INCOME AND OTHER TAXES COMMITTEE

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ATTORNEY/CPA PRIVILEGE ISSUES

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Attorney/CPA Privilege Issues

I. Privilege Generally

A. Attorney-Client privilege

i. "Text Book" definition: When legal advice is sought from a legal advisor, the communications relating to that advice made in confidence are protected from disclosure unless the privilege is waived. See 8 JOHN HENRY WIGMORE, EVIDENCE § 2290, at 542 (John T. McNaughton ed., 1961).

ii. Purpose: The attorney-client privilege is intended to facilitate sound and comprehensive legal advice by eliminating the incentive the client would otherwise have to not fully inform his attorney of the facts. See *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

a) In other words, the purpose is to encourage clients to have complete and open discussions with their attorneys.

iii. "Test" for Privilege. (All elements must be satisfied for the privilege to protect the communication):

a) Communications;

1. Documents may be privileged if they are communications, or prepared as a means of transmitting confidential communications, or a record of confidential matter created by the attorney.

2. Generally privilege must be established by the party claiming its protection on a specific, document-by-document (or communication) basis.

3. A privilege log must be kept to identify which documents are privileged and why.

b) Made for the purpose of receiving legal advice;

1. The privilege protects only disclosures that are necessary to seek professional legal advice.

c) From a legal advisor;

1. The advisor must be acting in his or her "lawyer" capacity.

2. Some communications to clients are "mixed," meaning that they contain both legal and business advice. The issue then becomes whether the particular

communication is privileged—was the communication legal advice or business advice? Communications may not be privileged if the attorney is simply giving business advice.

d) Made in confidence;

1. The client must have an expectation that the communication remain private.

e) The substance of which has not been disclosed to third parties; AND

1. Waiver to one third party generally constitutes a waiver as to all.

f) Which the client insists on protecting from disclosure;

1. The client holds the privilege.

2. Neither the attorney nor her client can be forced to disclose privileged communications.

3. If the client wants to disclose something and the attorney does not, the client is generally entitled to disclose unless some other exception applies.

4. An attorney can generally claim the privilege on behalf of the client.

5. Exception: there is clear evidence that the client intended to waive the privilege.

iv. When does privilege apply?

a) At all stages of all proceedings, regardless of whether the client is a party to the proceeding

v. Who is the Client?

a) A client is a person (or entity) who receives or seeks legal services from an attorney.

b) Privilege in the Corporate Setting

1. A corporation's lawyer usually represents the entity rather than employees or shareholders.

2. Some courts have required corporations claiming privilege to show that communications to in-house counsel were primarily for the purpose of obtaining legal advice as opposed to ordinary business advice.

3. A corporation cannot immunize every document by sending a copy to its attorney(s).

vi. Dual Purpose Correspondence

a) Taxpayers have been denied privilege claims when documents were prepared by both accountants and attorneys, or someone who serves both roles.

b) The non-privileged use of dual purpose documents can waive the privileged use.

c) Documents prepared for audits to substantiate positions taken on tax returns are not privileged because the preparation of tax returns and substantiating those returns is not considered to be the practice of law.

1. Analysis of law, however, is legal work even if done for an audit.

2. Information can become so intertwined with legal advice that it becomes privileged.

vii. When does Waiver of Attorney-Client Privilege arise?

a) Disclosure to a third party: deliberate or inadvertent

b) Advice of counsel defense (sword/shield)

1. The attorney-client privilege is waived when the client places an otherwise privileged tax opinion in controversy by asserting a reasonable cause defense to accuracy-related penalties.

2. In *Ad Investments 2000 Fund LLC v. Commissioner*, 142 T.C. 248 (April 16, 2014), taxpayers raised a reasonable cause defense to accuracy-related penalties imposed on a Son-of-BOSS tax shelter transaction. The Service sought to compel the production of six opinion letters issued by Brown & Wood LLP, a law firm. The taxpayer argued that the partnership reasonably believed that its tax treatment of partnership items was more likely than not the proper tax treatment without relying on the tax opinions. The Service argued that the taxpayer placed the tax opinions in controversy by relying on an affirmative defense to penalties that turns on the partnerships' beliefs or state of mind.

