PIERCE THE PRIVILEGE OR GIVE 'EM SHELTER? THE APPLICABILITY OF PRIVILEGE IN TAX SHELTER CASES

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I. INTRODUCTION

Over the past few years, the United States Internal Revenue Service (IRS), supported by the other parts of the Treasury Department and occasionally impelled by Congress, has developed and employed increasingly effective tools for identifying and challenging tax-advantaged transactions entered into by corporations and high income individuals. These transactions, known as "tax shelters," typically promoted to the taxpayer by accounting firms, law firms or financial institutions, rely on aggressive interpretations of tax laws to minimize, defer or avoid U.S. federal income tax.[1]

Not all tax shelters are abusive. Some tax shelters, such as investments in low-income housing, are completely legitimate.[2] According to the IRS, "abusive tax shelters exist solely to reduce taxes unrealistically," and "involve transactions with little or no economic foundation."[3] These explanations leave plenty of room for creative interpretation and manipulation by tax shelter promoters. Specifically, the IRS is targeting tax strategies that are "aggressive, abusive transactions that follow the letter of the law, but don't pass the smell test."[4] As a result, the IRS has used its authority to wage war on abusive tax shelters. In response, taxpayers and advisors have asserted numerous privileges, including the Federally Authorized Tax Practitioner (FATP) and "identity" privileges, in their defense and refusal to give up their clients.

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[1] One definition of "tax shelter" is: (I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity plan, or arrangement is the avoidance or evasion of Federal income tax. I.R.C. § 6662(d)(2)(C)(iii) (2004). The term "tax shelter" may also mean any investment:

> (A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and (B) which is (i) required to be registered under a Federal or State law regulating securities, (ii) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities, or (iii) a substantial investment. I.R.C. § 6111(c)(1)(A)-(B) (2004).

[2] Elizabeth Austin, *Client Privilege Comes Under Heightened Scrutiny*, CHI. LAW., Oct. 2003, at 34.

[3] *Id.*

[4] *Id.*

Part II of this Note describes the IRS's tools used to attack tax shelters, its recent trends in information gathering and the relevant privileges asserted in opposition to the government's attempts to obtain certain information. Part III analyzes recent high-profile cases addressing these tax issues (including the § 7525 FATP and identity privileges), some collateral effects of these decisions and events, and concludes by recommending that the § 7525 tax practitioner privilege and the identity privilege (as contained in both the § 7525 privilege and the attorney-client privilege) should be abolished in tax shelter cases.[5]

II. Background Facts and Legal Doctrine

A. *The Government's War on Tax Shelters*

The IRS initially issued temporary and proposed regulations regarding disclosure and list maintenance for tax shelters on February 28, 2000. Under these initial temporary regulations, the Treasury was dissatisfied with the minute number of reported transactions. The government believed that certain taxpayers and their advisors were interpreting the tax laws narrowly and the exceptions broadly as a means to avoid disclosure of tax shelters.[6] As a result, the IRS issued temporary regulations that modified the disclosure and list maintenance rules.[7] These regulations aim to accomplish two goals: (1) they define which transactions are subject to the reporting, registration and list maintenance obligations; and (2) they establish how such transactions must be reported, registered and placed on investor lists.[8] Various provisions of the Code also address these issues and provide the IRS with the means to attack tax shelters, which the government has utilized in its recent information-gathering efforts.[9]

1. *Three Primary Tools Used by the IRS To Attack Shelters*

The government employs three main tools in its battle against abusive transactions: (1) enforcement of reporting, registration and list maintenance obligations; (2) application of settlement programs, litigation resources and penalties; and (3) broad summons power to expose individuals and organizations.

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[5] A recent Tax Notes Article noted that the sixth edition of the *Standards of Tax Practice* covers various new rules providing attorneys with greater latitude in disclosing client confidences to protect continuing harm to others and reviews the emerging case law under § 7525. The book also analyzes important recent precedents (many of which are discussed here) concerning the attorney-client scope and § 7525 privileges. Kenneth W. Gideon, *Standards of Tax Practice*, TAX NOTES, Sept. 27, 2004, at 1573.

[6] T.D. 9017, 67 Fed. Reg. 64799, 64800; *see also* James A. Doering, *The Final Disclosure and List Maintenance Tax Shelter Regulations*, TAXES, May 1, 2003, at 31.

[7] *See* Richard M. Lipton, *Final Corporate Tax Shelter Disclosure and List Maintenance Regulations Impose Burdens on Everyone*, J. TAX'N, March 2003, at 133.

[8] George M. Clarke & Robert S. Walton, *What the US War on Tax Shelter Transaction Means*, INT'L TAX REV., Sept. 1, 2003, at 2.

[9] *See, e.g.*, I.R.C. §§ 6111, 6112 and 7602 (2004).

a. Enforcement of Reporting, Registration and List Maintenance Obligations

Many taxpayers believe the modified reporting, registration and list maintenance rules, which were finalized March 4, 2003, are invasive and hard to navigate even for regular transactions. However, on December 29, 2003, the IRS and Treasury issued new final rules significantly reducing the circumstances under which confidential tax transactions must be reported to the IRS.[10]

The rules relate to the disclosure of potentially abusive tax shelter transactions by certain taxpayers on their federal income tax returns under Internal Revenue Code (IRC or Code) Section 6011.[11] As particularly relevant in tax shelter cases, IRC § 6111 requires the registration of tax shelters and § 6112 requires organizers and sellers of potentially abusive tax shelters to keep lists of their investors. In addition to the disclosure rules, the IRS modified the rules relating to the preparation, maintenance and furnishing of lists of persons in potentially abusive tax shelters under IRC § 6112.

The heart of the reporting obligation is Treasury Regulation § 1.6011-4(b), which provides six categories of "reportable" transactions: (1) listed transactions; (2) confidential transactions; (3) transactions with contractual protection; (4) loss transactions; (5) transactions with significant book-tax difference; and (6) transactions involving a brief asset holding period.[12] Failure to report could be a factor that the IRS considers in either the application of the negligence penalty under § 6662(b)(1) or the reasonable cause and good faith exception under § 6664.[13]

With regard to registration, promoters and organizers are required to register two types of transactions: (1) confidential corporate tax shelters; and (2) transactions that satisfy the "tax-shelter-ratio" test.[14] To be a confidential corporate tax shelter, three criteria must be met: (i) a significant purpose of the transaction was the avoidance or evasion of U.S. Federal income tax; (ii) the transaction was offered under conditions of confidentiality; and (iii) the tax shelter promoters received fees in excess of $100,000 from the transaction.[15] However, in order to circumvent this regulation, many tax shelter promoters eliminated confidentiality provisions.[16]

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[10] T.D. 9108, 68 Fed. Reg. 75128 (Dec. 30, 2003). For discussion of the new rules, see 72 U.S. LAW WEEK 2382 (Jan. 6, 2004).

[11] On August 8, 2003, the Tax Executive Institute (TEI) made suggestions for improving the disclosure rules that would narrow the scope of the definition of reportable confidential transactions and narrow the scope of taxpayer reporting obligations, thereby making the rules more efficient for taxpayers and the IRS to apply. *TEI Offers Suggestions for Improving Confidential Transaction Regulations*, TAX MGMT. WEEKLY REPORT, Aug. 18, 2003, at 1323.

[12] *See* Doering, *supra* note 6, at 32-3 for a detailed discussion of each of the six reportable transactions.

[13] Clarke & Walton, *supra* note 8, at 3.

[14] *Id.* at 4. It is important to note that there are different penalty targets under the Code. For example, failure to maintain investor lists will result in penalties for the promoter and IRC § 6662 imposes accuracy-related penalties on the taxpayer for portions of underpayments of tax required to be shown on a return.

[15] I.R.C. § 6111(d).

[16] Clarke & Walton, *supra* note 8, at 5.

Similarly, the "tax-shelter-ratio" test has proven to be an ineffective tool for attacking corporate tax shelters. Pursuant to Treasury Regulation § 301.6111-2(b)(2), any transaction that is listed under Treasury Regulation § 1.6011-4(b)(2) has the necessary "significant purpose" to satisfy the first prong of this test, but a non-listed reportable transaction must be registered only if it "has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction."[17] This test was clearly designed to combat conventional tax shelter investments wherein taxpayers invest in highly leveraged partnerships or trusts in exchange for deductions and credits generated largely by non-recourse indebtedness. However, this test does not efficiently affect many of the modern tax-advantaged transactions.[18]

Treasury Regulation § 301.6112-1 imposes an obligation on any organizer and promoter of potentially abusive tax shelters to maintain a list of participants in such transactions (along with other information pursuant to Treasury Regulation § 301.6111-1(a)). Any transaction that must be reported under Treasury Regulation § 1.6011-4 or registered under Treasury Regulation § 301.6111-2 gives rise to a list maintenance obligation under IRC § 6112 and Treasury Regulation § 301.6112-1. Nonetheless, only a "material advisor" will be considered an organizer or promoter for these purposes. A material advisor is any person who has a registration obligation under IRC § 6111 or receives or expects to receive a minimum fee and makes a "tax statement" with respect to a reportable transaction.[19]

The list maintenance regulations require the preparation of lists for the same transactions that must be disclosed. By aligning the rules for disclosure and list maintenance, the government hopes to obtain multiple sources of information about the same questionable transactions.[20] Although the regulations provide procedures for claims of privileged communications, the scope of the privilege continues to be contested, as will be discussed later in the Note.

b. Application of Settlement Programs, Litigation Resources and Penalties

Once the IRS gathers information through reporting, registration, and list maintenance provisions, it has a choice: resolve the tax treatment of the discovered transactions administratively or litigate the resulting disputes in court. With respect to tax shelter settlement opportunities, the IRS outlined a program to allow taxpayers to disclose transactions, thereby precluding the application of accuracy-related penalties.[21]

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[17] *Id.* at 4-5; *see also* Treas. Reg. § 301.6111-2(b)(3) (2004). The test is met if the aggregate amount of deductions and 350% of the credits stemming from the transaction, divided by the amount invested in the transaction, is greater than 2:1. Clarke & Walton, *supra* note 8, at 5.

[18] Clarke & Walton, *supra* note 8, at 5.

[19] A "tax statement," according to Treasury Regulation § 301.6112-1(c)(2)(iii)(A), is an oral or written relevant statement that causes the transaction to be a reportable transaction.

[20] Doering, *supra* note 6, at 61.

