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Legal Updates

Taxpayer 2, Government 1 in Recent Privilege and Work-Product Disputes: *Countryside v. Commissioner, Valero Energy Corp. v. United States*, and *United States v. Deloitte & Touche*

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On June 8, 2009, two decisions were published which address the scope of the federal practitioner privilege under Internal Revenue Code section 7525 and the protection of work-product for documents disclosed to independent auditors. Both cases are defeats for the Government. The first, *Countryside*, continues the rehabilitation of the statutory privilege for tax practitioners while the second, *Deloitte*, continues a trend of cases holding that the work product protection is not waived for documents disclosed to outside auditors in the course of financial audit. On June 17, 2009, the Government prevailed in an appeal to the Seventh Circuit in *Valero* regarding the scope of the so-called "tax shelter" exception to the section 7525 privilege.

Countryside

In *Countryside Limited Partnership v. Commissioner of Internal Revenue*, 132 T.C. No. 17, the Tax Court addressed certain fundamental interpretive questions regarding the federal tax practitioner statutory privilege found in Code section 7525. In this case, the IRS moved to compel production of documents from the taxpayer, a partnership, including written minutes of communications between the taxpayer's attorneys and longstanding tax accountant regarding business planning matters including taxes and a two-page handwritten note taken by one of the partners at a meeting with the accountant regarding tax planning. The taxpayer objected to production of these documents claiming that the documents were protected from disclosure by section 7525(a).

As an initial comment, it is important to note that the taxpayer was able to show the court that the privilege applied to these documents in the first instance. This is something of a sea change for practitioners who had predicted the demise of the privilege a few years back after certain ill-reasoned decisions appeared to severely limit even the basic scope of the section 7525 privilege. These decisions simplistically argued that if the tax advice was given in connection with the formulation of a tax return position it fell into the "tax return preparation exception" of the attorney-client privilege. The application of this exception was thought to emasculate the section 7525 privilege.[1] Such a consequence is likely not

what Congress intended when it enacted the new privilege; rather the new privilege was intended to level the playing field for taxpayers who sought the same type of tax advice outside the auspices of a law firm that would be protected by the attorney-client privilege had such taxpayers consulted attorneys.[2]

In *Countryside*, issue was joined over the application of the tax shelter exception. That exception provides that the privilege "shall not apply to any written communication which is . . . 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))." 7525(b). The Tax Court, following the lead of the Seventh Circuit in *United States v. BDO Seidman LLP*,492 F.3d 806 (2007), put the burden on the IRS to establish that the exception applied. Thus, the IRS had to prove that there was a (i) written communication between the practitioner and the taxpayer which (ii) was made in connection with the promotion of a tax shelter. Regarding the handwritten notes, the Tax Court concluded that notes of an oral conversation were not "written communications." The Tax Court inferred that the communication must be *through a writing* in order to fall into the exception. Letters and memoranda sent to a taxpayer would however clearly be examples of written communications within the meaning of the statute. The Tax Court's distinction is consistent with the purpose for the exception, which is to exclude shelter promotional materials from the protection of the privilege. The Tax Court suggested that if the notes themselves had been transmitted to another then this action would convert the notes to a written communication. However, even if that is a fair reading of the statute, there would still be a question whether that further, secondary, communication was itself made in connection with the promotion of a tax shelter.

Turning to the written minutes, the Tax Court apparently determined that these were "written communications" potentially subject to the exception. Nevertheless, the Government could not prove these communications were in connection with the promotion of a tax shelter. The Tax Court reasoned that there is no promotional activity where the tax advisor is giving tax advice in the course of a routine relationship between the advisor and the client. "Promotion" is not defined in section 7525 and the Tax Court concluded that it had an ambiguous meaning. The court therefore looked to the legislative history of the statute. The conference report, H. Conf. Rept. 105-599, at 269 (1998), 1998-3 C.B. 747, 1023, stated: "The Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client." In this case, the minutes involved communications with a tax accountant who had a longstanding, professional relationship with key members of the taxpayer. In the course of that relationship, the accountant prepared returns, assisted with tax planning, and provided other tax advice for which the accountant billed hourly or through commonly-used fixed-fee arrangements. There were no special bonuses or fee arrangements in connection with the tax advice he gave relating to partnership redemptions (which were the transactions being scrutinized by the IRS in this case). The accountant relied on no generic promotional or marketing materials. For the Tax Court, the relationship between the taxpayer and the accountant had all the indicia of a "routine relationship" which would not be, in the words of the conferees, "adversely affected" by the tax shelter limitation. *Id*. Accordingly, the Tax Court concluded that the written minutes were not a communication in the connection with the promotion of a tax shelter and denied the IRS's motion to compel.