(i) The Tax Court found that the taxpayer placed the partnerships' legal knowledge, understanding, and beliefs into contention, topics which the tax opinion may bear. The Court held that if the taxpayer is to rely on its legal knowledge and

understanding to establish reasonable cause and good faith, "it is only fair that respondent be allowed to inquire into the bases of that person's knowledge, understanding, and beliefs including the opinion." The Tax Court granted the Services' motion to compel.

viii. Exceptions to the Privilege:

a) Crime/Fraud:

1. If a client seeks advice from an attorney to assist with the furtherance of a crime or fraud or the post-commission concealment of the crime or fraud, then the communication is not privileged.

2. Query: How might this apply in the (medical) marijuana context?

- Are communications regarding forming marijuana entities and tax planning in furtherance of a crime because marijuana is illegal under federal law?
- Are these communications privileged or do they lose the privilege?

b) Common Interest

1. In example – Joint Defense Agreements, supra

c) Breach of Duty

1. Malpractice

d) Fiduciary Duty

1. An exception to the privilege has been carved out when the corporation's shareholders wish to pierce the corporation's attorney-client privilege.

e) Deceased Client. The privilege, which transfers to the personal representative, may be waived upon the death of a testator-client if litigation ensues between the decedent's heirs, legatees or other parties claiming under the deceased client.

f) Tax Return Preparation. Tax return preparation services rendered by an attorney are not protected by the attorney-client privilege because these services are akin to accounting services as opposed to giving legal advice.

1. Taxpayers cannot immunize their tax returns by having them prepared by a lawyer instead of an accountant.

B. Privilege v. Duty of Confidentiality

i. Duty of Confidentiality. The duty of confidentiality places ethical restrictions on a lawyer's disclosure of information relating to the representation of the client.

a) Almost every state's ethics rules are based on the ABA Model Rules of Professional Conduct. Model Rule 1.6 sets forth the parameters of the duty of confidentiality.

ii. Attorney-Client Privilege. The evidentiary principle of the attorney-client privilege is usually a creature of common law. If the privilege applies to a communication, disclosure of that communication cannot be compelled.

iii. Comparison: The duty of confidentiality and the attorney-client privilege are similar but they are not the same. A lawyer may have a duty of confidentiality with regard to information about his or her representation of a client, but because the information is not a part of a confidential communication, it does not benefit from the protection of the privilege. A court could compel the client or the lawyer to disclose that information.

a) Think in terms of:

1. Nondisclosure/confidentiality agreements; and

2. Specific information regarding a client's case which is discussed with a tax authority (as it is being discussed with the opposing party, it is clearly not privileged). However, the client certainly does not expect much, if any, of their "private" matters to be discussed with anyone who does not have a "need to know".

C. Attorney-Work Product

i. Generally

a) Federal Rules of Evidence ("FRE"), Rule 502(g)(1):

1. "Work-product protection" means the protection that applicable law provides for tangible material (or its intangible equivalent) <u>prepared in anticipation of litigation or for trial</u>.

a. It essentially provides document-based protections.

b) Federal Rules of Civil Procedure ("FRCP") Rule 26(b)(3):

1. [A] party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) … and prepared in anticipation of litigation or for trial by or for another party … 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 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

c) Purpose: An attorney should not be able to obtain an unfair advantage by "peering into the adversary's thoughts and analysis."

1. Although some courts (and many practitioners) refer to it as one, the attorney work product doctrine is not a privilege. Unlike the attorney-client privilege, its purpose does not lie in protecting confidential communications; rather, its purpose is to encourage lawyers to prepare thoroughly for litigation without fear of being forced to aid an adversary at the expense of the 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 through no fault of the lawyer or the client.