[21] *See* I.R.C. § 6662 (2004). This section does not include fraud penalties; it applies to the portion of any underpayment which is attributable to one or more of the following: (1) negligence or disregard of rules or regulations; (2) any substantial understatement of income

One goal of the settlement program was to inform the IRS about transactions not previously disclosed under the preceding reporting regulations.[22] As a result, a considerable number of taxpayers made the necessary disclosures under the program.[23] A second objective of the program was to gather information regarding particular taxpayers and specific transactions.[24] In order to comply, taxpayers were required to provide certain information and to waive any privilege with regard to tax opinions relating to the transactions.[25]

While the settlement programs have since expired, the IRS has implied that further settlement programs will be forthcoming.[26] However, the prior settlement programs were rigid and mandated one-sided settlements in favor of the IRS with restricted benefit to the taxpayers. Thus, it is likely that some tax shelters may be simply too aggressive for the government to entertain any settlement that involves a partial concession by the IRS.[27]

Commentators have suggested that if the IRS's settlement programs were a "carrot" to entice taxpayer compliance, then the threat of litigation is the "stick."[28] The IRS has the ability to target specific cases for litigation both to coerce compliance with the government's view of the law and to create that law through selectively choosing cases on given issues.[29] The effect of which may likely cause a change in the eagerness of taxpayers to enter into transactions that are driven in whole or in part by aggressive tax objectives.[30]

c. *Broad Summons Power To Expose Individuals and Organizations*

A third tool in the attack on abusive tax shelters is the IRS's summons power to secure compliance with the previously discussed registration and list maintenance requirements. Generally, when the IRS seeks information necessary to perform its duties, it simply asks for, and usually gets, it.[31] Sometimes, however, either the taxpayer or a third party refuses to comply with the request

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tax; (3) any substantial valuation misstatement under chapter 1; (4) any substantial overstatement of pension liabilities; or (5) any substantial estate or gift tax valuation understatement. I.R.C. § 6662(b)(1)-(5) (2004).

[22] *Id.*

[23] *Id.* The IRS has initiated over 640 tax shelter promoter investigations and has at least 430 promoter leads. Amy Hamilton & Sheryl Stratton, *IRS to Serve More Summonses, Updates Shelter Stats*, TAX NOTES, Nov. 3, 2003, at 567. The IRS has also issued at least 313 administrative summonses in 37 cases. *Id.* Approximately 100 summonses involving nine promoters have been referred to the Department of Justice for enforcement. *Id.*

[24] Hamilton & Stratton, *supra* note 23, at 567.

[25] *Id.* In addition, taxpayers electing to enter into settlement agreements with the IRS did not get the benefit of judicial review. CCH ANALYSIS OF TOP TAX ISSUES FOR 2003, 66, (George G Jones ed., 2003).

[26] Clarke & Walton, *supra* note 8, at 9. The "basis-shifting" offer expired December 2, 2002 and the "contingent liability" offer expired January 3, 2003. *See* CCH ANALYSIS, *supra* note 25, at 66.

[27] Clarke & Walton, *supra* note 8, at 9.

[28] *Id.* at 7.

[29] *Id.* at 8. The increased disclosure requirements and efficient settlement programs have allowed the IRS to pursue litigation in cases the government deems most egregious. *Id.*

[30] *Id.*

[31] *See* I.R.M. 25.5.1.4. (1999) (stating that the IRS should first ask the taxpayer for needed information); *see also* Bryan T. Camp, *Tax Administration as Inquisitorial Process and the*

for information.[32] In those cases, the government may issue a summons to obtain the desired information.

Although the government attempts to employ informal information requests, the possibility of the issuance of a summons enforcement action, authorized by IRC § 7602, is the ultimate force behind such requests. It is also the IRS's primary source of information gathering prior to trial.[33] Because the summons power is so broad, it is difficult for taxpayers to effectively challenge a summons in court.[34] Such power is consistent with administrative law generally, which typically allows wide latitude to government agencies in information gathering.[35] If anything, the IRS is afforded even more freedom than other agencies due to the fiscal imperative of revenue collection.[36]

2. *Recent Trends in IRS Information Gathering*

In 2000, the IRS revealed its attack plan for identifying and shutting down abusive tax shelters.[37] Included in this plan were proposed rules and announcements that appeared to proclaim an era of aggressive enforcement.[38] However, in 2001, the government seemed to withdraw from this stance by keeping a startlingly low profile in comparison to the aggressive position that had been anticipated.[39] Concurrently, though, the IRS heightened the standards measuring a taxpayer's belief that its tax treatment was either generally accepted or reasonable under the circumstances.[40]

By 2002, the IRS had pulled off its gloves and gotten its hands dirty when it began to pursue tax shelters with relentless determination. The government suspected that it had lost tens of billions in revenue due to abusive tax shelter activity; with tax revenue as its lifeline, the government had no choice but to fight back.[41]

There were four defining events that took place in 2002 that altered the tax shelter landscape: (1) disclosure "amnesty;" (2) stricter disclosure regulations, in which transactions that previously had attempted to avoid IRS censure by varying its structure slightly from that of "listed transactions," could no longer do so; (3) expansion of those transactions targeted by the IRS to individual taxpayers and partnerships, in addition to corporations; and (4) congressional

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Partial Paradigm shift in the IRS Restructuring and Reform Act of 1998, 56 FLA. L. REV. 1, 32 (2004).

[32] Camp, *supra* note 31, at 32.

[33] *See also* I.R.C. § 7609 (2004) (special rules as to third-party summonses).

[34] *See, e.g.*, United States v. Bisceglia, 420 U.S. 141, 145-6 (1975); United States v. Powell, 379 U.S. 48 (1964).

[35] United States v. Dalm, 494 U.S. 596, 604 (1990); Bull v. United States, 295 U.S. 247, 259 (1935) (stating that "taxes are the lifeblood of government"); *see also* Steve R. Johnson, *Reasonable Relation Reassessed: The Examination of Private Documents by Federal Regulatory Agencies*, 56 N.Y.U. L. REV. 742 (1981).

[36] *Dalm*, 494 U.S. at 604.

[37] *See* CCH ANALYSIS, *supra* note 25, at 48.

[38] *Id.*

[39] *Id.* For example, the IRS surprised observers when it eliminated one criterion for identifying a potentially abusive transaction: lack of economic substance. *Id.*

[40] *Id.*

[41] *Id.* at 47.

outrage, driven by press accounts of blatant abuses.[42] Significantly, the IRS targeted not only corporate executives, but also wealthy (and even "middle-class") individuals who sought certain tax-advantaged transactions.[43] In addition, the IRS implemented innovative information-gathering techniques as part of its battle against abusive tax shelters. For example, in a January 14, 2002 announcement, the government agreed to waive certain penalties relating to tax shelters if taxpayers consented to supply particular types of information on request.[44] It was a four-month amnesty program in which taxpayers could report shelter schemes and be immune from penalties and prosecution. Understandably, however, taxpayers' concern with such a deal is whether giving up some documents believed to be privileged also waives privilege as to other documents in the same subject-matter category. The IRS anticipated this concern and addressed it in part in the Announcement by allowing participating taxpayers to enter into agreements under which the government committed to not assert subject-matter waiver.[45]

In September 2002, the IRS declared an adjustment of its audit strategy and resources to focus on six priority areas of non-compliance with the tax laws: (1) offshore credit card users; (2) high-risk, high-income taxpayers; (3)

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42 *Id.* at 50.

43 *Id.* at 49.

44 2002-1 C.B. 304 (2002); 2002 IRB LEXIS 403 (2002); 2002-2 I.R.B. 304 (2002); Announcement 2002-2 states in pertinent part:

> [A] disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. If a taxpayer discloses any item in accordance with the provisions of this announcement before April 23, 2002, the IRS will waive the accuracy-related penalty under § 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to that item.
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> This disclosure initiative covers all items except items resulting from a transaction that (1) did not in fact occur, in whole or in part, but for which the taxpayer claimed a tax benefit on its return; (2) involved the taxpayer's fraudulent concealment of the amount or source of any item of gross income; (3) involved the taxpayer's concealment of its interest in, or signature or other authority over a financial account in a foreign country; (4) involved the taxpayer's concealment of a distribution from, a transfer of assets to, or that the taxpayer was a grantor of a foreign trust; or (5) involved the treatment of personal, household, or living expenses as deductible trade or business expenses.
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> Under this disclosure initiative, the IRS will waive the accuracy-related penalty under § 6662(b) for that portion of an underpayment attributable to the disclosed item and due to one or more of the following: (1) negligence or disregard of rules or regulations; (2) any substantial understatement of income tax; (3) any substantial or gross valuation misstatement under chapter 1 of the Code, except for any portion of an underpayment attributable to a net 482 transfer price adjustment, unless the standards of § 6662(e)(3)(B) regarding documentation are met; and (4) any substantial overstatement of pension liabilities.
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> Disclosure under this initiative does not affect whether the IRS will impose, as appropriate, any other civil penalty that may be applicable under the Code or will investigate any associated criminal conduct or recommend prosecution for violation of any criminal statute.

45 2002-1 C.B. 304; 2002 IRB LEXIS 403; 2002-2 I.R.B. 304. A recent case addressing subject matter waiver is *Long-Term Capital Holdings v. United States*, 2002 WL 31934139 (D. Conn. 2002). *See also* Robin L. Greenhouse, Michael F. Kelleher & Joshua D. Odintz, *The Service's Tax Disclosure Initiative: What Has Become of Privilege?*, J. TAX'N, Oct. 2002, at 212.

abusive schemes and promoter investigations; (4) high-income non-filers; (5) unreported income, and (6) the National Research Program.[46]

First, while it is not illegal to have offshore credit cards, there is a reasonable basis for believing that some taxpayers are using offshore credit cards to evade paying U.S. federal taxes because such credit cards provide easy access to offshore funds and accounts in tax haven countries that allow taxpayers to hide income.[47] To resist such abuse, the IRS plans to increase resources devoted to working these cases in the upcoming fiscal years. In addition it will serve "John Doe" summons on credit corporations for records of offshore credit cards in order to obtain information on taxpayers using offshore credit cards to evade Federal taxes.[48]

Second, in 2003, the IRS began using a combination of filters to identify high-risk, high-income returns. The returns chosen for investigation are those most likely to have unreported income or "structured transactions."[49] A structured transaction is one with limited economic benefit and whose primary function is to reduce or eliminate a tax liability.[50]

Third, government attempts to attack abusive scams and schemes, including the offshore credit card transactions, will significantly increase in the upcoming fiscal years.[51] For example, a Promoter Lead Development Center has been established to identify and address promoter activity.[52]

Fourth, government attempts to address non-filers in 2004 and beyond are focusing on "the most egregious and high-risk segments of the population."[53]

Fifth, because unreported income represents the biggest piece of the "tax gap," the difference between what is reported and what should be reported, the IRS has developed a new tool for identifying returns with a high probability of unreported income.[54] The tool, Unreported Income Discriminant Index Formula (UI DIF), will produce a score rating the probability of income being omitted from the return.

Sixth, the National Research Program will measure reporting compliance and identify compliance issues, allowing the IRS to improve its efficiency.

On December 29, 2003, in an Advance Internal Revenue Bulletin Notice, the Treasury Department and the IRS issued four items of administrative guidance as part of their ongoing effort to immobilize abusive tax shelter transactions and maximize effective use of IRS audit resources.[55] The purpose of the first of the items released is to improve the tax system through heightened standards for tax advisors.[56] The other three are intended to increase trans-

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[46] *New Audit Strategy Focuses on 'High Risk' Noncompliance Areas*, J. TAX'N, Oct. 2002, at 195.
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] IR-2003-147.
[56] *Id.*

parency and disclosure of information to the IRS.[57] Improved disclosure, in addition to more effectively using the information obtained, is central to the government's strategy for identifying abusive tax-advantaged transactions early and addressing them promptly.[58] The transparency that disclosure brings serves as a deterrent to abusive tax avoidance transactions as well.[59]

B. *Relevant Privileges*[60]

A valid defense to IRS information gathering is privilege.[61] There are four key privileges that may be applicable in this context: (1) the Fifth Amendment privilege; (2) the work product doctrine; (3) the attorney-client privilege; and (4) the "identity privilege" as a component of both the attorney-client privilege and IRC § 7525.

