THE NEW FEDERALLY AUTHORIZED TAX PRACTITIONER PRIVILEGE

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The New Federally Authorized Tax Practitioner Privilege.


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

2. Workpapers Also Not Protected. Thus, the IRS may inspect an independent auditor's confidential tax-accrual workpapers. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). (Before the Supreme Court rendered its opinion, the IRS revised the Internal Revenue Manual to provide that tax-accrual workpapers could be summoned only in unusual circumstances and only after the revenue agent had failed to obtain the requested information from the taxpayer. INTERNAL REVENUE MANUAL 4024.4. The Supreme Court was aware of the change. 465 U.S. at 821 n.17.

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

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

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


**B. The New Law: Code Section 7525.**

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

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

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

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

3. **Definitions.**

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

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

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

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

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**Obvious Limitations of Section 7525.**

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

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

   a. Query: Are state and foreign tax matters automatically excluded by this definition?

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

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

   a. **Non-Criminal.** The statute is specifically inapplicable in criminal proceedings before the Internal Revenue Service and in criminal proceedings in a Federal Court.

   b. **Bankruptcy Covered?** Bankruptcy is not a non-criminal federal court matter “by or against the United States” until an adversary proceeding is filed.
c. **All Bankruptcy Covered?** Does the new provision cover all bankruptcy cases in which the United States is a party, or just cases in which a determination of tax liability is involved?

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

   a. **Ambiguous At Best.** Although reference is made to Section 6662, the definition of tax shelter in that section is far from precise. See discussion below regarding unresolved issues.

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

5. **Tax Return Preparation Not Covered.** The privilege for tax advice is the same as if the professional were an attorney. This means, among other things, that the privilege does not ordinarily attach to the preparation of tax returns or to other areas where a communication would not be privileged even if made to an attorney. Federal courts have denied attorney-client privilege to tax return preparation work on different grounds.

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

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

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

A. **Dual Purpose Representation.** The Seventh Circuit has ruled that dual purpose documents are not privileged. Judge Posner’s opinion also noted that documents created by a lawyer-accountant representing clients on audit are not privileged. *U.S. v. Frederick*, 83 AFTR2d ¶99-686 (7th Cir. 1999).

**Unresolved Issues.** Section 7525 leaves many questions unanswered that no doubt will spawn considerable litigation.

1. **Catch 22.** Can accountants (or even attorneys working within accounting firms) advise clients on the issue of whether the privilege applies to them? Since the privilege provision will be in the Internal Revenue Code, maybe it is considered to be tax advice, but advice about the applicability of a privilege generally has been considered to be legal advice beyond the purview of accounting work. Moreover, the scope of the privilege generally depends upon interpretation of state common law, which again is outside of the accounting field.

2. **Waiver of Privilege.** Section 7525 means that the waiver doctrine will be revisited in connection with the assertion of the privilege in tax cases.

   a. **Prior Disclosures to Government Agencies.** Disclosure of privileged information to another federal agency certainly would constitute a waiver in the Government’s view. But what if that disclosure were compelled by law?

   b. **Compelled Disclosure to SEC.** Publicly traded corporate taxpayers often must make tax accrual workpapers available to the SEC. *e.g.*, *Genentech, Inc. v. Internat’l Trade Comm’n*, 122 F.3d 1409 (Fed. Cir. 1997); *In re Steinhardt*

c. **Involuntary Waivers.** Choosing to become a government contractor also might result in waiver of tax information. See United States v. M.I.T., 129 F.3d 681 (1st Cir. 1997) (disclosure of lawyer’s billing records to Defense Department for contract audit waived attorney-client privilege for IRS record request).

4. **Civil v. Criminal.** The inapplicability of the privilege in “criminal matters” will require a determination of when an otherwise civil tax dispute becomes a criminal matter. Often an agent has made a determination to refer a matter to the Criminal Investigation Division but continues to work on the case until formal referral is made. A practitioner advising a client in this circumstance will be at risk to reveal communications that occur after the matter becomes “criminal.”

a. **The La Salle National Bank Issue Again.** Special agents have duties to investigate both criminal and civil liabilities. Is it automatically a criminal matter if a special agent is involved? La Salle National Bank indicates that a matter is not criminal until there is an institutional referral to the Department of Justice, which provision has been adopted in Code § 7602(c).

b. **Reinstatement of Privilege?** Assume a criminal investigation has commenced, the practitioner has been forced to disgorge otherwise privileged information, and now the criminal case has been killed. Does the privilege reinstate itself?

