CONSIDERATIONS FOR PROTECTING PRIVILEGED DOCUMENTS IF THE IRS COMES KNOCKING: A BRIEF EXPLORATION OF PRIVILEGE NUANCES IN THE TAX CONTEXT

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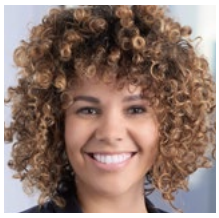

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Attorney-client privilege and relevant equivalents exist to protect the confidentiality of client communications and to ensure that clients feel free to have frank and honest conversations when seeking advice from counsel. However, privilege protections are nuanced in the tax context and require careful analysis. This article discusses applicable privileges in the tax context, as well as two key exceptions: waiver and the crime-fraud exception. It also examines several cases that highlight the practical implications of these exceptions.

OVERVIEW OF APPLICABLE PRIVILEGES IN THE TAX CONTEXT

The attorney-client privilege protects communications between the client and lawyer that are made in confidence and for the purpose of obtaining legal

advice. This privilege extends to information given for the purpose of obtaining legal representation. Attorneys may not disclose communications or information protected by the attorney-client privilege, and clients cannot be compelled to disclose protected communications. The purpose of the attorney-client privilege is to promote unrestrained communication and contact between the lawyer and client in matters in which the attorney's professional judgment is sought. A key exception to the attorney-client privilege in the tax context is the crime-fraud exception, which excludes communications made: (i) if the client was in the process of committing or planning a fraud or crime; and (ii) in furtherance of the fraud or crime.

The Internal Revenue Code (Code) also creates a tax practitioner privilege to encourage clients to provide tax practitioners with complete information to better assist their clients in obeying the law. Specifically, under Code section 7525, communications between "federally authorized tax practitioners" and their clients regarding federal tax advice are protected to the same extent as attorney-client communications. "Federally authorized tax practitioners" include CPAs, enrolled agents, actuaries, and in-house tax department employees who may represent their employers before the Internal Revenue Service (IRS). There are certain exceptions to the tax practitioner privilege including the crime-fraud exception as well as communications regarding tax shelters; however, a recent court decision, discussed below, has raised concerns about the scope of this privilege.

Finally, the work product doctrine is designed to protect communications, documents, and tangible items from discovery when they were made in anticipation of litigation. The work product doctrine is broader than attorney-client privilege; it covers materials prepared by anyone at the direction of the attorney when future litigation is a distinct possibility. However, a party seeking discovery of otherwise protected information can overcome the work product doctrine by showing substantial need and an inability to access the information without undue hardship.

WAIVER

While a lawyer can invoke the attorney-client privilege to protect communications with her client, it is the client who technically "owns" the privilege. Thus, the client can waive privilege by sharing otherwise privileged information with individuals other than her attorney, or sharing privileged information with an attorney for a non-legal purpose. The communication's purpose determines whether the communication is privileged. For example, business, tax preparation, and accounting advice are not protected, even if provided by a licensed attorney.

Non-legal advice is not privileged

Companies and individuals must be cognizant that providing otherwise privileged information to attorneys for a non-legal purpose will often result in a waiver of the attorney-client privilege and work product protection.[1]

In *United States v. Sanmina*, the lower court held that a corporation waived the attorney-client privilege and work product protection when it provided privileged information to a law firm for the non-legal purpose of preparing a valuation report for the IRS.[2] In the report, the law firm relied upon two memoranda prepared by Sanmina's in-house counsel to reach its conclusion.[3] When faced with an IRS summons, the corporation refused to produce the two documents referenced in the valuation report on the basis of the attorney-client privilege.[4] The magistrate court denied enforcement of the summons and the IRS appealed.

The Ninth Circuit remanded the case for in camera review of the two documents, instructing the district court to "reconsider its ruling on the asserted privilege following its review of the pertinent documents."[5] On remand, the district court held that the two documents were protected by attorney-client privilege and work product protection, but that both privileges had been waived.[6] The court noted that the valuation report had relied upon the two documents and "[t]he analyses that informed the valuation report's conclusions should, in fairness,

be considered together" with the reports.[7] Sanmina appealed the decision.