1. *Fifth Amendment Privilege*

While the Fifth Amendment provides no protection based on the contents of voluntarily prepared documents, it does protect taxpayers from compelled production of documents where the act of production itself "could implicitly communicate incriminating facts, such as the admission that papers existed, were in the [producing party's] possession or control, and were authentic."[62] The privilege is generally available when either of two conditions is satisfied: (1) where the government does not know of the existence or location of documents sought in a summons; or (2) where the production itself would provide the basis for authentication.[63] Under such circumstances, a taxpayer may be justified in withholding certain documents requested by the IRS because the act of producing those documents poses a risk of self-incrimination. Although taxpayers may assert the Fifth Amendment privilege in response to specific questions or requests (if the responses were in fact potentially incriminating), taxpayers cannot make blanket assertions of the Fifth Amendment to avoid attendance at a deposition or production of documents.[64]

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[57] *Id.*

[58] *Id.*

[59] *Id.* The four items are: (1) proposed changes to Circular 230 that set high standards for the tax advisors and firms that provide opinions supporting tax-motivated transactions; (2) final regulations that will increase the cost of failing to disclose abusive tax avoidance transactions; (3) revised final regulations clarifying that the disclosure of confidential transactions on a return is limited to transactions for which a promoter has imposed confidentiality on a taxpayer to protect the promoter's tax strategies from disclosure; and (4) proposed new Form 8858 requiring information reporting by U.S. persons that own foreign entities that are disregarded for U.S. tax purposes. *Id.*

[60] Though the "work product doctrine" is not technically a privilege, several courts have interpreted it as such. *See, e.g., In re* Grand Jury Subpoena Dated October 22, 2001, 282 F.3d 156 (2d Cir. 2002); Black & Decker Corp. v. United States, 219 F.R.D. 87 (D. Md. 2003); United States v. Randall, 194 F.R.D. 369 (D. Mass. 1999); Hambarian v. Comm'r, 118 T.C. 565 (2002).

[61] *See generally* Michael I. Saltzman, IRS PRACTICE AND PROCEDURE ¶ 13.11 (1999 & Supp. No. 3 2003).

[62] United States v. Hubbell, 530 U.S. 27 (2000).

[63] United States v. Cianciulli, 2002 WL 1484396 (SDNY July 10, 2002).

[64] Howard W. Goldstein, *Corporate Crime: Recent Privilege Developments*, N.Y. L.J., May 2003, col. 1.

2. *Work Product Doctrine*

Under the work product doctrine, any material obtained by counsel, the party or the party's representative in preparation or anticipation of litigation is "work product" and therefore immune from discovery.[65] In the tax law context, a crucial issue in determining the availability of the work product protection is what constitutes "litigation."[66] Some consider "litigation" to be a misnomer and argue that it should include any adversarial process, e.g., an adversarial audit – not just actual litigation.[67] However, not all courts have agreed on this issue.[68]

The principle against invading the privacy of a professional in performing his duties is so well recognized and essential to the orderly working of our legal system that the party seeking work product material has the burden to show reasons to justify such production. As the *Hickman* Court explained, "A lawyer is an officer of the court, bound to work for the advancement of justice while faithfully protecting the rightful interests of his clients and entitled to freedom from unnecessary intrusion by opposing parties and their counsel."[69]

Two recent cases discussing the applicability of work product doctrine in the tax context are *In re Grand Jury Subpoena Dated October 22, 2001*[70] and *Hambarian v. Commissioner*.[71] In the former, the court, citing *Hickman*, noted that the work product doctrine "establishes a zone of privacy for an attorney's preparation to represent a client in anticipation of litigation."[72] The court further commented that "work product" is any fact obtained by an attorney, as well as the attorney's opinions and strategies, during the course of the attorney's (or taxpayer's) preparation to represent the client taxpayer in anticipation of litigation.[73] In the latter case, the court held that the mere selection of particular documents by the taxpayer's defense attorney did not automatically transform the documents into "work product."[74] Further, the taxpayer failed to make the requisite showing of how the disclosure of the documents selected and converted to electronic databases would reveal the defense attorney's mental impressions of the case. Therefore, the requested documents and com-

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[65] Hickman v. Taylor, 329 U.S. 495 (1947) (codified in FED. R. CIV. P. 26). To override immunity protection, the party seeking discovery must show: (1) a substantial need; (2) that the information is otherwise unavailable without undue hardship; and (3) that the documents are not mental impressions. *Id.*; FED. R. CIV. P. 26(b)(3).

[66] Robert T. Smith, *After the Alamo: Taxpayer Claims of Privilege and the IRS War on Tax Shelters*, TAX NOTES, Jan. 13, 2003, at 243.

[67] Peter A Lowy & Juan F. Vasquez, Jr., *When is the Work of a tax Professional Done in Anticipation of Litigation and Thus 'Work Product'?* J. TAX'N, Mar. 2003, at 155.

[68] *See* Smith, *supra* note 66, at 243, *citing* United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998); McEwen v. Digitran Sys. Inc., 158 F.R.D. 678 (D. Utah 1994); and United States v. Gulf Oil Corp., 760 F.2d 292 (Temp. Emer. Ct. App. 1985).

[69] *Hickman*, 329 U.S. at 495; *see also* FED. R. CIV. P. 26, 30(b)(d), 31(d), 33, 34 and 35.

[70] 282 F.3d 156 (2d Cir. 2002) (privilege successfully asserted).

[71] 118 T.C. 565 (2002) (privilege unsuccessfully asserted).

[72] *In re* Grand Jury Subpoena Dated October 22, 2001, 282 F.3d 156, 160 (2d Cir. 2002); *see also* FED. R. CIV. P. 26(b)(3).

[73] *Grand Jury Subpoena*, 282 F.3d at 161; *see also* FED. R. CIV. P. 26(b)(3).

[74] *Hambarian*, 118 T.C. at 569-70.

puterized electronic media were not protected by the work product doctrine in the civil proceeding wherein the taxpayer challenged income tax deficiency.[75]

In sum, the privilege is not an "umbrella that shades all materials prepared by the lawyer."[76] "The work product doctrine [centers] only on material assembled and brought into being in anticipation of litigation" and excludes materials accumulated in the ordinary course of business or pursuant to public requirements unrelated to litigation.[77]

3. *Attorney-Client Privilege*

The attorney-client privilege is "the oldest of the privileges for confidential communications known to the common law."[78] For centuries, an attorney's duty to keep quiet regarding communications with a client has held a sacred place at the center of our legal system.[79] The notion of attorney-client privilege dates back to Roman law.[80] In ancient Rome, attorneys were not permitted to testify against their clients because it was thought that any lawyer willing to take the stand against his client was obviously a disloyal scoundrel whose testimony was therefore questionable.[81]

In Elizabethan England, the privilege actually belonged to the attorney due to professional self-interest.[82] For example, compelling a lawyer to testify against his own client would discredit the attorney, which would in turn be bad for business.[83] In the eighteenth century, however, the view evolved to give only the client the right to invoke or waive attorney-client privilege.[84] According to the U.S. Supreme Court, "the attorney-client privilege serves the function of promoting full and frank communications between attorneys and their clients .... It thereby encourages observance of the law and aids in the administration of justice."[85]

The elements of the privilege have been conveyed in various fashions. Nonetheless, a common theme in these articulations is that the attorney-client privilege requires that communication be made in confidence for the purpose of obtaining legal advice from a lawyer.[86] If only accounting service or account-

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75 *Id.* at 571.

76 United States v. El Paso Co., 682 U.S. F.2d 530, 542 (5th Cir. 1982).

77 *Id.*

78 Upjohn v. United States, 449 U.S. 383, 389 (1981).

79 Austin, *supra* note 2, at 30. Nonetheless, during the last couple of years, this privilege has been criticized on several levels. *Id.* For example, some commentators have characterized the attorney-client privilege as little more than a "screen for scofflaw clients and their collusive lawyers." *Id.* In addition, IRS Commissioner Mark Everson declared, "There are clear indications that professional standards have eroded in some corners of the practitioner community. Attorneys and accountants should be the pillars of our system of taxation, not the architects of its circumvention." *Id.* at 32.

80 8 JOHN HENRY WIGMORE, WIGMORE ON EVIDENCE § 2290 (McNaughton rev. 1961).

81 *Id.*

82 *Id.*

83 *Id.*

84 *Id.*; *see also* Smith, *supra* note 66, at 243.

85 Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 348 (1985).

86 United States v. Kovel, 296 F.2d 918, 922 (2d Cir. 1961). One of the most quoted summaries of the elements of the privilege is that of Judge Wyzanski:

ing advice is involved, then no privilege exists.[87] Should the privilege apply, it affords confidential communications between lawyer and client absolute protection from disclosure as long as the client does not waive the privilege.[88] Waiver can be express or implied, intentional or unintentional.[89] Although the protections are vested once they attach, they are extremely fragile and easily relinquished should the client fail to firmly preserve the confidential character of the communication.[90]

Because it impedes the full and free discovery of the truth, the attorney-client privilege is construed narrowly.[91] For example, the privilege may not be used as a blanket over an undifferentiated group of documents; it must be specifically asserted with respect to particular documents.[92] Additionally, preparation of tax returns is generally not "legal advice" within the scope of the privilege.[93] A few recent cases testing the application of the attorney-client privilege in tax context are: (1) *Cavallaro v. United States*;[94] (2) *Johnson v. Commissioner*;[95] and (3) *Bria v. United States*.[96]

In the first case, the court held that even if the parties to a merger and their owners all had an exact unanimity of interest, it would not render privileged the communications created by or shared with accountants within the attorney-client privilege, when the accountants were providing accounting services (as opposed to facilitating communication of legal advice between attorneys for one of the parties and their clients).[97]

In *Johnson*, the court held the taxpayer impliedly waived his attorney-client privilege when he pleaded the affirmative defense of good faith reliance on advice of experts while defending against deficiencies and fraud penalties in Tax Court.[98] His defense made his attorney's advice relevant to the case, and

> (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.

United States v. United Shoe Mach. Corp., 89 F. Supp. 357, 358-59 (D. Mass. 1950).

87 *Kovel*, 296 F.2d at 922. Of course, the crime-fraud exception acts as a bar to the privilege. *Id.*

88 *In re* Grand Jury Subpoena, 204 F.3d 516, 519 (4th Cir. 2000); Hawkins v. Stables, 148 F.3d 379, 383 (4th Cir. 1998).

