PRIVILEGED COMMUNICATIONS BETWEEN TAX SHELTER PROMOTERS AND THEIR CLIENTS CHALLENGED

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PRIVILEGED COMMUNICATIONS IN GENERAL

The waiver cases may be synthesized by the proposition that, generally, the waiver is triggered when there is no longer a reasonable expectation of confidentiality.1 A "federally authorized tax practitioner" includes any nonattorney who is authorized to practice before the IRS such as an enrolled agent, an enrolled actuary or a certified public accountant (Code Sec. 7525(a)(3)(A)). "Tax advice" is defined as advice given by an individual with respect to a matter that is within the scope of the individual's authority to practice before the IRS (Code Sec. 7525(a)(3)(B)). The ABA has suggested that this would include any tax aspect of any matter, even if the tax component of the matter is very slight in relation to the overall content of the matter.

SCOPE OF THE TAX SHELTER PROBLEM

The Conference Committee Report for P.L. 105-206 states that a tax shelter is any partnership, entity, plan or arrangement a significant purpose of which is the avoidance or evasion of income tax. Tax shelters where there will be no privilege of confidentiality include those required to be registered as Code Sec. 6111(d) confidential corporate tax shelter arrangements. The report also states that since the promotion of tax shelters is not part of the routine relationship between a tax practitioner and a client, the tax shelter limitation should not adversely affect such routine relationships otherwise protected in Sec. 7525. The report goes on to state that the confidentiality privilege to nonattorneys may be waived in the same way, such as disclosure of information to third parties, as the attorney-client privilege.2
In a speech the IRS Commissioner, Charles Rossotti made before the Tax Executives Institute and the AICPA in October 1999, he said: "Our objective will be to identify-and where appropriate to stop-transactions which have no real business purpose other than tax savings. Of course, we know that there are complex transactions that do serve a legitimate business purpose. But when we find U.S. corporations engaged in such activities, for example, as leasing a city hall in a foreign country and immediately leasing it back to that entity with large tax benefits to the U.S. corporation, we think we have reason for concern."

On March 16, 2004 Senator Levin introduced a comprehensive tax reform bill called the Tax Shelter and Tax Haven Reform Act. “This bill is intended to respond to the ever increasing tax shelter and tax haven abuses that are undermining the integrity of our tax system, robbing the Treasury of tens of billions of dollars each year, and shifting the tax burden from high income corporations and individuals onto the backs of the middle class. Abusive tax shelters and the misuse of tax havens must be stopped.”3 This proposed legislation is the direct result of the disclosures made in the Permanent Subcommittee on Investigation's hearings on the "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professional (S. Hrg. 108-473)," held November 18 and 20, 2003.

At those hearings, Senator Levin said, “According to the GAO, a recent IRS consultant estimated that for the 6-year period 1993 to 1999, the IRS lost an average of between $11 and $15 billion each year from abuse of tax shelters. The GAO reports that an IRS database tracking unresolved abusive tax

shelter cases over a number of years estimates potential tax losses of about $33 billion from listed transactions and another $52 billion from unlisted abusive transactions, for a total of $85 billion"[4].

PRIVILEGE FOR LAW FIRMS

Historically communications between an attorney and a client, or a prospective client, with respect to legal advice are protected by a common-law privilege of confidentiality. These protected communications must be based on facts that the client provides the attorney for the purpose of receiving the attorney's advice, legal opinion, legal services, or assistance in some legal proceeding. The confidentiality privilege applies only to advice on legal matters. The privilege does not apply if the attorney is acting in another capacity, such as where the attorney is engaged to prepare a tax return. In United States v. Lawless the court made a finding that "information transmitted for the purpose of preparation of a tax return, though transmitted to an attorney, is not privilege information".[5]

PRIVILEGE FOR ACCOUNTING FIRMS

The following discussion reviews several recent pertinent cases which shed further light on this issue accounting firm privilege with respect to tax shelters. The first is *United States v. BDO Seidman*.[6] After the Seventh Circuit set forth an exhaustive analysis of the §7525 privilege, it held that clients' "participation in potentially abusive tax shelters is information ordinarily subject to full disclosure under the federal tax law." Further,