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

ii. Elements:

a) Test under FRCP 26(b)(3).

1. Documents and tangible things;

2. Prepared in anticipation of litigation or for trial;

3. By or for a party (or by or for the party's representative).

Note that the protection extends beyond just the work prepared by the attorney to work prepared by the client and the client's employees, agents, etc., at the direction of the lawyer

c) The privilege extends beyond attorney-created documents

1. The rule contemplates two types of work product: (i) factual and (ii) opinion or "core" work product. Under unusual circumstances, factual work product is discoverable as described in the above-quoted Rule (FRCP 26(b)(3)). By comparison, opinion work product "enjoys a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances." (*In re Murphy*, 560 F.2d 326, 336 (8th Cir. 1977).)

iii. Anticipation of Litigation. Because the doctrine promotes the adversary system by safeguarding the fruits of an attorney's trial preparation, and not a confidential

relationship, disclosure to a third party which is not inconsistent with maintaining secrecy against opponents is not a waiver.

a) Circuit Court Split:

1. Majority

(i) A document is privileged if it was prepared "because of potential or anticipated litigation." (*United States v. Adlmani*, 134 F.3d 1194 (2d Cir. 1998)

2. Minority

(i) A document is privileged if the primary motivating purpose for preparing the document is preparation for litigation. (*U.S. v. El Paso Co*., 682 F.2d 530 (5th Cir. 1982).)

iv. Waiver of Work Product Privilege. 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. 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

a) Test: Was the document disclosed to an adversary or conduit to an adversary?

1. If yes, there is a waiver of the work-product privilege.

b) Does disclosure to a financial auditor waive work product protection?

1. See *U.S. v. Textron, Inc*. 577 F.3d 21 (1st Cir. 2009): in responding to an IRS summons for documents, the company withheld and redacted attorney-created materials under a claim of work product protection, even though the materials had been shared with the company's auditor. Because the rule for attorney-client privilege is that waiver occurs when the material is shared with any third person, the exchange with the company's auditor effected a waiver of that privilege. By contrast, because the rule for work product protection is that waiver occurs when confidential material is shared with an adversary or a conduit to an adversary, the work product protection was not waived, because the auditor was actively engaged in evaluating the tax issues for the company with the lawyers, it was not an adversary.

D. Accountant-Client Privilege

i. Generally

a) Intended to protect communication regarding Federal tax advice between both tax advisors and taxpayers (as if the tax advisor was an attorney), IRC § 7525(a)(1) is a statutory privilege enacted by Congress in 1997:

1. "With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any "federally authorized tax practitioner" to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." (IRC § 7525(a)(1).)

2. "Federally authorized tax practitioner" means any individual who is authorized under Federal law to practice before the Internal Revenue Service ("IRS") if such practice is subject to Federal regulation under section 330 of title 31, United States Code. For example, the term includes certified public accountants ("CPAs") and enrolled agents. (IRC § 7525(a)(3)(A)).

3. It incorporates federal common law of attorney-client privilege into the non-attorney tax advisor context

4. There can be a waiver of the privilege

5. It's a very weak privilege compared to the attorney-client privilege

ii. Limitations:

a) IRC § 7525 applies to any noncriminal tax matter before the IRS and noncriminal tax proceeding in Federal court brought by or against the United States.

PRACTICE POINT: Consequently, if a taxpayer meets with his or her accountant and divulges information that may amount to a criminal offense, there is no privilege and the best course of action is for the accountant to advise the taxpayer to stop talking and seek competent tax counsel. Otherwise, the accountant can become a witness for the government. (IRC § 7525(a)(2)).

1. Distinguish criminal defense work from (Marijuana Tax & Business Planning) planning

b) IRC § 7525 Privilege does not apply to:

1. Criminal proceedings

2. Civil litigation

3. State tax matters:

(i) Consider the consequences where the Franchise Tax Board ("FTB") initiates an audit and shares information with the IRS.