The Ninth Circuit affirmed in part and reversed in part.[8] The Ninth Circuit agreed that Sanmina waived attorney-client privilege when it disclosed the memoranda to the law firm, and declined to analyze a waiver for the subsequent disclosure to the IRS.[9] The court found that Sanmina's purpose in sharing the two documents was to obtain a non-legal valuation analysis.

The Ninth Circuit concluded, however, that Sanmina did not waive work product protection when it provided the documents to the law firm.[10] Citing *United States v. Deloitte LLP*,[11] the court concluded that the law firm was not an adversary (which the government had conceded), nor a potential adversary, to Sanmina with respect to the subject matter the work product addressed.[12] The court then analyzed whether, by providing the two documents to the law firm for its preparation of the valuation report, Sanmina had disclosed them to a "conduit to an adversary," because, the IRS argued, the valuation report" was intended for disclosure to interested tax authorities [and therefore] any expectation of confidentiality was ... absent."[13] Again, the court rejected this argument, referencing *Deloitte*, and finding that Sanmina "'had a reasonable basis for believing that [the law firm] would keep the [the two documents] confidential' in the process of producing its valuation analysis."[14]

Sanmina highlights the importance of properly documenting and identifying the purpose of written privileged materials that are shared with non-legal advisors. In particular, to claim work product protection over legal advice shared to obtain non-legal services, it is important to establish that the advice was shared in anticipation of litigation.

Preserving privilege while working with accountants

Risk of waiver can present a problem for companies and individuals seeking legal advice regarding complex tax issues. Attorneys often need the advice of a third party (like an accountant) to fully understand material tax issues that their clients face. While the tax practitioner privilege applies in a civil setting, it is not available during a criminal investigation or prosecution. Therefore, disclosing privileged information to accountants during a criminal investigation runs the risk of waiver. Yet communications between a taxpayer's lawyer and accountant may remain privileged if the accountant was hired under a so-called *Kovel*[15] arrangement.

A *Kovel* arrangement allows the attorney-client privilege and work product doctrine to extend to communications with a third-party expert—like an accountant—so long as that expert was hired "for the purpose of obtaining [confidential] legal advice from a lawyer."[16] A *Kovel* arrangement is created when a client's lawyer hires an expert (e.g., an accountant) to help the lawyer understand the relevant issues in order to provide legal advice. Properly executed, the *Kovel* arrangement imports attorney-client privilege to the accountant's work and communications.

The common interest doctrine protects against third-party waiver

In connection with a complex financial transaction, taxpayers may decide to share otherwise privileged communications and materials with third parties (e.g., parties also having financial interests in the transaction) and their attorneys. Generally, disclosing a communication to a third party waives the attorney-client and tax practitioner privileges.[17] However, a taxpayer's disclosure of privileged information to a third party may be protected under the common interest doctrine. The common interest doctrine permits parties to share information without waiving privilege so long as: (i) a "common legal interest" exists between the parties; (ii) the information is exchanged solely for obtaining and providing legal advice; and (iii) the communications are intended to be kept confidential.[18] In most jurisdictions, no ongoing litigation is necessary for the common interest privilege to apply; instead, communications made during an "ongoing common enterprise and intended to further the enterprise are protected."[19] Courts have held that documenting

the existence of the common legal interest and the agreement to maintain the shared communications' confidentiality is relevant to the analysis of the common interest privilege's applicability.[20]

Schaeffler v. United States[21] demonstrates how courts analyze the common interest privilege and the importance of a common interest agreement in the tax context. *Schaeffler* involved the restructuring of the Schaeffler Group—a German company having 80 percent of its stock owned by a US resident—and the refinancing of debt owned by a consortium of banks (Consortium) in the wake of the 2008 financial crisis.[22] The Schaeffler Group hired legal counsel and an accounting firm to advise on assessing and minimizing the tax consequences of the restructuring and refinancing, knowing that the transactions would likely face IRS scrutiny.[23] In the course of the refinancing and analysis of its tax consequences, the Schaeffler Group shared materials, including privileged tax advice, with the Consortium pursuant to a common interest agreement.[24] The IRS later subpoenaed the documents containing the legal tax advice, and the Schaeffler Group moved to quash the subpoena and withheld the documents on the basis of the common interest privilege and the attorney work product doctrine.[25]

