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Nonlegal Roles of IRS Attorneys May Waive Attorney-Client Privilege.

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A December 13, 2012, order in Kearney Partners Funds LLC v. United States, No. 153-10, by the U.S. District Court for the Middle District of Florida reviewed documents sent between an LB&I senior counsel and field agents. The taxpayer had asked the court to compel the IRS to produce the documents on the ground that the materials were not subject to the attorney-client privilege because the government attorney was "simply another IRS employee working on the case and not counsel."

Although noting that the IRS attorney was a counsel representative to the LB&I issue management team overseeing the alleged abusive transaction, the court rejected the government's argument that the privilege applied because the attorney was counsel of record in Tax Court cases involving the shelter issue and had worked on other cases involving the same taxpayers. After an in camera review of the documents, the district court held that the government "does not assert that the documents reveal protected mental impressions, trial strategy, or legal advice," and that consequently, it did not "find good cause to support a claim for the attorney client privilege."

A February 4 court order clarifying the previous order reiterated that documents written by the IRS attorney addressed "factual issues" in a case and were "not addressing specific legal advice." The court found that the documents at issue in a discovery challenge were "merely communications" and "not specified confidential legal advice" subject to the attorney-client privilege.

"Merely because [the senior counsel] is an attorney is not sufficient grounds to impose the attorney-client privilege on her communications," the court said in the additional order.

Robin L. Greenhouse of McDermott Will & Emery said the district court decision points out that the increasing integration of LB&I counsel into the exam process is expected to affect the application of the attorney-client privilege to claims of protection from discovery by the government. "Frequently, IRS attorneys have dual roles, providing both legal advice but also acting as an examiner in drafting information document requests, interviewing witnesses, and preparing the notice of proposed adjustments," she said. "As the court in Kearney Partners found, in those circumstances it is difficult to ascertain whether an attorney was acting as a lawyer or part of an exam team."

The district court's decision is important because LB&I counsel have been increasingly acting in this dual capacity, particularly in transfer pricing cases, said Greenhouse. Consequently, "the court's opinion confirms that LB&I's counsel staffing structure could adversely impact its ability to claim privilege for work they are doing," she said.

The normal presumption is that outside counsel are providing legal advice to a client, but there is no presumption for in-house counsel because in-house frequently has both legal and nonlegal responsibilities, Greenhouse said. “Here the role of IRS LB&I counsel makes it difficult to draw lines, and thus their communications should be closely scrutinized to determine if the attorney-client privilege protection applies,” she said.

The litigation in Kearney Partners has covered several court venues and yielded interesting tidbits on how judges continue to evaluate privilege issues arising out of tax shelter transactions. Like in many other cases arising from transactions the IRS viewed as abusive, the government pursued a taxpayer who used partnership forms to artificially generate capital losses to offset significant gains. After the audit, the IRS made proposed adjustments disallowing the taxpayer’s claimed loss, which the taxpayer challenged in federal district court. During the litigation, the IRS issued a subpoena to the taxpayer’s law firm seeking the production of documents related to the investment structure used in the shelter.

The law firm objected to the production of some of the documents, claiming attorney-client, work product, and section 7525 tax practitioner privileges. In an action brought by the government to compel production, Kearney Partners Funds LLC v. United States, No. 11-4075, a magistrate judge for the U.S. District Court of the District of New Jersey held that the documents were protected by the attorney-client and work product privileges. The magistrate’s rationale under the work product doctrine, if it is upheld on appeal, could expand the privilege’s scope.

In construing the application of the attorney-client privilege, the magistrate found that the taxpayer’s adviser was providing “legal and tax advice pertaining to the transactions undertaken” by the taxpayer, including “the possibility of litigation arising out of the transactions,” and therefore that the privilege applied to the communications. The magistrate also held that the adviser hadn’t waived the taxpayer’s privilege.

Of substantial interest to tax practitioners are the magistrate judge’s thoughts on work product. After an in camera review of the contested documents, the magistrate held that the legal evaluation of the taxpayer’s proposed investment scheme qualified for work product protection because the documents were prepared in anticipation of possible litigation with the IRS.

“The motivating purpose behind the creation of the Communications was to aid in future litigation,” the magistrate wrote, adding that “it is clear that the Communications were intended to inform [the taxpayer] about the complexity of the proposed investment that could lead to legal exposure because of its aggressive nature.”

The government appealed the magistrate’s opinion and order regarding the motion to compel, but only concerning the attorney-client privilege, leaving the work product portion unchallenged. The district court upheld the magistrate’s decision.

Other courts have steadfastly resisted the notion of pre-litigation advice receiving work product protection. In Textron Inc. et al. v. United States, No. 09-750, the full First Circuit held that the work product privilege extends only to documents prepared for use in litigation, rather than documents created to comply with financial reporting rules. The en banc opinion reversed an original First Circuit panel that had upheld a federal district court’s decision that the workpapers at issue were protected from disclosure because the documents had been prepared in anticipation of litigation.