(ii) See California Revenue and Taxation Code § 7099.1(a)(1), which extends attorney-client type privilege to communications between federally authorized tax practitioners and clients. It only applies in noncriminal tax matters before the FTB, and does not apply to matters involving tax shelters.

4. Non-tax regulatory investigations

5. Written communications in connections with the promotion of an IRC § 6662 "tax shelter"

c) IRC § 7525 does not provide work product protection

iii. Case examples:

a) *United States v. Frederick*, 182 F.3d 496 (7th Cir.1999), was the first case to address the tax practitioner privilege. The *Frederick* court took IRC § 7525 into account in concluding that, because the audit services rendered by the lawyer would not have qualified for the attorney-client privilege before enactment of the new privilege, the new privilege would not apply to the audit services rendered. (*Frederick*, 182 F.3d at 502.) Therefore, any information included in the documents involved in preparation of a tax return or involved in verification of a tax return during audit may lose either the attorney-client privilege or the new tax practitioner's privilege.

b) Burden is on the IRS to establish that the "tax shelter" exception applied. *United States v. BDO Seidman LLP*, 492 F.3d 806 (2007)

1. IRS could not demonstrate that handwritten notes were "written communications," or that written minutes were in connection with the promotion of a tax shelter. *Countryside Limited Partnership v. CIR*, 132 T.C. 347 (2009)

2. "Tax shelter" exception applied to portion of documents sought in summons. *Valero Energy Corp. v. United States*, 569 F. 3d 626 (7th Cir. 2009).

II. Defenses That Avoid Waiver

A. Selected "Limited" Waiver

i. Generally, voluntary disclosure of a privileged communication to a third party will destroy the attorney-client privilege

a) See *Diversified Industries v. Meredith*, 572 F.2d 596 (8th Cir. 1978 en banc) where they adopted the theory of "selective waiver" related to voluntary disclosure of otherwise privileged material to government agencies

1. Relying on the theory of selective waiver, corporations have subsequently divulged privileged information to the government with the expectation that the corporation could still assert the privileges as to private litigants

2. Few federal appellate courts have upheld the theory of selective waiver

b) Exceptions (a case-by-case analysis):

1. In *In re Steinhardt Partners, L.P.*, 9 F.3d 230 (1993), the 2nd circuit acknowledged that a voluntary disclosure could be protected as a selective waiver if the disclosing party and the government enter into an explicit confidentiality agreement

2. But see *United States v. Massachusetts Institute of Technology*, 129 F.3d 681 (1st Cir. 1997) (selective waiver doctrine does not apply where the existence of a confidentiality agreement would not have made a difference on disclosure of documents to the government and they would have had to be disclosed anyways)

B. *Kovel* Agreements

i. Generally

a) *Kovel* agreements are named after the case *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961) – involving communications between an attorney and an accountant.

b) Under limited circumstances, the attorney-client privilege may extend to cloak communications involving third party experts.

c) Factors:

1. Expert works under the attorney's direction and control;

2. Work papers and documents are the attorney's property; and

3. Attorney pays the bill.

4. The purpose of the third party expert is to assist the attorney in rendering legal advice to the client. Thus, experts engaged by an attorney to assist in rendering tax advice and representation to a taxpayer fall under the attorney-client privilege.

(i) *Kovel* recognizes that the inclusion of a third party in attorney-client communications does not destroy the privilege if the purpose of the third party's participation is to improve the understanding of the communication between the attorney and client.

5. There needs to be a written engagement letter in place between the expert and the attorney setting forth the terms of this engagement.