The magistrate judge held that the Schaeffler Group had waived the attorney-client and tax practitioner privileges upon disclosure of the documents to the Consortium.[26] On appeal, the Second Circuit reversed, holding that: (i) the common interest doctrine protected the exchange of privileged information;[27] and (ii) the work product doctrine also applied to materials prepared during the course of the transaction because the documents were prepared in anticipation of an IRS audit.[28]

In holding that the Schaeffler Group and the Consortium had a common legal interest, the Second Circuit explained that the parties "had a strong common interest in the outcome of [the] legal encounter [with the IRS]" surrounding the tax treatment of the refinancing and restructuring.[29] The court noted that "[a] financial interest of a party, no matter how large, does not preclude a court from finding that a common legal interest also exists and is shared with another party where the legal aspects materially affect the financial interest."[30] The finding of a common legal interest between the parties in *Schaeffler* was supported by the nature of the parties' communications, which were "made in the course of an ongoing common enterprise" and were "of a sufficient legal character to prevent a waiver."[31] The court noted that the common interest agreement documented the parties' "common legal strateg[ies]" and "the[ir] mutual obligations."[32]

In holding that the work product doctrine applied to the documents the IRS sought, the court explained that the tax advice at issue "was necessarily geared to an anticipated audit and subsequent litigation."[33] The court noted that the tax advice was more detailed than advice that would be given during the preparation of a "routine tax return"[34] and "candidly discusse[d] the attorney's litigation strategies [and] appraisal of the likelihood of success."[35]

CRIME-FRAUD EXCEPTION

Another exception to the attorney-client and tax practitioner privileges is the crime-fraud exception. The crime-fraud exception excludes communications from the scope of both privileges where the taxpayer attempts to obtain advice to further the commission of a crime or fraud. Similarly, a *Kovel* arrangement will not protect communications (or documents) about future criminal acts.

Courts vary in their application of the crime-fraud exception. Generally, however, the party opposing the assertion of privilege must demonstrate that there is a reasonable basis to suspect that: (i) the lawyer or client was committing or intending to commit a crime or fraud; and (ii) that the attorney advice/work product was used in furtherance of the alleged crime or fraud.[36]

A November 2018 decision highlights how the crime-fraud exception works in practice. In *United States v. Issa*,[37] the Southern District of New York held that a *Kovel* arrangement did not protect three documents as a result of the crime-fraud exception.[38] The court found that the documents were prepared

and submitted to the defendant's *Kovel* accountant for the purpose of allowing the accountant to prepare a false and fraudulent amended tax return for corporations controlled by the defendant.[39] Accordingly, the IRS was allowed to use the documents in its criminal case against the taxpayer.[40]

RECENT TRENDS IN LITIGATION

Privileges are fragile. Still, courts recognize the policy reasons behind their existence and endeavor to protect the right to have candid communications with counsel and other advisors. Recent litigation illustrates the different methods that the IRS may employ to discover potentially privileged information from taxpayers, attorneys, and tax practitioners despite these well-established privilege protections. The following three cases are relevant for any corporation, law firm, tax practitioner, or individual seeking to rely upon privilege protections.

"Primary purpose" distinctions: Potential limitations of tax practitioner privilege protections

Companies and individuals must be aware of increased scrutiny by taxing authorities when relying upon the tax practitioner privilege. A 2020 decision by a federal district court highlights the potential pitfalls that companies may face in seeking tax advice for business purposes.

In January 2020, a Washington federal district court ordered Microsoft Corporation to produce documents to the IRS that Microsoft asserted were privileged.[41] The decision arose out a long-running discovery dispute between Microsoft and the IRS, in connection with the IRS's examination of Microsoft's cost-sharing transactions with its Puerto Rican subsidiary that had purchased intellectual property from a US affiliate. Microsoft had engaged KPMG to provide "tax consulting services" to explore whether and how to enter into this cost-sharing transaction.[42] Microsoft had argued that most of the documents were protected by the work product doctrine and the federally authorized tax practitioner privilege, and that a small number of documents were protected by the attorney-client privilege. For the majority of the documents, the court held that none of these protections applied.

