

Properly Shielding Information/Documents From Tax Authorities

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In recognition of the federal and state tax authorities' ramping up their tax enforcement efforts over the past years by more aggressively utilizing their Summons and Subpoena powers/tactics, a review of the current law, as well as legitimate strategies to protect a client's transactional tax memoranda/analysis (ex. tax accrual workpapers, tax opinions etc.) is both timely and worthwhile.

At the outset, notwithstanding the First Circuit's setback in United States v. Textronic, Inc., 577 F.3d 21 (1st Cir. 2009) cert. denied 130 S. Ct. 3320 (2010) holding that tax accrual workpapers were not protected against disclosure to the IRS by the work product doctrine, the work product doctrine (which protects documents prepared in anticipation of litigation from compelled disclosure) is alive and well based upon subsequent Court precedent as it relates to tax accrual workpapers, and together with the utilization of the so-called "Kovel" accountant concept and the IRC §7525 tax practitioner privilege can play a critical role in tax defense litigation.

More specifically, in Schaeffler v. United States, 806 F.3d 34 (2d Cir. 2015) the Second Circuit recently rejected the Textronic work product doctrine reasoning and strongly affirmed its prior decision in United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998) and reversed a District Court decision denying a taxpayer's petition to quash an IRS summons served on the taxpayer's CPAs for memoranda identifying potential U.S. tax consequences of transactions and possible IRS challenges to the taxpayer's tax treatment of these transactions.

The Second Circuit decision in Schaeffler is significant primarily because it held the tax memoranda were protected because it was in fact geared to the high likelihood that the transactions would lead to litigation (including anticipation of a dispute with the IRS at the administrative level), and that it was therefore entitled to work product protection even if it was also created to assist in these transactions themselves. In addition, it demonstrates that the common legal interest doctrine can protect waiver of attorney client privilege when transaction tax analysis is shared between parties so long as they share a common legal interest.

The Schaeffler decision is also significant because of its strong affirmation of its prior decisions in Adlman and United States v. Kovel, 296 F.2d 918 (2d Cir. 1961). Those holdings should serve as reminders to tax defense counsel of the importance of protecting disclosure by utilizing the so-called Kovel type of accountant technique to extend attorney client privilege to cover such an accountant's analysis and work product and keep it out of the IRS' reach since the Kovel case holds that the attorney-client privilege covers communications with an accountant hired by an attorney to assist the attorney in providing legal advice to the client.

Furthermore, although not directly related to the Second Circuit’s Schaeffler ruling, it is also important for tax defense counsel to consider the altered privilege landscape which came into play with IRC §7525. While strictly circumscribed, the tax practitioner privilege concept may be useful when needed, and should not be overlooked when constructing legal arguments to shield from disclosure federal tax advice type communications between an accountant and a client. Of course, it is important to recognize that section 7525 provides that it can be asserted only in non-tax shelter type matters and non-criminal tax matters before the IRS or non-criminal tax proceedings in federal court brought by or against the United States. Thus, it is not useful in criminal tax cases, state proceedings, or with regulatory bodies other than the IRS. Furthermore, it doesn’t apply to business or investment advice and can be waived if confidentiality is not maintained.

Lastly, best practices dictate that in order to obtain work product protection for tax accrual workpapers it must be established that such analysis/documentation were prepared for and at the direction of an attorney.

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