(i) Is this a requirement or a precaution?

a. IRS opinion?

b. Is there a more strict standard in the criminal context? See *United States v. Hatfield*, No. 06-CR-0550 (E.D.N.Y. Nov. 13, 2009), holding that even though the law firm had an engagement letter with a consulting firm at one point, circumstantial evidence indicated that the engagement terminated and future services for the client by the consulting firm were not afforded any privilege even though the attorney was a party to those communications between the client and the attorney.

(ii) The work must be for the purpose of rendering legal advice, not simply for the preparation of tax returns.

(iii) State the purpose of the engagement (and that any communications to the expert are made solely for the purpose of enabling the attorney to provide legal advice to the client).

ii. What sorts of experts can *Kovel* Agreements protect?

a) In addition to protecting communications with CPAs, they can protect communications with other experts who act as the attorney's agent.

1. Public relations firms (*In re Copper Market Antitrust Litigation*, 200F.R.D.213 (S.D.NY. 2001))

2. Appraisers.

(i) But see *United States v. Richey*, 632 F.3d 559 (9th Cir. 2011) holding that:

a. Because the appraiser was retained by a lawyer to assist with the appraisal of the conservation easement, the attorney-client privilege did not extend to the entire appraisal file -- any communication relating to the preparation and drafting of the appraisal for submission to the IRS was not made for the purpose of providing legal advice, but, rather, for the purpose of determining the value of the easement; and

b. The appraisal file was not protected by the work-product doctrine because the appraisal was not prepared in anticipation of litigation.

(ii) IRS opinion?

b) But see *United States v. Ackert*, 169 F.3d 136 (2d Cir. 1999). Circuit Court held that conversations between an investment banker and an in-house attorney were not privileged. Court would not extend *Kovel* because, rather than translating or interpreting communication between the attorney and the client, the banker was simply providing factual information about a transaction to the attorney.

C. Joint Defense Agreements

i. Generally

a) Sometimes referred to as the "common interest doctrine" or "common interest privilege," the Joint Defense Doctrine preserves the attorney-client privilege, despite disclosure of the privileged information to third parties, when a client shares privileged communication among parties with common interest.

b) The doctrine emerged in the context of a criminal defense, but has expanded to include parties in both civil and criminal matters.

ii. Common interest privilege requirements:

a) The underlying communication is privileged;

b) The parties disclosed the communication in the course of a joint defense effort;

c) The parties shared a common legal interest;

d) The parties have not waived the privilege.

iii. The Doctrine does not apply when parties share only a common business or commercial interest. ***[Distinguish "joint defense"]***

iv. What is "common interest"?

a) Courts have not uniformly defined the boundaries of "common interest"

1. Some courts require "identical" legal interest. (see e.g., Delaware)

2. Other courts do not require a complete unity of interests among the participants. (See, e.g., California, Florida)

b) Courts are not in agreement whether the common interest doctrine can apply absent anticipated or pending litigation (an element required under the work product doctrine).

v. *United States v. BDO Seidman LLP*, 492 F.3d 806 (7th Cir. 2007). BDO asserted privilege over a memorandum sent to Jenkens & Gilchrist who did not represent BDO. Jenkens & Gilchrist jointly serviced tax clients with BDO on the same or related transactions. No formal joint defense agreement was entered into.

a) The Seventh Circuit concluded that BDO and Jenkens shared a common legal interest because they were acting as joint ventures to defend their tax products. The Court further found that BDO shared the document with Jenkens so that they could coordinate a "common legal position that BDO and Jenkens would communicate later to common clients." The Court ruled that the communication did not need to be made in anticipation of litigation.

D. Non-Disclosure/Confidentiality Agreements with the IRS

i. What scenarios do these arise in? How often does this happen?

a) A potential scenario is when the taxpayer and the IRS enter into a settlement agreement which limits disclosure by the taxpayer and the IRS of the settlement terms. Can these settlement terms later be used against the taxpayer under the guise of waiver in other proceedings?