89 Smith, *supra* note 66, at 241. Words or conduct may be sufficient to waive the privilege regardless of the client's intentions. *Id.*

90 *Id.* The "common interest" doctrine is an exception to the general rule that disclosure of the communication to a third party constitutes a waiver. *Id.*

91 *Grand Jury Subpoena*, 204 F.3d at 519; United States v. Evans, 113 F.3d 1457, 1461 (7th Cir. 1997).

92 United States v. El Paso Co., 682 U.S. F.2d 530, 542 (5th Cir. 1982).

93 *Id.* at 539.

94 284 F.3d 236 (1st Cir. 2002), *aff'g* 153 F. Supp. 2d 52 (D. Mass. 2001) (denying application of the privilege).

95 119 T.C. 27 (2002) (denying application of the privilege).

96 2002 WL 663862 (D. Conn. Mar. 26, 2002) (denying application of the privilege only in part).

97 *Cavallaro*, 284 F.3d at 250.

98 *Johnson*, 119 T.C. at 39.

the IRS could show that such reliance was unreasonable or did not occur only by knowing what tax advice the taxpayer received from his attorney.[99]

The third case, *Bria*, addressed the question of the scope of the attorney-client privilege when information is divulged to an attorney who is also acting as a tax preparer. The court recognized the general rule that "[i]f the client transmitted the information so that it might be used on the tax return, such a transmission destroys any expectation of confidentiality which might have otherwise existed."[100] However, the court distinguished between the actions the attorneys took in their capacity as tax return preparers and the actions they took as legal advisors, thereby permitting the IRS access to information with regard to the former capacity and barring access to information with respect to the latter.[101]

4. *§ 7525 Federally Authorized Tax Practitioner Privilege*

Unlike the well-established protections afforded to communications between attorneys and their clients, federal common law has never recognized an accountant-client privilege.[102] In order to expand their role in providing tax-related services, accountants lobbied Congress to receive a confidentiality privilege comparable to that enjoyed by lawyers under the common law.[103] They ostensibly succeeded in 1998 when IRC § 7525, the Federally Authorized Tax Practitioner privilege (FATP or "tax practitioner" privilege), was enacted as part of the IRS Reform and Restructuring Act.[104]

Section 7525 protects against the disclosure of the content of confidential communications between a tax advisor and client.[105] Thus, discussions relating

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[99] *Id.*

[100] Bria v. United States, 2002 WL 663862, at *2 (D. Conn. March 26, 2002).

[101] *Id.*

[102] Smith, *supra* note 66, at 243.

[103] *Id.* at 237, 243.

[104] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

[105] The privilege applies only to communications occurring after the date the statute was enacted. I.R.C. § 7525, in its entirety, provides:

> (a) Uniform application to taxpayer communications with federally authorized practitioners (1) General rule
>
> 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.
>
> (2) Limitations Paragraph
>
> (1) may only be asserted in —
>
> (A) any non-criminal tax matter before the Internal Revenue Service; and
>
> (B) any non-criminal tax proceeding in Federal court brought by or against the United States. (3) Definitions For purposes of this subsection —
>
> (A) Federally authorized tax practitioner
>
> The term "federally authorized tax practitioner" means any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code.
>
> (B) Tax advice
>
> The term "tax advice" means advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice described in subparagraph (A).

to the receipt of tax advice, given by a tax practitioner, generally enjoy the same confidentiality protections as communications with an attorney.[106] There are many exceptions, however.[107] The privilege does not apply in criminal tax matters, or to corporate tax shelters, i.e., written communications between a tax practitioner and a director, shareholder, officer, employee, agent or representative of a corporation in connection with the promotion of the participation of the corporation in a tax-advantaged transaction.[108]

United States v. Frederick discussed the § 7525 privilege.[109] The court held that, while there is no common law accountant's or tax preparer's privilege, § 7525 protects communications between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. It does not protect work product, nor does it entitle a non-lawyer to privilege when they are doing other than a lawyer's work.[110]

Information communicated by a taxpayer for the purpose of tax preparation, such as a taxpayer's name, does not create a reasonable expectation of confidentiality because tax returns are disclosed to third parties.[111] Generally, under both the attorney-client and FATP privilege, a client's identity is not protected from disclosure.[112] However, the identity privilege may apply to identity disclosures in limited circumstances where the IRS has uncovered so much of a confidential communication that the mere identification of the taxpayer would effectively disclose the communication.[113] Consequently, one of the issues relating to the identity privilege that has been left unresolved is whether, and to what extent, this privilege allows a tax practitioner to refuse to disclose a taxpayer's name if the IRS requests it as part of an investigation.[114]

The above-mentioned privileges are not confined to any one form, as their scope is shaped by their purpose and principle.[115] Thus, the development and application of the privileges remain the duty of the courts.[116]

(b) Section not to apply to communications regarding corporate tax shelters. The privilege under subsection (a) shall 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 (as defined in section 6662(d)(2)(C)(iii)).

106 I.R.C. § 7525 (2004).

107 *See* Part III.B. for a more detailed discussion of this privilege's pitfalls and why it should be abolished.

108 I.R.C. § 7425(a)(1)-(b) (2004).

109 182 F.3d 496 (7th Cir. 1999), *cert. denied*, 528 U.S. 1154 (2000).

110 *Id.* at 502. For further case discussion, see Part III below.

111 United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003).

112 United States v. BDO Seidman, 2003 WL 932365, at * 1 (N.D. Ill. Feb. 5, 2003).

113 *Id.*

114 For further discussion of this privilege, see, *e.g.*, Steve R. Johnson, *The Proposed Tax Advisor-Client Privilege: An Idea Whose Time Should Never Come*, 78 TAX NOTES 1041 (1998); Louis Lobenhofer, *The New Tax Practitioner Privilege: Limited Privilege and Significant Disruption*, 26 OHIO N.U.L. REV. 243 (2000).

115 United States v. El Paso Co., 682 U.S. F.2d 530, 538 (5th Cir. 1982).

116 Smith, *supra* note 66, at 236.

III. Analysis

A. *IRS Flexes Its Muscles: Enforcement Actions in the Latest Vastly Publicized Cases*

As mentioned in Part II, the government's tax shelter strategy requires promoters to identify and register potentially abusive tax shelters, maintain lists of investors and provide the IRS with investor lists. Should the IRS desire confirmation of such compliance, it may audit these promoters.

The IRS has conducted numerous investigations of promoters, served hundreds of summonses and identified a significant number of abusive transactions.[117] For that reason, while the following are the most prominent cases in this area of tax, they are by no means comprehensive.

1. *Decided Cases*

a. *KPMG LLP*

In 2002, the government served twenty-five summonses on KPMG to determine the firm's compliance under the registration and list requirements.[118] Although KPMG produced eighty-four boxes of documents, the IRS claimed that the firm failed to completely comply, and in June 2002, the Department of Justice (DOJ) petitioned the court to enforce the summonses.[119] KMPG produced an additional 183 boxes, but prepared a document-by-document privilege log for certain documents it withheld on privilege grounds.[120]

Judge Hogan, holding that much of the documentation may be characterized as tax return preparation and thus not protected under the § 7525 tax practitioner privilege, referred the privilege log to a Special Master, retired Magistrate Judge Attridge, to conduct an examination of the withheld documents, evaluate the asserted privileges and submit a Recommendation to the court.[121]

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[117] In August 2003, Eileen O'Connor, Assistant Attorney General of the Tax Division, stated that the IRS had taken the following actions to combat abusive transactions: (1) investigated 99 promoters, including law firms, investment banks, and accounting firms; (2) issued 272 summonses to 35 promoters since January 1, 2002 to acquire information on compliance with the registration and list requirements; (3) obtained investor lists from at least 25 promoters for numerous transactions; (4) identified 27 abusive tax shelters through formal guidelines; and (5) via a variety of sources, audited taxpayers to determine whether they invested in abusive transactions. *See IRS Sues to Enforce Promoter Summonses, Get Investor Names from Jenkens & Gilchrist*, Tax Mgmt. Weekly Report, Aug. 18, 2003, at 1327. By November 2003, the IRS revealed its latest actions in a "background information" sheet that included the following information: (1) 640 promoter investigations with another 430 promoter leads (in addition, the IRS stated that the Small Business/Self-Employed Lead Development Center is receiving an average of 105 promoter leads per month); and (2) 313 administrative summonses issued to 37 promoters. *See* Amy Hamilton & Sheryl Stratton, *IRS to Serve More Summonses, Updates Shelter Stats*, Tax Notes, Nov. 3, 2003, at 567.

[118] United States v. KPMG LLP, 237 F. Supp. 2d 35, 36 (D.D.C. 2002).

[119] *Id.*

[120] *Id.* at 36-7.

[121] *Id.* at 48. For competing views of this decision, compare Lee A. Sheppard, *No Privilege for Tax Planning*, Tax Notes, Jan. 13, 2003, at 159, with Jay L. Carlson & David A. Roman, *The Tax Advice Privilege is Alive and Well*, Tax Notes, Apr. 21, 2003, at 399.

Judge Attridge has since issued two reports. In the first, delivered in January 2003, the Special Master determined that KPMG failed to show that two of three documents were protected from disclosure under the § 7525 privilege because the documents were prepared as exhibits in support of disclosures made on the tax returns of investors.[122] A third category was considered protected under the attorney-client privilege.[123]

The Special Master issued his second and final report on October, 8, 2003, after reviewing the remaining documents and supplemental submissions, reexamining KPMG's privilege log, the entire record and Judge Hogan's previous opinion.[124] With respect to the tax practitioner privilege, Judge Attridge relied mainly on two Seventh Circuit opinions: *United States v. Frederick*[125] and *United States v. Lawless*.[126] Based on these opinions, he recommended that certain types of documents be protected under § 7525, including but not limited to: KPMG memos regarding conversations with clients discussing the consequences of proposed tax legislation; internal memos discussing tax advice given to clients; KPMG letters to clients including tax information, tax advice, tax planning and tax opinions; and various types of e-mails communicating tax advice.[127] Other documents, however, were said to be unprotected by § 7525. For instance, documents containing information relating to tax returns, business matters (as opposed to client-specific advice) and policy issue discussions were not privileged.[128] Thus, it appears that that the FATP privilege is still alive in the KPMG case.[129]

More recently, Judge Hogan granted the government's petition to enforce the summonses against KPMG.[130] In a harsh opinion, the court stated that it had "lost confidence in KPMG's privilege log since it has been shown to be inaccurate, incomplete, and even misleading regarding a very large percentage

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[122] Doc. 2003-66451; 2003 TNT 52-18; *see also* Sheryl Stratton, *Special Master Recommends Court Find KPMG Docs Privileged*, TAX NOTES, Oct. 27, 2003, at 444. The two categories varied only in that one set of documents included further analysis articulating that there was at least a fifty percent probability that the transactions would be upheld if the IRS challenged them. *Id.*

[123] Stratton, *supra* note 122, at 444.

[124] Doc. 2003-22677; 2003 TNT 202-12. For a detailed discussion of the Special Master's recommendation with regard to each of the privileges asserted, see Stratton, *supra* note 122, at 444-47.

