an attorney at J & G," there was nothing uniquely tied to the individual investors' financial situation, and the package contained no confidential information. In addition, the section 7525 privilege did not apply with respect to KPMG. First, the privilege only applies in cases by or against the government and before the Service, and *Wachovia* involved a suit by investors seeking an injunction against Wachovia, not a proceeding by or against the United States. Second, section 7525 provides that the privilege does not apply "to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter," which the court found precisely described the circumstances of the case – KPMG's communications were with Wachovia, a corporation. Finally, KPMG's advice was in the context of return preparation, which is not privileged.

The increasing number of instances in which attorney-client privilege and the section 7525 privilege have been asserted when the Service has sought to obtain communications from tax advisors to their clients and other related documents emphasizes the importance of understanding the scope of these doctrines not only at the controversy stage, but also at the planning stage, when these documents are being created. Both practitioners and their clients need to be aware of the extent to which potential communications are privileged. This is not necessarily as easy as it sounds because the parameters and scope of privilege in the context of tax planning are still being developed, as evidenced by the recent cases discussed above. It is very important to be as aware of the cases in which the claims have been rejected as it is to understand the cases in which they have been accepted. ■