The court held the work product protection did not apply because there was no ongoing litigation at the time the document was prepared and the primary purpose of the communications was business, not legal. (Microsoft had argued that work product protected 170 of 174 documents). Instead, the court held that the documents were created because Microsoft thought the IRS would challenge the transaction. "Microsoft's documents were not created in anticipation of litigation. Rather, Microsoft anticipated litigation because of the documents it created."[43] The court also noted that, even though Microsoft claimed to anticipate litigation regarding the transaction, Microsoft had not engaged KPMG to represent it in the anticipated litigation.[44]

The court held the tax practitioner privilege did not apply to Microsoft's communications with KPMG because the communications fell within the tax shelter exception to the tax practitioner privilege set forth in Code section 7525(b). The court concluded that "a significant purpose, if not the sole purpose, of Microsoft's transactions was to avoid or evade federal income tax."[45] The court distinguished a tax shelter from a permissible tax structure, which "achieve[s] a legitimate business purpose."[46] The court noted that the "transactions did not appear necessary to satisfy Microsoft's operational needs."[47] The court concluded that KPMG was a promoter of a tax shelter, and that it "originated and drove the structuring of the transactions."[48]

Crucially, the court did not acknowledge the economic decision by Microsoft to own and maintain the subject intellectual property, which is a business-motivated decision. Once a business decision has been made, a company typically may then structure a transaction or ownership in the most efficient manner. And yet, the court focused on only a small aspect of Microsoft's intellectual property management (the question of which affiliate should own and assume the responsibility to maintain the property) and evaluated "tax motivation" on a narrow basis.

This decision is another example of the increased scrutiny on corporations by taxing authorities, both in the US and abroad. Documents that have both a legal and a business purpose will receive additional scrutiny. While it is not yet clear whether other courts will adopt this outlier approach to the tax practitioner privilege, entities that engage tax practitioners or attorneys to provide tax or legal advice should be cognizant of the bounds of the respective privileges in order to preserve them.

A John Doe summons: Recent methods by the IRS to discover unknowable clients

Companies must also be aware that the IRS has begun to aggressively seek the use of John Doe summonses to investigate potential tax evasion. A John Doe summons pursuant to Code section 7609(f) may be issued with respect to an unknown party provided that the IRS establishes certain statutory requirements, including that "there is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law" and the information to be discovered "is not readily available from other sources."

In *Taylor Lohmeyer Law Firm PLLC v. United States*,[49] the IRS served a John Doe summons on Taylor Lohmeyer Law Firm PLLC, an estate planning firm, in an effort to discover the identities and other information of clients that the IRS suspected had concealed taxable income abroad between 1995 and 2017. The John Doe summons was largely based on an earlier investigation of one of the law firm's clients, who used the law firm to set up offshore accounts and admitted to $2 million in unpaid tax liability from 1996 to 2000. The law firm estimated that 32,000 pages of documents were responsive to the summons and petitioned to quash it.

The US District Court in the Western District of Texas declined to quash the summons and instead enforced it. It held that the government has only a "slight" and "minimal" burden to enforce a John Doe summons, while the challenger's burden to quash it is "heavy."[50] The court decided that the government's low burden was satisfied with a single affidavit from an IRS agent. It emphasized that the agent relied on "an interview with [a] former partner of the firm, [who] estimated that he structured offshore entities for tax purposes for 20 to 30 clients between the 1990s and early 2000s," which permitted the agent to infer from one client's admission that the law firm had helped other clients avoid tax liability.[51]

The court rejected all of the law firm's attempts to meet its "heavy" burden to quash the summons, including the argument that the information the summons sought—names and other information related to the firm's clients—was protected by the attorney-client privilege. The argument failed largely because the law firm asserted a blanket privilege, rather than asserting it on a document-by-document basis. In rejecting the blanket assertion, the court held that a client's identity was privileged only in a very narrow set of circumstances, which turned on whether "disclosure of the client's identity by his attorney would have supplied the last link in an existing chain of incriminating evidence likely to lead to the client's indictment."[52] The Fifth Circuit affirmed the district court's decision and the United States Supreme Court denied certiorari on the law firm's petition.[53]

This decision provides a warning that, despite privilege protections, firms may still be the target of potentially cumbersome John Doe summonses. The cases suggest that the attorney-client and work product doctrines may not provide blanket protections where the IRS seeks a large number of documents and the law firm is in the business of providing legal counsel. Nonetheless, although undoubtedly burdensome, the law firm may still invoke privilege protections with respect to each document, provided that the firm produces a corresponding privilege log.

