Guidelines for Protecting Privilege in Tax Cases

By Joshua D. Smeltzer, David Gair, and Larry Jones*

Joshua D. Smeltzer, David Gair, and Larry Jones examine privilege at every stage of a tax issue from pre-controversy to litigation in court.

Lawyers, tax or otherwise, understand that privileged information must be protected to encourage a full and frank dialogue that might not occur without confidentiality.[1] Tax information, in particular, contains some of the most private information for both individuals and businesses. The private nature of tax return information is protected by statute with penalties imposed for wrongful disclosure.[2] However, despite the private nature of tax and other information, courts still construe privileges narrowly under the theory that it inhibits the search for the truth.[3] A recent case from the Fifth Circuit Court of Appeals, *T. Lohermeyer*,[4] has caused lawyers and the courts to re-examine the scope of privilege. This case serves as a reminder that lawyers must consider privilege at all stages of a tax dispute—including before a dispute arises.

In *Lohmeyer*, the Justice Department sought, and received, enforcement of a John Doe summons issued to the Texas based law firm for specific client identities and other information.[5] Claiming violation of the attorney-client privilege, the law firm appealed. The Fifth Circuit disagreed and upheld the enforcement order.[6] When all the judges voted on re-hearing *en banc*, the legal community saw how close the issue of privilege was, with eight votes in favor of re-hearing and nine votes against.[7] The denial of re-hearing included a written dissent noting that there "is good reason to be wary of investigations that exert pressure on lawyers."[8] The dissent also noted the complicated nature of tax law and that attorneys can only help clients comply "if they have the client's full disclosure."[9] The law firm has further options to challenge the requested disclosure. Regardless, it serves as a reminder to lawyers to take every precaution to protect privilege. The following article discusses privilege at every stage of a tax issue from pre-controversy to litigation in court.

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Pre-Controversy Privilege Protections

Pre-controversy communications with taxpayers may not involve a tax lawyer but a CPA or other financial advisor. A federally authorized tax practitioner can be any individual authorized to practice before the IRS (*e.g.*, CPAs, attorneys, enrolled agents, enrolled actuaries). These authorized practitioners may assert the Section 7525 of the Internal Revenue Code.[10] However, it doesn't protect communications made as part of the preparation of the tax return.[11] Therefore, seemingly confidential information may not be protected by the Code Sec. 7525 privilege if it is sufficiently connected to the preparation of the return. Also, the Code Sec. 7525 privilege only applies to civil administrative proceedings with the IRS (*e.g.*, examinations or appeals) or litigation before the U.S. Tax Court or other federal courts. Criminal tax proceedings or any other nontax proceeding is outside the scope of the privilege.[12] As such, the Code Sec. 7525 privilege has potentially no value if there is criminal exposure or implications beyond tax. Another limitation is that the Code Sec. 7525 privilege will not apply if the communication is found to be in connection with the promotion or direct or indirect participation of any tax shelter.[13] The definition of tax shelter is any entity, plan, or arrangement with a "significant purpose" of the avoidance or evasion of federal income tax.[14] Although the statute doesn't define "significant purpose" courts have interpreted it broadly.[15] For practical purposes, much of what the government may be interested in could fit into the definition of a tax shelter.

Considering and documenting privileges throughout the process protects the confidentiality necessary for effective legal advice regarding tax issues.

When an accountant is needed to help facilitate the legal advice, the conventional answer is to enter into a *Kovel* agreement, named after the defendant in the case, with the accountant.[16] *Kovel* stands for the proposition that attorney-client privilege can be claimed with an accountant if he is hired by the lawyer to assist the lawyer with providing legal advice. Properly executed, it imports the attorney-client privilege to the accountant's work and communications. This can provide a client with the best of both worlds by allowing the tax attorney to use the expertise of the accountant to assist with the legal advice. The *Kovel* arrangement generally works well but is ineffective with client-accountant relationships that predate the *Kovel* letter where confidential information has already been provided. Thus when a new matter comes along it is often vital to hire a new accountant to handle the work.

Another potential protection, pre-controversy, beyond the attorney-client privilege is the work-product privilege. Under the work-product doctrine, documents, statements, correspondence, affidavits, attorney notes, models, exhibits, and similar materials prepared by an attorney, or by third parties acting under the direction of an attorney, may be protected from discovery if they were prepared "in anticipation of litigation."[17] Courts have found that administrative proceedings before the IRS qualify as litigation for purposes of work-product privilege.[18] Also, the application of the work-product doctrine does not require that litigation actually occur.[19] However, a conclusory assertion that something was prepared in anticipation of litigation without more may not establish the privilege.[20]

Protecting Privilege in IRS Administrative Proceedings

Once a taxpayer receives notice of a tax dispute or audit then privilege analysis may turn from affirmative protections to defensive considerations. Perhaps a taxpayer has taken pre-controversy steps, like those listed above, perhaps not. However, once the IRS starts examining a taxpayer, they must consider their responses and protect and claim any applicable privileges.