III. Best Practices for IRS Examinations

A. Pre-examination

i. Preserving the Privilege in the Corporate Setting

a) *Upjohn Co. v. US*, 449 U.S. 383 (1981)

1. Attorney-client privilege can extend beyond communications with individuals capable of controlling a corporation to communications of lower-and middle-level employees.

b) Confidentiality

1. Confidentiality – avoid any action inconsistent with the confidential nature of the communication.

2. Privilege waived where disregard for confidentiality. See *Coastal States Gas Corp. v. Department of Energy*, 617 F.2d 854 (D.C. Cir. 1980) (circulation within the Department of Energy of audit memoranda produced during compliance audits).

3. Confidentiality maintained no privilege waiver. See *FTC v. GlaxoSmithKline*, 294 F.3d 141 (D.C. Cir. 2002) (clear admonitions not to further disseminate information was sufficient).

c) "Need to know" standard

1. Need to know -- keeping distribution to designated group within the corporation

ii. Establishing Work Product

a) The key element is creation in anticipation of litigation.

b) Memorialize litigation-oriented aspects of document

c) Counsel involvement/oversight in creation of document

iii. Work Product and Duty to Preserve

a) Duty to Preserve Generally

1. The duty to preserve documents and the penalty for failure to do so, i.e., spoliation, are defined by the courts.

(i) *Consolidated Edison Co. of N.Y. v. United States*, 90 Fed. Cl. 228 (Fed. Cl. 2009), ("Sanctions for spoilation arise out of the court's inherent power governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases."), *reversed and remanded on other grounds*, 703 F.3d 1367 (Fed. Cir. 2013).

2. The duty to preserve arises when litigation is reasonably anticipated:

(i) "While a litigant is under no duty to keep or retain every document in its possession, once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a litigation hold to ensure the preservation of relevant documents." *Adorno v. Port Auth. of New York and New Jersey*, 258 F.R.D. 217, 227 (S.D.N.Y.2009).

b) Special considerations in tax cases?

1. Burden of proof always on taxpayer

(i) The IRC requires maintenance of relevant records supporting return positions. Failure to maintain such records can result in the imposition of a negligence penalty under IRC §6662.

2. The Government can ask for a finding that missing documents are adverse to the taxpayer.

3. Intentional destruction of relevant documents outside the normal record retention policy raises other issues such as fraud, concealment and obstruction of justice.

iv. Protecting Work Product in Financial Audit

a) Generally

1. Keep a record regarding the purpose of meetings with outside auditors and their intention to discuss litigation evaluations as part of their meeting agenda

2. Supplement existing ethical requirements of confidentiality for accountants regarding their attest client files with a specific agreement between the client and auditor setting forth conditions of confidentiality

3. Request that the auditor segregate from its own audit workpapers work product documents received from the company

4. Request that any use of such work product in the audit workpapers be specifically identified to the company

B. During the examination

i. Maintain rigorous document review and scrutiny

ii. Evaluate whether you can make a good faith argument for privilege

iii. Not everything which involves counsel is necessarily privileged

iv. Simply copying counsel on an email does not protect the document unless the purpose is to engage counsel for legal advice

v. Maintain/create an adequate privilege log

vi. Documents created during the audit to assist in defense of the audit can be work product/privileged

IV. Alternative Methods for Document Production

A. Generally

i. The point is to preserve privilege and protections while at the same time satisfying the IRS with its request for information

ii. What to do when potentially privileged documents are implicated by an IDR?

a) Assert all bona fide privileges and protections and, if needed, prepare a privilege log

1. IRS input: Typically at audit stage, a revenue agent without legal training will not require a privilege log. It might be insisted upon by IRS counsel if they are assisting in audit which is more typical in Large Business/International cases.

a. For example, IRS counsel will likely become involved in any audits stemming from the Panama Papers fiasco because they are high profile cases.

iii. Alternatives to producing documents

a) Persuade IRS that it is not necessary for them to evaluate the issue

b) Provide fresh analysis

c) Provide redacted documents