5. **Work Product Covered?** Section 7525 refers only to the attorney-client privilege. No mention is made of the work product doctrine. Left unanswered is whether any work product protection exists for practitioner prepared documents that are not otherwise protected by the attorney-client extension of the privilege.

a. **Work Product as Part of Attorney Client Privilege?** In Hickman v. Taylor, 329 U.S. 385 (1947), the Supreme Court ruled that an attorney’s work product -- the mental impressions, thought processes, legal theories, and files -- developed in anticipation of litigation were generally not
discoverable. The bar on discovering these materials has come to be known as the work product privilege. Some courts and commentators have indicated that the work product privilege is a common law extension of the attorney-client privilege. If so, under Section 7525 which applies the “same common law protections of confidentiality” to communications between the federally authorized practitioner and client, a practitioner's mental impressions, thought processes, legal theories and files developed in anticipation of litigation with the U.S. should be generally exempted from discovery.

b. **Work Product Privilege?** On the other hand, some courts and commentators also view the work product privilege as a separate privilege or doctrine unrelated to the attorney-client privilege. For example, in the *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), the court referred to work product as a privilege. If so, does the new statute therefore create a work product privilege as well as an attorney-client privilege? What about documents prepared in anticipation of litigation that constitute communications between a taxpayer and counsel? The statute refers to communications, not privileges; thus arguably, these documents would be exempt from discovery.

6. **Business Advice v. Tax Advice.** Section 7525 is also limited to “tax advice.” The “gray area” dividing business advice and tax advice is still being debated by the courts in traditional attorney-client cases. Further confusion likely will develop in interpreting this new statute.

7. **Whose Privilege to Protect/Waive?** The language of Section 7525 may imply that the privilege belongs to both the client and the practitioner independently. If so, the statute has made a substantial departure from the traditional attorney-client privilege which has long been held to belong solely to the client.

8. **What is Promotion of a Tax Shelter?** The failure of the statute to explicitly define “tax shelter” and the word “promotion” will no doubt require the practitioner to determine when ordinary corporate tax planning becomes promotion of a tax shelter. Given the aggressiveness of recent corporate tax planning vehicles, the IRS likely will take a broad view of this exception to the privilege.

a. **Shelter Definition.** A tax shelter is defined under Section 6662 as any partnership, entity or plan "a significant purpose
of which is the avoidance or evasion of income tax.” The Taxpayer Relief Act of 1997 replaced the words “the principal purpose” with the words “a significant purpose.” Section 6662(d)(2)(C)(iii).

b. Narrow Interpretation. Senator Connie Mack during the debate of the conference report stated that Congress intended for the IRS to narrowly interpret the exception from the privilege for communications regarding tax shelters.

The amendment was meant to target written, promotional and solicitation materials used by the peddlers of corporate tax shelters. But [it] appears to me to be vague and unfortunately employs ambiguous definition of tax shelter that some argue could be read to include all tax planning. The language of the conference report, however, could be interpreted in a manner which does not fully reflect our understanding and thus undermines the intended benefit to taxpayers. This is an item we will have to address at the soonest possible instance, in the next tax bill.

Senator Mack has indicated that if there is another tax bill in 1998, he will push for clarification of the tax shelter exception.

c. “Promotion”. The “promotion” language probably means activities undertaken in the solicitation and marketing phase of a tax shelter.

(i) Must an idea be offered through syndication to multiple investors in order to be “promoted” or be a tax shelter?

(ii) Is promotion limited to activities before the taxpayer has engaged the advisor?

(iii) Once a corporation has made the decision to invest in a shelter, subsequent communications probably are protected, because they are not in connection with the promotion of participation in the shelter. Others have argued that if you contact the client with promotional
materials and then subsequently provide a tax opinion, the opinion probably is not privileged.

d. **Routine Advice Still Privileged?** The Conference Report carefully stated that the conferrees “do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client.” Many would like the “routine relationship” language clarified to make clear it covers rendering tax planning advice, including making tax savings recommendations, so long as they are not written communications to promote the purchase of a tax shelter.

e. **Independent Advice Should be Protected.** Conference members apparently wanted to protect communications of a taxpayer under examination for involvement in a shelter who then sought the advice of an accounting firm that did not promote the shelter.

(i) What if a corporate taxpayer solicits a risk analysis memo from his own accounting firm relating to a product promoted by another accounting firm or an investment bank?

(ii) Accounting firms are left without much guidance on whether their risk analysis memos will be protected.

9. **Procedural Problems.** Many procedural hitches exist as a result of the new privilege.

a. **Summons Enforcement.** District courts will have to determine if something is a corporate tax shelter in order to decide summons enforcement actions in which the tax practitioner privilege is raised to prevent compelled production of promotional materials.

b. **Compelled Disclosures.** Should the privilege extend to a coerced disclosure, such as a disclosure in a civil state court proceeding?

10. **Ambiguities in the Attorney/Client Privilege.** We can all recite the attorney-client rule, but we often disagree whether the facts fit the rule. The new law just adds a level of complexity to an already unclear area of the law.

11. **Conflicts Between the New Statutes?** How might the requirement that a taxpayer cooperate with the IRS investigation in order to shift the burden of proof conflict with the existence of a
privilege in the information communicated with the tax advisor? Will courts hold that the failure to produce information that is privileged fails the cooperation tests and leave the burden of proof on the taxpayer?