[125] 182 F.3d 496 (7th Cir. 1999) (discussed in Part II *supra*).

[126] 709 F.2d 485 (7th Cir. 1983).

[127] *Id.*

[128] *Id.*

[129] Although, on December 8 2003, the DOJ accused KPMG of noncompliance and obstructing justice after the firm allegedly delayed disclosing documents to the IRS. Doc 2003-26292; 2003 TNT 239-16. *See also* Kenneth A. Gary, *KPMG Accused of Noncompliance, Obstructing Justice*, TAX NOTES, Dec. 15, 2003, at 1254. In November 2003, KMPG released another privilege log disclosing an additional 21 documents of which the DOJ had no prior knowledge. *Id.* As such, the filing requests the court to waive the claim of privilege and order production of the documents because "[a]fter nearly two years of dodging the IRS and this Court, KPMG should not be allowed to assert new reasons it is not complying with these summonses." *Id.*

[130] *See* United States v. KMPG LLP, 316 F. Supp. 2d 30 (D.D.C. 2004).

of the documents."[131] In holding the § 7525, attorney-client and work products privileges invalid, KPMG was ordered to produce all of the documents related to the OPIS and FLIP transactions as specified in the January 28, 2002, summons.[132]

b. BDO Seidman

The IRS sought enforcement of summonses against accounting firm BDO Seidman, LLP (BDO) for its alleged failure to properly disclose potentially abusive tax-advantaged transactions that the firm promoted.[133] On October 10, 2002, the district court held that: (1) the summonses were prima facie issued in good faith and (2) the firm's claim of privilege required examination of each document by Magistrate Judge Ashman.[134]

After the court ordered disclosure of certain documents, BDO appealed.[135] Two separate groups of John Doe clients ("Does" and "Roes") of BDO sought to intervene in the summonses enforcement action.[136] The Seventh Circuit remanded, allowing the district court to enter more extensive findings regarding documents as to which proposed intervenor-appellants asserted privilege.[137] The district court, on remand, held that information with respect to the identity of BDO's clients was not privileged and that the clients were not entitled to intervene.[138] That decision was also appealed in July 2003, the Seventh Circuit affirmed, ruling that the information regarding the identity of the clients who had consulted with a tax shelter promoter, BDO, with respect to their participation was not protected from disclosure under § 7525 in a tax enforcement action against the promoter.[139]

The FATP privilege did not apply because the clients failed to prove that a confidential communication would be disclosed if their identities were known.[140] In addition, because the IRC §§ 6111 and 6112 require that promoters register and maintain lists of every tax shelter investor-client, the court reasoned, the clients had no reasonable expectation of confidentiality with regard to their participation in the tax shelter investments.[141] Significantly, the court noted that while the identity privilege exists in limited instances, just as it does in the attorney-client context generally, information provided to a tax practi-

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[131] *Id.* at 44; *see also* Sheryl Stratton, *BDO Court Rules Attorney-Client Privilege Applies To Shelters*, TAX NOTES, July 12, 2004, at 125.
[132] *Id.*
[133] United States v. BDO Seidman, 225 F. Supp. 2d 918 (N.D. Ill. 2002).
[134] *Id.*
[135] United States v. BDO Seidman, 2002 WL 32080709 (N.D. Ill. 2002).
[136] *Id.*
[137] *Id.*
[138] United States v. BDO Seidman, 2003 WL 932365 (N.D. Ill. 2003).
[139] *Id.* In addition, the Does and Roes filed a motion to stay the issuance of the court mandate pending a petition for writ of certiorari. Doc. 2003-21218; 2003 TNT 187-17; *see also Summaries/Court Opinions*, TAX NOTES, Oct. 6, 2003, at 79. The court denied the motion because the appellants failed to prove that they had a reasonable probability of success on the merits. *Id.* It also noted that the motion was procedurally incomplete. United States v. BDO Seidman, No. 02-3914; No. 02-3915 (7th Cir. Sept. 25, 2003).
[140] *BDO Seidman*, 337 F.3d 802.
[141] *Id.*

tioner for the purpose of preparing a tax return is not privileged.[142] The § 7525 privilege does not include communications about tax return preparation. It encompasses only information such as tax advice.[143]

c. Ernst & Young

In April 2002, the government served accounting firm Ernst & Young (E&Y) a summons demanding a wide range of documents relating to one allegedly abusive transaction and all other similar transactions executed by the firm.[144] E&Y's clients expressed that they did not want their identities known and directed E&Y to assert the § 7525 privilege.[145] The clients, "Does," argued that their identities as taxpayers who invested in tax shelters could not be determined from the information revealed by their tax returns filed by E&Y.[146] As such, not only had the privilege not been waived, but disclosing their identities to the government would reveal the nature of the advice sought from E&Y.[147]

Similar to the *BDO* case discussed above, however, the clients' attempt to intervene by means of John Doe litigation was dismissed.[148] The court suggested that the identity privilege was inapplicable when an accounting firm is used as a return preparer.[149] Nonetheless, the case was ultimately dismissed because the IRS had independently ascertained the clients' identities.[150]

d. Arthur Andersen LLP

In April 2002, the government issued nineteen administrative summonses to Arthur Andersen LLP (Andersen) as part of an investigation into the firm's compliance with the IRC regulations governing potentially abusive tax-advantaged transactions.[151] After the clients were informed about the summonses, two groups of independent investors sought to intervene ("Does" and

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142 *Id.*; *see also* Cassell Bryan-Low, *Court Rules Tax Shelter Clients Lack Privilege of Confidentiality*, WALL ST. J., July 24, 2003, at 1.

143 *Id.* However, under the Seventh Circuit's 2002 decision, the court articulated a four-prong test to determine whether the identity privilege exists under the § 7525 protection: (1) Was the purpose of the transaction to provide tax advice? (2) In light of such purpose and the history of the firm's representation, would disclosing the clients' identities necessarily reveal their motives for seeking tax advice? (3) Did the clients waive the privilege, i.e., would the IRS have been able to ascertain the client names independent of the firm? (4) Was the document or communication made for the purpose of preparing the clients' tax returns? According to the court, in order for the clients' identities to be privileged under § 7525, the answers to the first two questions must be yes, and the answers to the last two questions must be no. *BDO Seidman*, 2002 WL 32080709 (N.D. Ill. 2002). *See also Confidentiality—How Protected is Communication With a Tax Advisor?* CONTROLLER'S TAX LETTER, July 1, 2003, *available at* 2003 WL 8916737. Thus, it is unclear how relevant these inquires are in light of the 2003 opinion.

144 Sheryl Stratton, *Identity Privilege Pits Shelter Clients Against Accounting Firms*, TAX NOTES, Jan. 13, 2003, at 168.

145 Stratton, *supra* note 144, at 168.

146 *Id.* at 169.

147 *Id.* at 169-70.

148 Ernst & Young, No. 02-CV-10100 (S.D.N.Y. Dec. 20. 2002).

149 *Id.*

150 *Id.*

151 United States v. Arthur Anderson, LLP, 273 F. Supp. 2d 955 (N.D. Ill. 2003).

"Roes") and asserted the § 7525 privilege.[152] On the IRS's motion to compel compliance with a production order, on June 30, 2003, the district court held that: (1) the investors' identities were protected by the FATP privilege and (2) the investors were permitted to intervene using fictitious names.[153] But before the investors could celebrate the victory, the July 23rd *BDO* decision rained on their parade.

The Seventh Circuit handed down its *BDO* ruling just a few weeks after the June 30th decision. In light of the recent opinion, the IRS filed a motion to reconsider the *Andersen* district court's order. Reluctantly, on August 15, 2003, the district court granted the government's motion, holding that the investors may not assert the identity privilege under § 7525 and therefore their identities must be revealed to the IRS.[154]

The court concluded that it was bound by the Seventh Circuit's "generally applicable prohibition on the assertion of the identity privilege" in IRS summons enforcement actions, which appears unchangeable by varying factual circumstances.[155] The *Andersen* district court even went so far as to admit that the *BDO* opinion left the court "puzzled as to the correct outcome" in the principal case.[156] Concerned about the dangers of an unrestricted exercise of the IRS summons power, possibly resulting in an unfair infringement on the taxpayer's entitlement to privacy, the court expressed its hope that Congress explicitly state its purpose underlying Code §§ 6111 and 6112 to include targeting for penalties those taxpayers who participate in abusive tax shelters.[157]

e. Wachovia Corp.

Just a week prior to the June 30th *Andersen* district court decision, a district court in North Carolina denied injunctive relief to shelter investors seeking, on privilege grounds, to prevent Wachovia bank (Wachovia) from turning over investor lists.[158] The investors had used Wachovia to invest in allegedly abusive tax shelters. KPMG, LLP provided accounting advice and Jenkens & Gilchrist provided legal advice.[159] Thus, the *Wachovia* action was procedurally different from the previously discussed *Andersen* and *BDO* summons enforcement proceedings because the IRS was not a party in the case. Furthermore, the investors, who used the bank to facilitate a tax strategy for which Jenkens & Gilchrist provided legal advice and KPMG provided accounting

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152 *Id.*
153 *Id.*
154 United States v. Arthur Andersen, LLP, 2003 WL 21956404, 2003 U.S. Dist. LEXIS 14228 (N.D. Ill. 2003). The action has been stayed pending the investors' appeal to the circuit court. *Id.*
155 *Id.* at *6. The *Andersen* court reviewed its understanding of the four factual inquiries to determine whether the identity privilege exists under § 7525, set forth in the Seventh Circuit's 2002 *BDO* opinion, but the Seventh Circuit's broad language in the 2003 opinion left the *Andersen* court questioning the role of the four factors under the 2002 decision. *Id.*
156 *Id.*
157 *Id.* at *7. For more discussion of the case and its history, see Sheryl Stratton, "No Identity Privilege for Andersen Investors, Court Reluctantly Rules," TAX NOTES, Aug. 25, 2003, at 985-7.
158 Doe v. Wachovia Corp., 268 F. Supp. 2d 627 (W.D.N.C. 2003).
159 *Id.*

advice, claimed the § 7525 privilege.[160] The investors sought protection by claiming that Wachovia communicated privileged information to both the law and accounting firms to implement the tax strategy.[161]

The court ruled that no attorney-client relationship existed between the investors and the law firm because the law firm merely sold a package to the investors that contained a description of the transaction and a memo as to the potential tax consequences stemming from the transaction.[162] Further, the court determined that the FATP privilege was inapplicable because the communications fell within the corporate tax shelter exception under § 7525(b).[163]

Prior to this decision, there had been much uncertainty over how the corporate tax shelter exception would be applied.[164] Notably, the United States District court for the Northern District of North Carolina was the first to expressly hold that an individual taxpayer's communications will not be privileged if they relate to a shelter transaction involving a corporation.[165]

f. G-I Holdings, Inc.