Kovel arrangements: An analysis of waiver and the crime-fraud exception

A *Kovel* arrangement, as discussed above, seeks to provide protections for all involved parties—the

company, the hired third party, such as an accountant, and the attorney or law firm. These arrangements are crucial to any litigation involving an accountant. An October 2018 decision, *United States v. Adams*,[54] demonstrates how one court approached the privilege analysis in the context of a *Kovel* arrangement where the government sought communications and documents reflecting legal advice and analysis created after the controversy at issue had begun.

In *Adams*, the defendant faced multiple counts of embezzlement, fraud, and tax evasion.[55] In response, Adams, under advice of counsel and with the aid of a *Kovel* accountant, filed amended tax returns.[56] Prior to filing the amended returns, the government had sought a range of communications between Adams, his attorneys, and his accountants, but Adams asserted that they were privileged and refused to provide them to the government.[57] The government argued that the filing of the amended returns waived any applicable privileges or protections of documents containing information used in preparing the amended returns.[58] Further, the government argued that the crime-fraud exception to attorney-client privilege would apply, permitting discovery of the communications.[59] In its decision, the court rejected both privilege challenges.

In analyzing the waiver argument, the court reviewed the information on the amended returns, and held that the attorney-client privilege and work product doctrine still protected the information, advice, and data that was "unpublished" on the returns but utilized in their preparation.[60] Because the information in the documents that the government sought was not revealed on the amended tax returns, the privilege was not waived.[61]

The court also held that the government had failed to meet the threshold to invoke the crime-fraud exception.[62] Specifically, after an in camera review of the documents at issue, the court held that the government did not establish that the advice that Adams sought from his lawyer or *Kovel* accountants was itself obtained in furtherance of a crime or fraud.[63]

KEY TAKEAWAYS

When considering privilege in the tax context, it is important to keep in mind the following suggestions:

- Waiver rules are complicated. When in doubt, clients should not share confidential or privileged information without first obtaining legal advice regarding the implications of doing so.
- Consider privilege and work product issues early in transactional and litigation contexts. Establishing—and following—proper confidentiality protocols can avoid potential waiver and future litigation expenses.
- While communications between a client and his accountant are privileged in the civil setting, they are not in a criminal setting.
- *Kovel* arrangements between attorneys and accountants should be properly documented, and all formalities in implementing them must be respected.
- If third parties share a common legal interest and anticipate sharing otherwise privileged materials, the common legal interest and the obligation to keep any shared information confidential should be documented in a common interest agreement. The shared interest must be legal in nature, and not purely commercial.
- When disclosing privileged documents pursuant to a common interest agreement, disclose only the privileged documents that are directly related to the shared legal interest, and only with counsel's approval.

Notes

1 United States v. Sanmina Corp., No. C 15-00092 WHA, 2018 WL 4827346, at *1 (N.D. Cal. Oct. 4, 2018), aff'd in part, rev'd in part and remanded, 968 F.3d 1107 (9th Cir. 2020).

2 Id.

3 Id.

4 Id.

5 United States v. Sanmina, 707 F. App'x 865, 865 (9th Cir. 2017).

6 Sanmina., 2018 WL 4827346, at *3 (N.D. Cal. Oct. 4, 2018).

7 Id.

8 United States v. Sanmina Corp., 968 F.3d 1107, 1112 (9th Cir. 2020).

9 Id. at 1116-19.

10 Id. at 1125.

11 610 F.3d 129, 139 (D.C. Cir. 2010).

12 Sanmina, 968 F.3d at 1122-23.

13 Id. at 1122.

14 Id. (quoting Deloitte, 610 F.3d at 141).

15 In United States v. Kovel, an accountant employed by the law firm representing the target of an investigation was subpoenaed to appear before the grand jury investigating the target. 296 F.2d 918, 919 (2d Cir. 1961). When the accountant refused to answer questions, he was held in contempt and sentenced to a year in prison. Id. at 919–20. On appeal, the US Court of Appeals for the Second Circuit reversed the conviction, holding that attorney-client communications did not lose their privileged nature by virtue of having been shared with the accountant. Id. at 921–22. Rather, the court analogized the accountant's role to that of an interpreter facilitating communications between an attorney and a non-English speaking client and found the accountant "necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit." Id. at 921.