Valero

In *Valero Energy Corp. v. United States*,Case No. No. 08-3473, the Seventh Circuit took a very different view regarding the shelter exception in section 7525. The Seventh Circuit adopted a broad definition of "promotion." Moreover, the appellate court took the position that Government's burden in showing that the exception applied was not heavy: "[t]he burden to overcome the privilege is relatively light – it need only show there is some foundation in fact that a particular document falls within the tax shelter exception." Slip op. at 16. The taxpayer had sought a stay of an earlier district court opinion approving enforcement of the IRS's summons regarding certain documents withheld by the taxpayer. The documents involved various communications and related materials between the taxpayer and its historic accountant, Arthur Andersen, regarding, *inter alia*, the tax consequences of a planned major acquisition by Valero. The district court granted the stay pending a decision by the appeals court. The Seventh Circuit agreed with the district court that with respect to a certain group of documents the IRS had met its burden that the shelter promotion exception applied. Contrary to the Tax Court, the Seventh Circuit did not consider the notion of promotion to be ambiguous. It acknowledged that there were two senses of the word in ordinary usage, (i) active furtherance of the sale of a product through marketing or, more generally, (ii) furtherance or encouragement. Had the first of these senses been adopted by the court, Valero would have been assured a reversal because there was no evidence that the tax advisor, Arthur Andersen, marketed the tax advice it provided to Valero. The Seventh Circuit resolved this definitional question not by reference to other uses of the term "promotion" in the context of shelters in the Code, nor

by reference to legislative history, but by reference to the last element of the exception: "tax shelter (as defined in section 6662(d)(2)(C)(ii))." In that section, tax shelter is defined as "(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." The appellate court then asserted that because this definition of tax shelter has no necessary reference to marketing or promotional activities in the sense urged by Valero, the more general sense of the word urged by the Government was appropriate. Of course this conclusion begs the question: cannot any of these types of shelters be marketed? A review of the over 30 transactions denominated as "potentially abusive" by the IRS is evidence enough that marketed shelters can take many different forms. *See* http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html (identifying 34 "listed" transactions including those involving trusts, partnerships, corporations, intermediaries, notional principal contracts, etc.).[3]

But there is perhaps a more important question about the court's reasoning because it ignores other parts of the exception, specifically the requirement that the communication be *written*. Under the appellate court's expansive reading, it would make no sense for Congress to limit the exception to written communications. A better reading of the exception respects the inclusion of that important limitation and it seems true that written materials are more closely associated with the sense of promotion urged by Valero, identified by the district court in *United States v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007) (referencing "pre-packaged" shelters), and described by one Senator during the consideration of the statute. Marketed shelter ideas are notable for the generic investment materials and legal opinions associated with their promotion.[4] In any event, the Seventh Circuit concluded that, because Arthur Andersen encouraged Valero to undertake the tax-beneficial structures and transactions associated with the planned acquisition, Andersen was promoting those transactions within the meaning of the statute, and affirmed the district court.