GAF Chemical Corp. (GAF) is G-I Holdings, Inc.'s predecessor.[166] In 1990, GAF entered into a partnership with Rhone-Poulenc, Inc. where each corporation contributed property to create a limited partnership.[167] In 1993, the IRS audited the partnership, but did not make any adjustments regarding the 1990 transaction.[168] The partnership was audited a second instance in 1996; this time, the IRS reviewed the transfer of property to the partnership.[169] The government asserted tax deficiencies against GAF and Rhone-Poulenc after concluding that the property transfer constituted a taxable sale as opposed to an IRC § 721 nontaxable contribution.[170]

In their defense, the taxpayers claimed reasonable reliance on the advice given to them by their tax advisors, William S. McKee and William F. Nelson, regarding the 1990 property transfer.[171] As a result, the IRS attempted to discover the communications between the corporations and McKee and Nelson.[172]

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160 *See* Sheryl Stratton, *Privilege Sidelines Shelter Actions, Government Changes Tack*, TAX NOTES, July 21, 2003, at 295.

161 *Id.* After Wachovia decided to comply with the summons, several investors brought suit against the bank asserting various theories, including breach of contract and breach of fiduciary duty. *Wachovia*, 268 F. Supp. 2d at 627.

162 *Wachovia*, 268 F. Supp. 2d at 627.

163 *Id.* The court examined the language of the § 7525 exception and the § 6662(d)(2)(C) definition of shelter. After reviewing one Jenkens & Gilchrist tax opinion, the court determined that the tax-advantaged transaction necessitated the participation of a corporation, and therefore rendered the privilege inapplicable.

164 Doc. 2002-20732; 2002 TNT 176-19; *see* Sheryl Stratton, *Privilege Sidelines Shelter Actions, Government Changes Tack*, TAX NOTES, July 21, 2003, at 295.

165 Stratton, *supra* note 164, at 295.

166 *In re* G-I Holdings, Inc., 2003 WL 22300502 (D.N.J. 2003). *See also* Sheryl Stratton, *Another Privilege Argument Fails; Nelson, McKee To Be Deposed*, TAX NOTES, Aug. 4, 2003, at 634.

167 *G-I Holdings*, 2003 WL 22300502.

168 *Id.*

169 *Id.*

170 *Id.*

171 *Id.*

172 *Id.*

On July 17, 2003, the New Jersey court ruled that, because the tax advisors did the tax planning for the transaction (including writing the opinion letter upon which the corporations relied as an affirmative defense), such communication was in question.[173] In effect, by asserting the reasonable reliance defense, there was waiver of all the communications between the corporations and the advisors, thereby limiting the application of privilege to the information.[174]

1. *Pending Cases*

a. *Jenkens & Gilchrist P.C.*

On June 19, 2003, the government served a John Doe summons on one of the country's largest law firms, Jenkens and Gilchrist (J&G), seeking to obtain information on some listed transactions and other potentially abusive transactions organized or sold by the firm's Chicago office.[175] This action marked the first time the government has summoned a law firm in its war against tax shelters.[176]

According to the IRS, J&G clients claimed at least $2.4 billion in artificial losses from their investments, chiefly from COBRA (currency options bring reward alternatives), a proprietary version of the "son of BOSS shelter."[177] The government believes that the attorneys were not acting solely in their capacities as lawyers, but were promoters required to comply with the Code regulations and turn over their client lists.[178] J&G refuted that belief and resisted the summons on the ground of attorney-client privilege.[179]

J&G CEO William P. Durbin has commented, "Our clients expected confidentiality when they sought legal advice concerning their taxes . . . it is well established that the privilege covering our dealings with clients belongs to them, and that we must assert it on their behalf. We have done so."[180] As

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[173] *Id.*

[174] *Id.*

[175] No. 03C5693 (N.D. Ill.).

[176] John McKinnon & Cassell Bryan-Low, *U.S. Sues Law Firm in Tax-Shelter Crackdown*, WALL ST. J., June 20, 2003. A John Doe summons differs from an administrative summons in that it suspends the statute of limitations for assessing tax deficiencies for the investors is automatically suspended beginning six months after the service of the summons while objections related to the summons are resolved. Amy Hamilton, *Government Seeks Enforcement of Summons on Jenkens & Gilchrist*, TAX NOTES, Aug. 18, 2003, at 877.

[177] In one typical form of a son of BOSS shelter, a taxpayer purchases and writes economically offsetting options and then purports to create substantial positive basis by transferring those option positions to a partnership. On the disposition of the partnership interest (the liquidation of the partnership or the taxpayer's sale or depreciation of distributed partnership assets), the taxpayer will claim a tax loss, even though the taxpayer has not incurred a corresponding economic loss. *See* Notice 2000-44, 2000-2 C.B. 255; *see also* Temp. Reg. § 1.752-6 (2004).

[178] Jenkens & Gilchrist PC, No. 03C5693 (N.D. Ill. May 13, 2004). *See also* Hamilton, *supra* note 176, at 877.

[179] *Jenkens*, No. 03C5693.

[180] Hamilton, *supra* note 176, at 877. Durbin further stated, "The law deems this exchange between a lawyer and a client confidential. This confidential communication between client and lawyer is the essence of attorney-client privilege, and the identity of the clients is an important element of the privilege in this case." *Id.*

such, the issue is whether lawyers are acting beyond their advisor role and becoming promoters.[181] If the attorney is found to be selling a tax shelter (as opposed to providing legal advice), the privilege disappears.[182]

The IRS subsequently filed an action requesting the district court to enforce compliance with the John Doe summons and with five administrative summonses the government had issued as part of its examination of J&G's possible promotion of tax shelters on August 14, 2003.[183]

On May 14, 2004, the U.S. District Court for the Northern District of Illinois ordered the firm to comply with the summonses seeking identities and other relevant information. The next month, Judge Moran held J&G's clients' identities unprotected by the attorney-client privilege.[184]

b. Sidley Austin Brown & Wood LLP

In October 2003, the IRS served a John Doe summons on the law firm Sidley Austin Brown & Wood (Sidley) for information on more than 370 individuals or entities who participated in a listed transaction organized or sold by the firm.[185] It was the second time in a year the IRS filed summonses against a Chicago law firm seeking the names of clients.[186] The government received approval from the U.S. District Court for the Northern District of Illinois to serve the summons to obtain the identities of clients who invested in listed transactions or other potentially abusive transactions organized or sold by the law firm's Chicago office.[187]

Specifically, the IRS is sought from the law firm and Brown & Wood LLP,[188] the names, addresses and taxpayer identification numbers of all U.S. clients who participated in listed or potentially abusive transactions organized or sold by the firm's Chicago office during any part of the period from January 1, 1996 to October 15, 2003.[189] Pursuant to its petition, the IRS believed Sidley developed and/or sold a number of transactions.[190] In addition, the government discovered more than thirteen transactions for which Sidley provided approximately six hundred opinions.[191] In response, Sidley gave the IRS "non-

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[181] *See Wachovia*, 268 F. Supp. 2d at 627; *see also* Richard Acello, *Give 'Em Shelter? Some Tax Shelters Can Expose Attorneys and Firms to Grief and Liability*, A.B.A. J. E-REPORT, July 25, 2003.
[182] *See Wachovia*, 268 F. Supp. 2d at 627.
[183] Jenkens & Gilchrist PC, No. 03C5693. Doc. 2003-22851; *O'Connor Testifies on Tax Shelters at Finance Committee Hearing*, 2003 TNT 204-33, Oct. 21, 2003.
[184] Sheryl Stratton, *Jenkens & Gilchrist Turns Over Investor Lists*, TAX NOTES, May 24, 2004, at 944.
[185] Karla L. Miller, *Justice Releases Exhibits in Sidley Austin Summons Enforcement Action*, 2004 TNT 1-14, Jan. 2, 2004.
[186] Stephanie Francis Ward, *IRS Wants Sidley to Name Names*, A.B.A. J. E-REPORT, Nov. 7, 2003.
[187] Amy Hamilton, *IRS Serves John Doe Summons to Second Law Firm*, TAX NOTES, Oct. 20, 2003, at 316; *Sidley Austin Second Law Firm To Be Served with John Doe Summons*, U.S. LAW WEEK, Oct. 21, 2003, at 2224.
[188] The law firm of Sidley Austin Brown & Wood is a product of the merger between the two firms Sidley Austin and Brown & Wood.
[189] Hamilton, *supra* note 187, at 316.
[190] *Id.*
[191] *Id.*

client specific" documents concerning many of the transactions. However, the firm withheld information that would identify its clients.[192]

In a prepared statement, Sidley maintained that it "ha[d] been cooperating and will continue to cooperate with the IRS by producing the material requested to the extent consistent with professional responsibilities."[193] Nonetheless, on December 29, 2003, the government announced that it was petitioning a U.S. district court for enforcement of the summons, citing Sidley's failure to respond to its requests.[194] Clearly, privilege claims regarding a substantial number of documents have yet to be resolved by the court.

c. *Presidio/Grant Thorton LLP*

In order to identify tax shelter investors, the government has served John Doe summonses on the Presidio Group companies, two individuals who managed and owned them, and Grant Thorton LLP, a leading global public accounting firm serving middle-market companies.[195] The Justice Department has since filed a petition in federal district court in the District of Columbia to enforce nine administrative summonses issued to the Grant Thornton firm.[196] This was the sixth summons enforcement proceeding filed against a tax shelter promoter.[197]

B. *Some Collateral Consequences*

While there have been a number of developments as a result of the events and controversies discussed earlier, two noteworthy changes are: (1) an increase in tax shelter clients suing their attorneys and advisors; and (2) changes in ethics and conduct.

With regard to the first, many disgruntled taxpayers are suing their accounting firms and law firms that acted as tax shelter promoters.[198] In most cases, these former clients claim that their advisors breached a duty of confidentiality when the advisors sold the tax shelters and that the advisors should have somehow protected the clients' identities from being disclosed.[199] For example, Jenkens & Gilchrist and Sidley are two firms experiencing this development first hand. J&G has been named in at least one lawsuit filed by affluent clients suing their lawyers and other advisors for tax advice.[200] Sidley is also

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192 *Id.*

193 *Id.*

194 Miller, *supra* note 185.

195 *See* Amy Hamilton & Sheryl Stratton, *IRS To Serve More Summonses, Updates Shelter Stats*, TAX NOTES, Nov. 3. 2003, at 567.

196 Kenneth A. Gary, *Year In Review: Tax Shelter Crackdown Efforts Steer Government Policy*, TAX NOTES, Jan. 5, 2004, at 35.

197 *Id.*

198 Lee A. Sheppard, *Confidentiality and Customer Relations*, TAX NOTES, June 2, 2003, at 1303; *see, e.g.*, David Cay Johnston, *Wealthy Family is Suing Lawyer Over Tax Plan*, N.Y. TIMES, July 19, 2003, at C1.