Congress has determined that tax shelters are subject to special scrutiny, and anyone who organizes or sells an interest in tax shelters is required, pursuant to I.R.C. §6112, to maintain a list identifying each person to whom such an interest was sold. This list-keeping provision precludes the Does from establishing an expectation of confidentiality in their communications with BDO, an essential element of the attorney-client privilege and, by extension, the §7525 privilege. At the time that the Does communicated their interest in participating in tax shelters that BDO organized or sold, the Does should have known that BDO was obligated to disclose the identity of clients engaging in such financial transactions. Because the Does cannot credibly argue that they expected that their participation in such transactions would not be disclosed, they cannot now establish that the documents responsive to the summonses, which do not contain any tax advice, reveal a confidential communication.[7]

In the second relevant opinion in this area in *US v. KPMG*[8] the district court ordered the accounting firm to comply with nine IRS summonses demanding the firm turn over to the government the identity of clients who participated in potentially abusive tax shelters. The court allowed Code Sec 7525 did not protect communications between the firm and a client simply for the preparation of a tax return. The court also said with respect to various tax shelter opinion letters from legal counsel supporting positions taken on KPMG client returns the burden of proof was shifted to the accounting firm to show that any or all the letters were privileged under either the attorney-client privilege or the attorney work product privilege.

The third privilege opinion also involves KPMG. *See John Doe No. 1 and John Doe No. 2 v. KPMG LLP, United States, Intervenor* [9] That case involved taxpayer plaintiffs who sought to enjoin KPMG from disclosing their identities to the IRS. Those plaintiffs premised their request on the §7525 privilege. The court rejected this argument for several reasons. First, "[d]isclosing Plaintiffs' identities to the IRS ... only reveals Plaintiffs' participation in these shelters; it does not reveal any confidential communication made regarding these tax shelters." *Ibid.* at *5 (citing *BDO Seidman* , 337 F.3d at 812).

Further, "Plaintiffs' motives for participating in the tax shelter are not confidential, as virtually any taxpayer who seeks tax advice from an accounting firm is looking for ways to minimize his taxes or for assurance that he is complying with the tax law." (internal quotation marks and citation omitted). The court went on to find that

Plaintiffs' had no reasonable expectation of confidentiality as to their participation in the ... tax shelter because of the provisions in I.R.C. §§6111 and 6112. Section 6111 requires the organizer of a tax shelter to register the tax shelter with the IRS, and §6112 requires organizers and sellers of tax shelters to maintain lists of investors in tax shelters.... If Plaintiffs' tax returns were audited, Plaintiffs would be required to explain how the losses resulted. Knowing that any information included on a tax return could be questioned during an audit, Plaintiffs could not have reasonably believed their participation in the tax shelter was confidential.... The Court, therefore, adopts the Seventh Circuit's conclusion that §§6111 and 6112 destroy any reasonable expectation of confidentiality as to participation in a tax shelter. *See BDO Seidman* [2003-2 USTC ¶50,582], 337 F.3d at 812.

CONCLUSION

It seems increasingly clear the IRS has taken a very aggressive approach to tracking down investors in abusive tax shelters. The courts are ordering self proclaimed "non-promoters" to disgorge their tax shelter investor lists. Neither law firms nor accounting firms can claim the common-law notion of attorney-client privilege when their clients have retained their services to assist them in investing in these abusive tax shelters.

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1 CCH-JOURNAL, TAXES-The Tax Magazine, June 2004, The Application of the Waiver Doctrine to Code Sec. 7525's CPA-Client Confidentiality Privilege , Robert R. Oliva

2 CCH-EXP, 2004FED ¶42,816F.021, Confidentiality of Communications with Non-attorneys: Confidentiality privilege extended to certain nonattorneys

3 MISC-LEG-DOC, 2004ARD 051-6, Introduction to Tax Shelter and Tax Haven Reform Act, Sen 2210, , (March 16, 2004)

4 MISC-LEG-DOC, 2004ARD 170-5, Senate Committee on Governmental Affairs Permanent Subcommittee on Investigation Hearings on the U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Volume 1 (S. Hrg. 108-473), , (September 7, 2004), Part 03 of 11

5 709 F.2d 485, 488 (7th Cir. 1983)

6 [2003-2 ustc ¶50,582 LK:NON: USTCLINK 2003-2USTCP50582], 337 F.3d 802 (7th Cir. 2003).

7 Ibid at 812.

8 US-DIST-CT, 2004-1USTC ¶50,281, United States of America, Petitioner v. KPMG LLP, Respondent

9 [2004-1 ustc ¶50,223 LK:NON: USTCLINK 2004-1USTCP50223], C.A. No. 03-cv-2036-H, 2004 WL 797719 (N.D. Tex. Apr. 12, 2004).