Deloitte

In *United States v. Deloitte & Touche*, Case No. 08-411, U.S. District Court for the District of Columbia (J. Leon), the district judge addressed the validity of a summons to an outside auditor, here Deloitte, where the summons sought three documents Deloitte had received from its client, Dow Chemical, in the course of a financial audit. Dow asserted that the documents were protected by the work-product doctrine. The IRS did not vigorously challenge whether the documents were work-product in the first instance but argued that their disclosure to Deloitte constituted a waiver of the work-product protection.[5] This question has been answered in the negative by various courts in the past few years, including *Regions Financial Corp. v. United States*, 101 AFTR 2d 2008-2179 (N.D. Ala. 2008) (work-product not waived); *United States v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007) (work-product not waived), *aff'd in part, vacated in part, and remand'd*, 103 AFTR 2d 2009-509 (1st Cir. 2009), *vacated and r'hearing en banc*, 103 AFTR 2d 2009-1436 (1st Cir. 2009); *In re JDS Uniphase Corp. Sec. Litig.* 2006 U.S. Dist. Lexis 76169 (N.D. Cal. 2006) (work-product not waived). After recounting the standard for waiver of work-product, the district judge in *Deloitte* summed up the analysis as follows: "Here, Dow's disclosure to Deloitte USA was not inconsistent with the maintenance of secrecy because Deloitte USA, as Dow's independent auditor, was not a potential adversary, and no evidence suggests that it was unreasonable for Dow to expect Deloitte USA to maintain confidentiality." Slip op. at 2-3. *Deloitte* follows the recent trend to hold that work-product continues to apply to documents disclosed to outside auditors as they perform their audit function. The courts have generally found that outside auditors are not adversarial, nor are they a conduit to an adversary. The First Circuit in its now-vacated decision of January 2009 did open up the possibility that the IRS might be able to gain substantive access to the information in work-product-protected documents if the auditor had included such information in its own audit workpapers. *See* our legal update at http://www.mofo.com/news/updates/files/15174.html. The district judge in *Deloitte* in discussing the *Regions* decision suggested this was not a correct result. The district judge described the holding in that case as "work product privilege extended to materials created by independent auditor that discussed, quoted, or explained documents containing the legal evaluations of petitioner's outside counsel." Slip op. at 2 n. 1. While this is a reasonable position on its own merits, it is not consistent with the record in *Regions*. In *Regions*, the documents were either tax opinions drafted by outside tax advisors (including a law firm and an accounting firm) or documents created by outside tax advisors that referred to such opinions. The plaintiff took pains in its briefing to point out that none of the second category of documents had been drafted by its outside auditor.

The district judge also addressed an interesting recurring issue regarding whether Deloitte had to produce documents which were in the possession of its Swiss affiliate. As a general matter, a party

which is subject to a summons must produce documents that are in its "possession, custody or control." Slip op. at 3 (citing Fed. R. Civ. Pr. 45(a)(1)(A)(iii)). If a party does not have the requisite control, it is not obligated to attempt to acquire control over documents in order to satisfy the summons. Here the district judge had to answer the interesting question whether Deloitte USA had control over documents in the possession of its Swiss affiliate, Deloitte Switzerland. The judge held that no such control existed. Both organizations were members of a Swiss *verein*, which is legal association of separate, independent, offices having no centralized authority. Though Deloitte USA and Deloitte Switzerland may have had a close working relationship on joint projects, including the audit of the Dow partnerships, the district judge reasoned that this could not be equated with legal authority to obtain documents from an affiliate. In fact, the court noted, Deloitte Switzerland refused to produce any documents to Deloitte USA absent an order from a Swiss court. Accordingly, the district court concluded that Deloitte USA did not have the necessary control over the documents in the possession of Deloitte Switzerland, and denied IRS's motion to compel.

Footnotes

[1] One such case was *U.S. v. KPMG LLP*, 237 F.Supp.2d 35 (D.D.C. 2002) (because the tax opinion recited that it was concerning the "Federal income tax consequences" of the proposed transaction, the opinion was treated as return preparation). *See also The Section 7525 Privilege and Related Issues*, Boylan, Erwin & Froelich, BNA Tax and Accounting Portfolio 5511 at A-306 to A-311 (discussing various cases).

[2] *The Section 7525 Privilege and Related Issues* at A-202 and A-311.

[3] Of course, for a transaction to reach the status of listed, it would have had to be sufficiently commoditized to reach numerous potential investors and attract the attention of the IRS.

[4] There is yet another point of critique of the appellate court's analysis. In short, the court failed to consider the overall purpose of section 7525 and how the court's decision is consistent with that purpose. This update is not well-suited to an extended discussion of this point.

[5] The district judge published his order on motion of the Government to state the basis for its ruling. It was not clear from the order whether two of the three documents were Dow's internal tax accrual workpapers. All that is disclosed is that they were created by an in-house attorney or contained Dow's attorney's opinions and mental impressions.