199 Sheppard, *supra* note 198, at 1303.

200 McKinnon & Bryan-Low, *supra* note 176.

named as a defendant in the suit.[201] Sidley has also been named in at least two other suits by wealthy individuals claiming they were sold bad tax advice.[202]

Second, many changes in ethics and conduct have taken place. For instance, on August 11, 2003, the American Bar Association (ABA) amended its Model Rules of Professional Conduct, specifically Rule 1.6, to permit lawyers to reveal information usually protected by the attorney-client privilege in order to prevent a client from committing financial fraud or to mitigate the damages from it.[203]

The ethical climate of corporate tax departments has also changed, particularly due to the Code's revised disclosure and list maintenance requirements.[204] According to Ernest J. Dronenburg Jr., a former member of the California State Board of Equalization and Franchise Tax Board and currently with Deloitte & Touche, while the tax departments of many major corporations "changed from cost centers to profit centers in the pre-Enron period[, now] the tax department is a damage-control center . . . the ethical pendulum has swung to the conservative edge."[205]

With respect to taxpayers, although personal integrity remains the strongest deterrent to noncompliance, the fear of being audited is increasing.[206] Fearing a tax audit is, to a greater extent, the reason that some taxpayers are complying and paying their fair share of taxes.[207] It appears as though the IRS's crackdown on tax shelters is playing a significant role in these changes.

C. Recommendation

1. Abolish the § 7525 Tax Practitioner Privilege

As discussed in Part II. B, there are a number of privileges that may be asserted in tax shelter cases. In particular, the FATP privilege has been criticized since its inception.[208] Not only does the tax practitioner privilege provide less protection than the attorney-client privilege, it may deceptively provide a

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201 *Id.*

202 *Id.*

203 *Current Developments: ABA Amends Rule on Client Confidentiality to Allow Lawyers to Disclose Financial Fraud*, TAX MGMT. WEEKLY REPORT, Aug. 18, 2003, at 1325. Congress also enacted the 2002 Sarbanes-Oxley Act on August 5, 2003 to promulgate rules of professional conduct for attorneys appearing before the Securities and Exchange Commission. *Id.* The rules require lawyers to report corporate authority violations of the securities law and other failures of legal compliance to the highest levels of corporate authority. *Id.*

204 Thomas F. Field, *Tax Shelters: Have Ethics Changed?*, TAX NOTES, Nov. 17, 2003, at 823. Accordingly, I would not be surprised to see more headlines in the news concerning the expulsion of partners from their firms. *See, e.g.*, Amy Hamilton and Sheryl Stratton, *IRS to Serve More Summonses, Updates Shelter States: Sidley Partner Expelled*, TAX NOTES, Nov. 3, 2003, at 568.

205 Field, *supra* note 204, at 823. Some commentators lament what they perceive to be an erosion of the legal "profession" into the legal "business." Anthony C. Infanti, *Eyes Wide Shut: Surveying Erosion in the Professionalism of the Tax Bar*, TAX NOTES, Oct. 27, 2003, at 517.

206 Amy Hamilton, *Taxpayer Fear of Audits on Rise, IRS Oversight Board Finds*, TAX NOTES, Nov. 3, 2003, at 577.

207 *Id.*

208 *See, e.g.*, Johnson, *supra* note 114; Lobenhofer, *supra* note 114.

false sense of security for the unwary.[209] Based on the succeeding points, some of which were mentioned earlier, the § 7525 privilege should be abolished.

First, the FATP privilege is very narrow and only extends a privilege akin to the attorney-client privilege to communications with certified public accountants, enrolled agents, and enrolled actuaries. Because it explicitly relies on the attorney-client privilege to establish the scope of its protections, the § 7525 privilege contains all of the restrictions of the attorney-client privilege.[210] To boot, the tax practitioner privilege contains many other considerable statutory limitations and undesirable effects. The aggregation of such confines makes the privilege almost useless. As the *Upjohn* Court articulated: "An uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."[211]

Another downside is the tax practitioner privilege may not be asserted in criminal matters.[212] Because our law enforcement system includes criminal and civil elements that are "inherently intertwined," determining whether an investigation is criminal or could become criminal is often problematic.[213] It appears that the mere commencement of a criminal investigation is sufficient to overcome the privilege.[214]

In tax cases, most criminal investigations start out as civil proceedings; thus, the FATP privilege may be lost as soon as the proceedings transition from civil to criminal.[215] While there are relatively few criminal tax cases prosecuted annually, this type of ephemeral privilege is likely to cause uncertainty and confusion among taxpayers who believed that communications made to their advisors were confidential regardless of the nature of the proceeding.[216] Such status is particularly disturbing due to the fact that the IRS is able to transform a civil proceeding into a criminal one almost effortlessly.[217] As such, in cases where the assertion of the privilege prompts a criminal investigation to eliminate the privilege, the existence of the § 7525 may put the taxpayer in a shoddier position than had there been no privilege at all.[218]

Third, § 7525 is limited to communications regarding "tax advice," which is "advice given by an individual with respect to a matter within the scope of the individual's authority to practice" before the IRS.[219] Impliedly, Congress' vague definition leaves it up to the courts to decide what constitutes "tax

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209 Smith, *supra* note 66, at 238.
210 *Id.*
211 Upjohn v. United States, 449 U.S. 383, 389 (1981).
212 I.R.C. § 7525(a)(2)(A) (2004).
213 Smith, *supra* note 66, at 244 (*quoting* United States v. LaSalle Nat'l Bank, 437 U.S. 298, 309 (1978)).
214 *Id.*
215 *Id.* at 245.
216 *Id.* The privilege may be considered ephemeral because it is "one that appears and disappears during the life of a single investigation." *Id.*
217 *Id.* For example, the IRS could instigate a criminal investigation by simply claiming that the taxpayer evaded taxes in violation of I.R.C. § 7201 to defeat the privilege. *Id.*
218 *Id.* While this may be theoretically possible, it is unlikely that that the IRS would attempt to abuse its power in this manner.
219 I.R.C. § 7525(a)(3)(B) (2004).

advice."[220] Trying to distinguish "tax advice" from general accounting services is not always simple, often requiring courts to conduct *in camera* reviews of masses of documents to separate the privileged items involving tax advice from the unprivileged items.[221] As the Seventh Circuit recently held, the § 7525 privilege does not include communications about tax return preparation.[222] Although just as drawing the line between legal and non-legal advice is difficult in the attorney-client context, separating tax advice from tax returns in the FATP-client context can also be complicated.

Another drawback is that the privilege is restricted to tax proceedings before the IRS or matters "in Federal Court brought by or against the United States."[223] In other words, the FATP privilege may only be applicable in IRS matters and proceedings with the U.S. government in Tax Court, federal district court, Court of Federal Claims, and bankruptcy courts.[224] Hence, a taxpayer's communications to a tax practitioner, even those considered "tax advice" are not protected under § 7525 in any civil proceeding, state and federal court included.[225] Similarly, the tax practitioner privilege may not be asserted to prevent disclosure of information to any regulatory agency other than the IRS, including the Federal Trade Commission, Securities and Exchange Commission, Pension Benefit Guaranty Corporation and the Environmental Protection Agency.[226] The FATP privilege does not apply in any of these forums. Therefore, the IRS has the ability to use discovery in these forums as a sort of "backdoor method" of obtaining information that would otherwise be protected in federal court.[227]

Fifth, the FATP privilege does not apply to advice to corporate tax shelters.[228] Specifically, § 7525 does not apply "to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, employee, agent or representative of a corporation in connection with

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220 Smith, *supra* note 66, at 244.

221 *See* cases discussed in Part III. A.

222 United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003). However, under the Seventh Circuit's 2002 decision, the court articulated a four-prong test to determine whether the identity privilege exists under the § 7525 protection: (1) Was the purpose of the transaction to provide tax advice? (2) In light of such purpose and the history of the firm's representation, would disclosing the clients' identities necessarily reveal their motives for seeking tax advice? (3) Did the clients waive the privilege, i.e., would the IRS have been able to ascertain the client names independent of the firm? (4) Was the document or communication made for the purpose of preparing the clients' tax returns? According to the court, in order for the clients' identities to be privileged under § 7525, the answers to the first two questions must be yes, and the answers to the last two questions must be no. *BDO Seidman*, 2002 WL 32080709 (N.D. Ill. 2002); *see also Confidentiality—How Protected is Communication With a Tax Advisor*? CONTROLLER'S TAX LETTER, July 1, 2003, *available at* 2003 WL 8916737. Thus, it is unclear how relevant these inquires are in light of the 2003 opinion.

223 I.R.C. § 7525(a)(2)(A)-(B) (2004).

224 Smith, *supra* note 66, at 245.

225 *Id.* Some states have enacted statutes providing an accountant-client privilege. Lobenhofer, *supra* note 114, at 256. Although, these state statutes normally apply only to public accountants, not enrolled agents or enrolled actuaries. *Id.*

226 *See* 144 CONG. REC. H5169 (daily ed. June 24, 1998).

227 Smith, *supra* note 121, at 245. While this may also be possible in theory, the IRS is careful not to misuse its power in this manner in practice.

228 I.R.C. § 7525(b) (2004).

the promotion of . . . any tax shelter."[229] Because the definition of "tax shelter" may be interpreted broadly, almost any corporate tax-advantaged transaction might fall outside the FATP privilege.[230] This is yet another reason why taxpayer reliance on §7525 is ill advised, especially with respect to corporations.

Another limitation is that § 7525 does not extend work product protection to the tax advisor. As discussed in Part II.B(2), the work product doctrine protects the work of the attorney prepared in anticipation of litigation, including information gathered from third parties and items that reflect the attorney's mental impressions.[231] The work product doctrine is completely separate from the attorney-client privilege. Thus, while the FATP privilege is a limited version of the attorney-client privilege, § 7525 does not extend the work product doctrine to non-attorney tax advisors.[232]

The privilege must be asserted and care must be taken not to waive it. With respect to claiming the § 7525 protection, it is unclear whether the client or the tax practitioner must assert it. Since the FATP privilege is modeled after the attorney-client privilege, a sound inference is that § 7525 also adheres to the principle that it is the client's privilege to claim.[233] A potential statutory conflict of interest between a tax practitioner and client may also exist due to the disclosure requirements that a tax shelter promoter must comply with under IRC §§ 6111 and 6112.[234]

The enactment of § 7525 has also served to increase tensions between attorneys and non-attorneys. Since the inception of the federal income tax, both attorneys and non-attorney advisors have guided clients with tax matters.[235] Each group has fought to obtain and maintain high-fee tax clients.[236] Prior to its passage, some attorneys opposed the FATP privilege as an assault on their roles as confidential advisors to taxpayer-clients, as many tax lawyers view the attorney-client privilege as a marketing advantage over non-attorney tax practitioners.[237] In addition, some attorneys fear that accountants may

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229 *Id.* Efforts have also been made to expand this exception to include all tax advice concerning tax shelters, not just corporate tax shelters. Smith, *supra* note 66, at 245.

230 Lobenhofer, *supra* note 114, at 258. Recall that one definition of tax shelter is "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a single purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax." I.R.C. § 6662(d)(C)(iii) (2004).

231 Hickman v. Taylor, 329 U.S. 495 (1947); FED. R. CIV. P. 26(b)(3).

232 *See* Lobenhofer, *supra* note 114, at 259. Obviously, protecting the client's original communications would not do much good if all of the tax advisor's subsequent internal memos and analysis were not privileged as well. Smith, *supra* note 66, at 246.