The scope of attorney-client privilege involves communications "necessary to obtain informed legal advice which might not have been made absent the privilege."[21] If there is doubt, then a taxpayer risks disclosure of the confidential information. If not at the IRS then perhaps in court. Therefore, removing doubt is paramount. Understanding when privilege applies, and clearly documenting the legal advice sought, is a tax attorney's best defense against disclosure of confidential material.

The IRS is granted, by statute, broad powers to compel production of both documents and testimony

when attempting to ascertain or collect a tax liability.[22] The IRS can also seek information from third parties by sending a formal summons or, in some cases, an informal request.[23] However, summonses and administrative document requests (*i.e.*, Information Document Requests or IDRs) are subject to traditional limitations and privileges. If a dispute arises, careful consideration of privilege is required because providing the material administratively may waive privilege in subsequent court litigation.

Protecting Privilege During Court Proceedings

The party asserting the privilege bears the burden of proving that a privilege exists. General allegations of privilege are usually insufficient to meet the required burden.[24] Therefore, when asserting a privilege in a tax dispute, all the relevant facts should be marshaled to both explain not only what but why a privilege applies. This may require the use of affidavits or other evidence to potentially avoid a dispute or win a challenge to a privilege claim.

It is clear from historical, and the recent *Lohmeyer* case, that merely having an attorney involved will be insufficient without a more detailed explanation. The attorney-client privilege, generally, protects the communications made for the purpose of receiving legal services but not the underlying facts[25] or communications in a non-legal role.[26] If it is unclear where legal advice begins and ends, then otherwise confidential communications risk disclosure. Also, it is important for clients to know that privileged communications must be kept confidential. Disclosure to third parties can potentially waive privilege. Especially when a corporation is the client, the identification of who is required to receive a communication, for purposes of legal advice, is vital. Broad disclosure can waive privilege.

Discovery rules in litigation also favor disclosure. For example, Federal Rule 26(b)(5) requires that withholding information based on privilege must be "expressly made" and also adequately described so the privilege claim can be evaluated.[27] Therefore, parties usually submit a privilege log identifying what is withheld. In some situations, a court may allow categories of documents to be grouped together with the privilege explained.[28] However, this is a special circumstance that will require a showing that individual listing of documents is unduly burdensome.

As cases become more complex and document intensive the risk of inadvertent disclosure of privilege information increases. The Federal Rules help protect against these types of disclosures. Federal Rule of Evidence 502(b) provides protection for inadvertent disclosures if the holder of the privilege takes reasonable steps to prevent disclosure and fix the error.[29] This includes the procedure outlined in Federal Rule of Civil Procedure 26(b)(5)(B). Under Fed. R. Civ. P. 26(b)(5)(B), the party must provide notification of the inadvertent disclosure and then the receiving party must return, sequester, or destroy the information and any copies. Many courts have standard orders under Rule 502(b) that parties can use to protect themselves from potential inadvertent disclosure during discovery. Because the government is the opposing party in most tax disputes, specific provisions may be requested to cover specific privacy concerns (*i.e.*, Section 6103 of the Internal Revenue Code).

Tax attorneys, when confronted with potentially privileged discussions or documents, engage in thoughtful consideration whether pre or post tax controversy in order to provide the best protection for truly confidential communications of their clients.

Also unique to tax cases, when the opposing party is usually the government, is the deliberative process privilege. This is a qualified privilege protecting certain statements of advice, deliberation, and recommendation of government officials. The privilege is protected by courts when the harm to intragovernmental candor outweighs the need for disclosure. However, like the attorney-client privilege, factual material is not protected by the deliberative process privilege. Also, the government has a formal process for asserting the privilege in litigation.[30] The guidance says that the attorney must identify any potential deliberative process privilege and separate non-privileged portions for production. Documents determined as subject to the

deliberative process privilege should be indexed and provide adequate descriptions of the document and reasons for the privilege including a declaration with the index.[31] Taxpayers should request such index, if not provided, and the accompanying declarations to evaluate whether a portion or all of a communication should be disclosed.