16 Id. at 922.

17 See Schaeffler v. United States, 806 F.3d 34, 40 (2d Cir. 2015) ("A party that shares otherwise privileged communications with an outsider is deemed to waive the privilege by disabling itself from claiming that the communications were intended to be confidential."); see also United States v. Rockwell International, 897 F.2d 1255, 1265 (3d Cir. 1990) ("The attorney-client privilege does not apply to communications that are intended to be disclosed to third parties or that in fact are so disclosed.").

18 See Schaeffler, 806 F.3d at 40 (citing United States v. Schwimmer, 892 F.2d 237, 243 (2d Cir. 1989)); Katz v. AT&T Corp., 191 F.R.D. 433, 436 (E.D. Pa. 2000) ("The common interest doctrine is an exception to the general rule that the attorney-client privilege is waived upon disclosure of privileged information with a third party.").

19 See Schaeffler, 806 F.3d at 40 (citing Schwimmer, 892 F.2d at 243).

20 Id. at 38 n.2.

21 806 F.3d 34.

22 Id. at 37.

23 Id.

24 Id.

25 Id. at 37-38.

26 Id. at 38-39.

27 Id. at 40-41.

28 Id. at 45.

29 Id. at 41.

30 Id. at 42.

31 Id. (citing Schwimmer, 892 F.2d at 243).

32 Id. at 41.

33 Id. at 44.

34 Id.

35 Id. at 45 (citing United States v. Adlman, 134 F.3d 1194, 1200 (2d Cir.1998)) (citations omitted).

36 See, e.g., Triple Five of Minnesota v. Simon, 213 F.R.D. 324, 327 (D. Minn. 2002), aff'd, No. Civ. 99-1894 (PAM)(JGL), 2002 WL 1303025 (D. Minn. June 6, 2002) (citing In re Grand Jury Investigation, 842 F.2d 1223, 1226 (11th Cir. 1987)) ("First, there must be a prima facie showing that the client was engaged in criminal or fraudulent conduct when he sought the advice of counsel, that he was planning such conduct when he sought the advice of counsel, or that he committed a crime or fraud subsequent to receiving the benefit of counsel's advice. Second, there must be a showing that the attorney's assistance was obtained in furtherance of the criminal or fraudulent activity or was closely related to it.")

37 United States v. Issa, No. 1:17-CR-74 (CM), 2018 WL 6518856, at *1 (S.D.N.Y. Nov. 28, 2018).

38 Id.

39 Id.

40 Id.

41 United States v. Microsoft Corp., No. C15-102RSM, 2020 WL 263577, at *1 (W.D. Wash. Jan. 17, 2020) (order directing producing of documents).

42 Id. at *2.

43 Id. at *3.

44 Id. at *4.

45 Id. at *7.

46 Id. at *8.

47 Id. at *9.

48 Id. at *8.

49 385 F. Supp. 3d 548 (W.D. Tex. 2019), aff'd sub nom. Taylor Lohmeyer L. Firm P.L.L.C. v. United States, 957 F.3d 505 (5th Cir. 2020), cert. denied sub nom. Taylor Lohmeyer L. Firm v. United States, No. 20-1596, 2021 WL 4507718 (U.S. Oct. 4, 2021).

50 Id. at 553.

51 Id. at 554.

52 Id. at 555.

53 Taylor Lohmeyer L. Firm P.L.L.C. v. United States, 957 F.3d 505 (5th Cir. 2020); Lohmeyer L. Firm v. United States, No. 20-1596, 2021 WL 4507718 (U.S. Oct. 4, 2021).

54 United States v. Adams, No. 017-CR-64 (DWF)(KMM), 2018 WL 5311410, at *1 (D. Minn. Oct. 27, 2018), aff'd, 2018 WL 6446387 (D. Minn. Dec. 10, 2018). The magistrate judge in Adams also considered whether certain other documents unrelated to the Kovel arrangement were privileged.

55 Id. at *1.

56 Id. at *1-2.

57 Id. at *2.

58 Id.

59 Id. at *3-4.

60 Id. at *2.

61 Id.

62 Id. at *4-5.

63 Id. at *5. The opinion did not discuss the first factor—whether Adams was engaged in criminal or fraudulent conduct at the time he sought advice of counsel—in its analysis of the application of the crime-fraud exception.