233 Smith, *supra* note 66, at 246-7.

234 There are no ethical rules governing a tax practitioner's commitment to a taxpayer-client's assertion of privilege. *Id.* at 247. Although, §§ 6111 and 6112 likely trump the FATP protections or create an implied waiver regarding the privilege. *Id.* Equally uncertain is when and how a taxpayer waives the § 7525 protection. Section 7525 and its legislative history do not address waiver specifically, but most likely, it follows the waiver rules of the attorney-client privilege (which also make the attorney-client privilege very tenuous). *Id.*

235 *See* Johnson, *supra* note 114, at 1041.

236 *Id.* at 1046.

237 *Id.* Some commentators have described it as a "watershed for the accounting industry," one of the first "volleys" in a "war," and even a "holy war," between the legal and accounting professions. *Id.* (citations omitted).

attempt to expand their new privilege.[238] Section 7525 is perpetuating this cycle of competitiveness by attempting to level the playing field with a privilege that falls short; the two groups are better off fending for themselves in their separate professional spheres.

Moreover, the concept of privilege is inconsistent with the accountant's role as "public watchdog."[239] Tax advisors are not under the same duty as attorneys to zealously advocate a client's position.[240] A tax practitioner, particularly a public certified accountant, performs a different role by assuming a "public responsibility transcending any employment relationship with the client . . . [he or she] owes ultimate allegiance to . . . the investing public . . . [and] complete fidelity to the public trust."[241]

In addition, § 7525 complicates the tax advisor's role. Notwithstanding how well versed they may be with respect to the IRC, tax advisors lack the training to assert the privilege correctly and to avoid waiving it.[242] While most attorneys gain a proficient understanding of evidentiary and client confidentiality concepts in law school, accountants undergo no such training in privilege law and are therefore not accustomed to applying it.[243] As such, the intricacies of the FATP privilege may frequently compel tax advisors to seek legal advice regarding § 7525's scope and limitations.[244] The new privilege might possibly make tax practitioners more reliant on attorneys than they were prior to § 7525's enactment.[245]

Finally, § 7525's scope is so limited that the identity privilege is questionable under FATP protection. While courts have found that the attorney-client privilege may shield client names under certain circumstances, it appears as though there is a movement away from this view to allow for the disclosure of investor names in tax shelters.[246]

In short, because of the many limitations and pitfalls associated with the § 7525 FATP privilege, it should be eliminated. At the very least, while the privilege remains in existence, those seeking tax advice on confidential matters would be wise to consult an attorney rather than another type of tax practitioner.

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238 *Id.*

239 Smith, *supra* note 66, at 244.

240 *Id.* at 237.

241 United States v. Arthur Young & Co., 465 U.S. 805, 817-8 (1984). While true in theory, in light of recent scandals (e.g., Enron and Worldcom), this might not be true in practice.

242 Lobenhofer, *supra* note 114, at 262; *see also* Johnson, *supra* note 114, at 1045.

243 Lobenhofer, *supra* note 114, at 262; *see also* Johnson, *supra* note 114, at 1045. That sanctions or penalties may be imposed for unmerited claims of privilege is another pitfall of the FATP privilege. While sanctions are not justified so long as there is a reasonable basis for claiming the privilege, tax practitioners, not being trained in asserting privilege, may fall prey to the IRS's frustration with inappropriate privilege assertions. *See* Smith, *supra* note 65, at 252. For discussion on prospective initiatives contemplated by the IRS, *see, e.g.*, Kenneth A. Gary & Sheryl Stratton, *Top Regulators Weigh In On Shelters*, TAX NOTES, Nov. 24, 2003, at 947; Thomas F. Field, *Tax Shelters: Have The Ethics Changed?*, TAX NOTES, Nov. 17, 2003, at 823; Heather Bennett & Timothy Catts, *No Single 'Silver Bullet' to Deter Tax Shelters, Jenner Says*, TAX NOTES, Sept. 29, 2003, at 1631.

244 Lobenhofer, *supra* note 114, at 262; *see also* Johnson, *supra* note 114, at 1045.

245 Lobenhofer, *supra* note 114, at 262.

246 *See, e.g.*, United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003).

2. *Abolish the identity privilege in tax shelter cases*

Tax shelter suits are complex and resource-intensive to prepare and file.[247] Compared to other tax cases, abusive tax shelter cases are particularly expensive to litigate.[248] Nonetheless, these are costs the government is willing to incur to combat abusive tax-advantaged transactions, which have resulted in billions of revenue loss over the past several years.[249]

The IRS has expended a great deal of resources in its efforts to address the growing culture of tax evasion and understatement. In order to maximize efficiency, the process calls for simplification, which has been justified on grounds related to compliance.[250] In many ways, the tax laws are so complex or so ambiguous that many taxpayers who intend to file accurate returns are defeated by their inability to know with certainty what the law requires.[251] Because tax revenue is our country's economic lifeblood, it is critical to strike a balance in which the traditional privileges are preserved and the government's financial objectives relating to revenue collection are not hindered.

As discussed earlier, while it is generally true that a client's name is not a protected "communication," there is a narrow exception to this rule: the "identity" privilege. A number of courts have found that a client's identity is privileged under certain circumstances.[252] Nonetheless, more and more courts are rejecting the application of the identity privilege in tax shelter cases – a definite

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247 2003 TNT 204-33 (Oct. 21, 2003).

248 *Id.* For instance, dozens attorneys and several highly paid expert witnesses have been employed to assist with cases. *Id.* The Tax Division staffs these cases at the outset with at least two attorneys, and usually three attorneys to handle the discovery and other pretrial work in a timely and efficient manner. The government must also hire its own private sector experts to testify about the purported business purpose, the values of any assets or liabilities at issue, foreign law and other subjects. *Id.*

249 While it is difficult to accurately determine the amount of unpaid taxes, the estimates are astounding: One to two million taxpayers currently use foreign entities, *e.g.*, trusts, offshore bank accounts and partnerships, to conceal income and get around paying $40 billion to $70 billion per year in federal income taxes. Smith, *supra* note 66, at 247. Many more billions have possibly been evaded in other transactions of different sorts. *Id.* For example, some have estimated that individual and corporate income tax noncompliance cost the federal fisc over $300 billion. DONALD L. BARTLETT & JAMES B. STEELE, THE GREAT AMERICAN TAX DODGE 3 (2000).

250 Steve R. Johnson, *The 1998 Act and the Resources Link Between Tax Compliance and Tax Simplification*, 51 KAN. L. REV. 1013, 1048 (2003). Other grounds include: (1) reduced compliance costs for taxpayers, (2) greater popular support for the tax system, (3) greater transparency of the system, and (4) greater fairness. *Id.*

251 Johnson, *supra* note 114, at 1049.

252 *In re* Grand Jury Proceeding, 898 F.2d 565, 568 (7th Cir. 1990) (finding special circumstances of case did not justify exception to attorney-client privilege to reveal identity of third party paying on behalf of defendant since that would necessarily implicate third party's involvement in crime). Identity may also be privileged where it provides the "last link" to indicting the client. *See* United States v. Sindel, 53 F.3d 874, 876-77 (8th Cir. 1995) (applying "last link" doctrine to find identity of client is privileged where it could lead to individual's conviction of federal crime while keeping in mind that "Congress cannot have intended to allow local rules of professional ethics to carve out fifty different privileged exemptions."). *But see* United States v. Blackman, 72 F.3d 1418, 1424 (9th Cir. 1995) (holding privilege does not apply where disclosure of identity might incriminate client or fee-payer, "but only where it would convey information tantamount to a confidential communication").

victory for the government.[253] In addition, there is pending legislation that would abolish the identity privilege in tax shelter cases.[254] This legislation, if enacted, will further limit the applicability of privilege when a tax-advantaged transaction is at issue; the identity of investors will no longer be protected under any circumstances.

For the benefit of the masses, the identity privilege should be abolished to allow the government to collect a necessary source of revenue. Caution must be taken to not forfeit the taxpayer's entitlement to privacy by granting the IRS unrestricted summons power.

IV. Conclusion

We must tread lightly when we consider granting or abolishing a privilege. Though a privilege has been granted, it is not impossible to alter, limit, or even abolish it. Though I advocate eliminating the FATP and identity privileges in

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[253] *See, e.g.*, United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003) (holding that, because they failed to prove that a confidential communication would be revealed, the information regarding the identity of clients who had consulted with a tax shelter promoter was not protected from disclosure under § 7525 in a tax enforcement action against the promoter; although the court's 2002 *BDO* opinion set up a 4-prong test to determine whether the identity privilege exists under the § 7525 protection).

[254] 108 H.R. 2896 (July 2003). The pending legislation states in pertinent part:

> SEC. 3003. TAX SHELTER EXCEPTION TO CONFIDENTIALITY PRIVILEGES RELATINGTO TAXPAYER COMMUNICATIONS.
>
> (a) In General. Section 7525(b) (relating to section not to apply to communications regarding corporate tax shelters) is amended to read as follows:
>
> "(b) Section Not To Apply to Communications Regarding Tax Shelters. The privilege under subsection (a) shall not apply to any written communication which is —
>
> "(1) between a federally authorized tax practitioner and —
>
> "(A) any person,
>
> "(B) any director, officer, employee, agent, or representative of the person, or
>
> "(C) any other person holding a capital or profits interest in the person, and
>
> "(2) in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662(d)(2)(C)(ii))."
>
> (b) Effective Date. The amendment made by this section shall apply to communications made on or after the date of the enactment of this Act.
>
> (5)(A) The heading for section 6708 is amended to read as follows:
>
> "SEC. 6708. FAILURE TO MAINTAIN LISTS OF ADVISEES WITH RESPECT TO REPORTABLE TRANSACTIONS."
>
> (B) The item relating to section 6708 in the table of sections for part I of subchapter B of chapter 68 is amended to read as follows:
>
> "Sec. 6708. Failure to maintain lists of advisees with respect to reportable transactions."
>
> (c) Required Disclosure Not Subject to Claim of Confidentiality.
>
> Paragraph (1) of section 6112(b), as redesignated by subsection (b), is amended by adding at the end the following new flush sentence:
>
> "For purposes of this section, the identity of any person on such list shall not be privileged."
>
> (d) Effective Date.
>
> (1) In general. Except as provided in paragraph (2), the amendments made by this section shall apply to transactions with respect to which material aid, assistance, or advice referred to in section 6111(b)(1)(A)(i) of the Internal Revenue Code of 1986 (as added by this section) is provided after the date of the enactment of this Act. (2) No claim of confidentiality against disclosure. The amendment made by subsection (c) shall take effect as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

tax shelter cases, the attorney-client privilege should remain intact. Even though doing so may still protect some undeserving taxpayers, the innocent taxpayers should not be punished for the misconduct of a minority. This should not be understood as sympathy for tax shelter promoters, but instead a manifestation of the reality that taxpayers who pay their fair share in taxes, as well as those needing the law's protections in other contexts, also benefit from the attorney-client privilege.[255] Based on the foregoing, the FATP privilege and the identity privilege should be abolished in tax shelter cases.

[255] *See* Smith, *supra* note 66, at 254.