Another unique aspect of tax cases is that there is a reasonable cause defense to penalties if you relied on a qualified tax professional. This advice is usually provided in a formal written tax opinion to the taxpayer outlining the relevant case law and how it relates to the facts. These tax opinions are valuable in assessing risk and deciding on tax reporting in addition to the potential penalty protection. However, if a taxpayer decides to assert reliance on the tax opinion as a defense to penalties under reasonable cause this will almost always waive privilege and require disclosure.

Considering and documenting privileges throughout the process protects the confidentiality necessary for effective legal advice regarding tax issues. Tax attorneys, when confronted with potentially privileged discussions or documents, should engage in thoughtful consideration whether pre or post tax controversy in order to provide the best protection for truly confidential communications of their clients.

ENDNOTES

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1 *Upjohn Co.*, SCt, 81-1 USTC ¶9138, 449 US 383, 389, 101 SCt 677.

2 *See* Code Sec. 6103; Federal Rule Crim. P. 6(e).

3 *See, e.g.*, *Perkins v. Gregg County*, DC-TX, 891 FSupp 361, 363 (1995) ("assertion of privileges inhibits the search for truth").

4 *T. Lohermeyer*, CA-5, 957 F3d 505 (2020).

5 *See Taylor Lohmeyer Law Firm, PLLC*, DC-TX, 385 FSupp3d 548 (2019).

6 *See Taylor Lohmeyer Law Firm, PLLC*, CA-5, 957 F3d 505 (2020).

7 *See Taylor Lohmeyer Law Firm, PLLC*, CA-5, No. 19-50506 (Dec. 14, 2020).

8 *Id*.

9 *Id*.

10 Code Sec. 7525.

11 *See, e.g.*, *KMPG, LLP*, DC-DC, 2003-1 USTC ¶50,174, 237 FSupp2d 35.

12 Code Sec. 7525(a)(2).

13 *See Countryside Ltd. Partnership*, TC, 132 TC 347, Dec. 57,846 (2009) (upholding privilege because the accountant failed to cross the line from trusted advisor to promoter).

14 Code Sec. 6662(d)(2)(c)(ii).

15 *See Valero Energy Corp.*, CA-7, 2009-1 USTC ¶50,445, 569 F3d 626, 632 ("the [tax shelter definition] language is broad and encompasses any plan or arrangement whose significant purpose is to avoid or evade federal taxes").

16 *L. Kovel*, CA-2, 62-1 USTC ¶9111, 296 F2d 918.

17 *See Hickman v. Taylor*, 329 US 495, 510–511 (1947); Federal Rules of Civil Procedure Rule 26(b)(3)(A).

18 *See, e.g.*, *Hodges, Grant & Kaufman*, CA-5, 85-2 USTC ¶9619, 768 F2d 719, 722.

19 *See Kent Corp. v. NLRB*, CA-5, 530 F2d 612, 623 (1976, *cert. denied*, 462 US 19 (1983)).

20 *See Binks Manufacturing Co. v. National Presto Indus., Inc.*, CA-7, 709 F2d 1109 (1983).

21 *See S. Fischer*, SCt, 76-1 USTC ¶9353, 425 US 391, 403, 96 SCt 1569.

22 Code Sec. 7602; *see also, La Salle Nat'l Bank*, SCt, 78-2 USTC ¶9501, 437 US 298, 98 SCt 2357; *M. Powell*, SCt, 64-2 USTC ¶9858, 379 US 48, 52–53, 85 SCt 248.

23 *See E.W. Speck*, CA-9, 95-2 USTC ¶50,341, 59 F3d 106 (finding that informal inquiries through letters to third parties are permissible).

24 *See El Paso Co.*, CA-5, 82-2 USTC ¶9534, 682 F2d 530, 539 ("attorney-client privilege may not be tossed as a blanket over an undifferentiated group of documents"); *see also, Nguyen v. Excel Corp.*, 197 F3d 200, 207 n. 16.

25 *See, e.g.*, *Thurmond v. Compaq Computer Corp.*, 198 FRD 475, 481 (E.D. Tex. 2000) (citing several cases).

26 *See Navigant Consulting*, 220 FRD 474–475 (holding that attorney-client privilege doesn't apply when the attorney is "functioning in some other capacity—such as an accountant, investigator, or business advisor").

27 Fed. R. Civ. P. 26(b)(5)(A).

28 *See, e.g.*, *SEC v. Thrasher*, 1996 WL 125661 (SDNY 1996) ("in appropriate circumstances, the court may permit the holder of withheld documents to provide summaries of the documents by category or otherwise limit the extent of his disclosure").

29 Fed. R. Evid. 502(b).

30 *See* CCDM 35.4.6.3.3.1.2 (Governmental, Executive, Deliberative Process, or Informant's Privilege).

31 *See Id*.