However, in Regions Financial Corp. et al. v. United States, No. 2:06-CV-00895, the district court held that analyzing a listed transaction is much more closely connected to litigation than preparing a

tax return, and thus the work product doctrine applies. The court stated that the "contested documents contain precisely the kind of legal analysis that the work product doctrine exists to protect." While the documents may have had some utility outside litigation, "they would not have been created were Regions not primarily concerned with litigating with the IRS" regarding the listed transaction, the court wrote.

The problem for taxpayers seems to be that while district courts have sometimes accepted the rationale that tax planning documents can be subject to the work product privilege, circuit courts have yet to uphold those conclusions. The Eleventh Circuit dismissed the government's appeal in Regions Financial after the IRS settled with the taxpayer, making the workpaper issue moot.

Most recently, in a May 22 order , the Florida district court addressed the added issue of judicial review of penalty assertions by the government in light of an IRS announcement offering penalty waiver for taxpayer disclosure of participation in the specified tax shelter. The taxpayer sought summary judgment on its claim that accuracy-related penalties should be waived for compliance with Announcement 2002-2, while the IRS argued that the court lacked subject matter jurisdiction on the issue. While the announcement established internal agency rules that lacked the force and effect of law, the court held that the IRS pronouncement was "an agency-wide directive designed to confer important benefits to taxpayers."

Because the announcement set forth a uniform rule of conduct by IRS personnel and was meant to induce taxpayers to disclose their involvement in tax shelters in exchange for the waiver of penalties, the court stated that the IRS "failed to observe self-imposed limits upon the exercise of its discretion which invited reliance upon such limitations." The use of "will" in the announcement's language regarding the waiver of penalties for properly disclosed taxpayer participation "indicates an intent to be bound," the court wrote. Consequently, it was proper under the Administrative Procedure Act for the court to review the taxpayer's disclosure for compliance with the announcement's terms.

However, the court rejected the taxpayer's argument that an LB&I directive on penalty imposition required IRS compliance in order to sustain a penalty. The IRS memo directed agents to obtain approval from the director of field operations in order to impose accuracy-related penalties, but in this case the decision to deny penalty relief to the taxpayer was made by chief counsel. The court held that the strictly internal procedure outlined in the memo was not subject to judicial review, but rather was a nonbinding rule that did not confer rights on taxpayers. That the IRS deviated from a "benign procedure for administering the disclosure process" did not deprive the taxpayers of a due process, the court wrote.

Thomas D. Sykes of Gould & Ratner LLP said the court's discussion of Announcement 2002-2 was "careful, balanced, and not obviously flawed," noting that public IRS pronouncements like announcements are often relied on by taxpayers.

Sykes said it was understandable that the government would, as a threshold matter, argue that a court lacks the jurisdiction or authority to review an IRS decision not to honor the terms of an IRS announcement. Jurisdictional analysis is highly formalistic, and the executive branch tends to try to protect its prerogatives from the other branches, although the role of the Administrative Procedure Act in the review of IRS actions is still being developed by the courts, he said.

An unanswered question is why the IRS sought to impose penalties despite the timely disclosure it had invited under Announcement 2002-2, Sykes said. It is one thing if there were extraordinary circumstances behind the IRS's refusal to waive penalties, but "if the IRS is backing away from its long-standing policy of honoring resolution arrangements that do not amount to a closing

agreement, then that is a worrisome development," he said.

The IRS frequently relies on an agreement procedure to close cases that isn't technically binding upon the government, and yet it has an established policy of honoring those agreements, Sykes said. "For decades, Forms 870-AD have been used far more often than closing agreements to memorialize settlements reached between the IRS and a taxpayer, and yet that form is not technically binding upon the IRS because they are generally executed by IRS officials who lack the settlement authority that is required for a closing agreement — the exclusive means prescribed by the code for settling tax disputes," he said. "Nonetheless, the IRS will seek to enforce the terms of a Form 870-AD against a taxpayer, using an equitable estoppel theory."

Sykes said that when he worked for the Justice Department Tax Division, there was a policy that the government would honor the terms of Forms 870-AD "in the absence of fraud or mutual mistake, even though those forms were not technically binding upon the IRS and even though equitable estoppel is a legal doctrine that only rarely, if at all, can be applied against the government." Now that the government has lost the threshold jurisdictional argument over whether IRS decisions made under an announcement are reviewable, "one hopes that government attorneys will give the policy issues — similar to those involved in the deliberations back in the 1980s over the respect to be given to Forms 870-AD — careful consideration," he said.

Miri Forster, the national leader for tax controversy at Rothstein Kass, said practitioners look to IRS internal guidelines for clarity and that taxpayers expect the IRS to adhere to those guidelines. "While the court makes a distinction between an announcement and an internal directive, the taxpayer's expectation is that IRS communications are in sync and will be followed in the same manner," she said. Although internal guidance is not authority, "why shouldn't the IRS be held responsible when it does not follow its own internal rules? If the IRS isn't going to follow its own guidelines, this may create confusion for those analyzing IRS guidance in connection with future initiatives," she said.

by Jeremiah Coder