Confidentiality Privilege Relating to Taxpayer Communications—New §7525 Added by the IRS Restructuring & Reform Act

(P.L. 105-206; 7/22/98; Act §3411)

Annette Nellen, CPA, Esq.
Graduate Tax Program
San José State University

March 1999

A. Primary Authority

See the text of IRC §7525 and IRSRRA'98 Committee Reports at the end of this outline.

B. Basics

The IRSRRA'98 extends the common law attorney-client privilege of confidentiality with respect to tax advice to any federally authorized tax practitioner (attorneys, CPAs, Enrolled Agents, and Enrolled Actuaries). This privilege is intended to apply to the same extent as it would between a taxpayer and an attorney; it does not expand the attorney-client privilege though. The §7525 privilege, if otherwise applicable, applies to *tax advice* furnished to a client-taxpayer or potential client-taxpayer. However, the privilege may only be asserted in a noncriminal tax matter before the IRS and any noncriminal tax proceeding in federal court by or against the U.S. "Tax advice" is defined as advice given by an individual with respect to a matter within the scope of the individual's authority to practice as a federally authorized tax practitioner (Circular 230) that involve matters under the IRC (Title 26). Thus, the §7525 privilege cannot be asserted to prevent any other regulatory agency (such as the SEC) or person from compelling the disclosure of information. The §7525 privilege does 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 the corporation in any tax shelter (per the definition at §6662(d)(2)(C)(iii)). New IRC §7525 applies to communications made on or after July 22, 1998.

Section 7525 goes beyond Rule 301 of the AICPA Code of Professional Conduct. Rule 301, *Confidential Client Information*, provides that a member in public practice shall not disclose any confidential client information without the client's consent. An exception exists if the member is required to comply with a validly issued and enforceable subpoena or summons. The §7525 privilege is legally enforceable (unlike Rule 301) and will prevent disclosure, even if compelled by the IRS through a summons (however, other limitations might apply, as discussed later). Also see California Board of Accountancy Regulation 54.1, *Disclosure of Confidential Information Prohibited.*

C. Relationship to the Attorney-Client Privilege

"The privilege established by [§7525] applies only to the extent that communications would be privileged if they were between a taxpayer and an attorney. Accordingly, the privilege does not

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apply to any communications between a [CPA, EA, or enrolled actuary] and such individual's client (or prospective client) if the communication would not have been privileged between an attorney and the attorney's client or prospective client. For example, information disclosed to an attorney for the purpose of preparing a tax return is not privileged under present law. Such information would not be privileged under the provision whether it was disclosed to an attorney, certified public accountant, enrolled agent or enrolled actuary." [Senate Committee Report No. 105-174]

Thus, CPAs and EAs will need to become familiar with the attorney-client privilege in order to fully understand the §7525 privilege. This will entail understanding what types of communications are covered by the privilege, what is not covered and whether it can/should be covered by the attorney-client privilege through a *Kovel* arrangement, how the privilege can be waived, what types of tax work fall within the privilege, and the differences between the privilege and the work-product doctrine.

D. Relationship to Practice of Law

"[§7525] relates only to matters of privileged communications. No inference is intended as to whether aspects of federal tax practice covered by the new privilege constitute the authorized or unauthorized practice of law under various State laws." [Conference Committee Report No. 105-599]

1. The attorney-client privilege only applies to legal advice. If a client sought investment advice from an attorney, the privilege would not apply. So, if the §7525 privilege is only to apply to the extent that communications would be privileged if they were between an attorney and a client, does this mean that the CPA or EA is providing legal advice (absent the above caveat in the legislative history)? Or, did Congress intend that "tax advice" was to be used in place of legal advice, such as in reading court cases that shed light on the attorney-client privilege?

2. The majority of courts have held that the preparation of a tax return is not legal advice. [*Canaday v. U.S.*, 354 F.2d 849 (8th Cir. 1966)—attorney's tax prep work described as scrivener's work; *U.S. v. Davis*, 636 F.2d 1028, 1043 (5th Cir. 1981), cert denied 454 U.S. 862 (1981)—"although preparation of tax returns by itself may require some knowledge of the law, it is primarily an accounting service."] However, a few courts have held that tax preparation can be legal advice, basically because it is performed by an attorney. [*U.S. v. Willis*, 565 F.Supp. 1186 (S.D. Iowa 1983)—"While preparation of tax returns is a task engaged in by nonlawyers as well as lawyers, such preparation ordinarily requires the giving of at least some legal advice." *U.S. v. Summe*, 208 F.Supp. 925 (E.D. KY 1962)—"There is nothing about the service of a lawyer in filing an income tax return that would necessarily take it out of these qualifications [for the privilege]."]

   In *In re Grand Jury Investigation-Appeal of Schroeder*, 842 F.2d 1223 (11th Cir. 1987), the court noted that "the preparation of a tax return should not be viewed as legal advice. If a professional accountant prepares a tax return, his client cannot invoke any privilege, for there is no accountant-client privilege under federal law."

   Now that a CPA/EA-client privilege exists, will any courts be more willing to treat tax return preparation as privileged? This would broaden the attorney-client privilege. Would such a position imply that tax return preparation involves rendering of legal advice? NOTE: Even if tax return preparation of a tax return is viewed as legal advice, the privilege

with respect to all of the information (or perhaps some of it depending on the circumstances and the jurisdiction) is waived because the tax return information is *intended* to be disclosed to a third party—namely, the IRS. See *Colton v. U.S.*, 306 F.2d 633, 638 (2d Cir. 1962), cert. denied 371 U.S. 951 (1963).

E. Rationale Behind IRC §7525

"A right to privileged communications in such situations should not depend upon whether the advisor is also licensed to practice law." [Senate Committee Report]

"The new tax practitioner-client privilege eliminates this unfair penalty imposed on taxpayers based on their choice of tax advisor." [Senator Mack, Cong. Rec. 7/8/98 page S7667]

Thus, the privilege was expanded for the benefit of taxpayers, not the CPA or EA professions.

F. Who Needs to Understand New §7525 and What Should They Be Aware Of

1. *Individual and business taxpayers*—need to know the differences between the attorney-client privilege and the §7525 privilege applicable to communications with CPAs and EAs[1] (such as the fact that the §7525 privilege can't be asserted in criminal matters or when an agency or person other than the IRS requests documents or testimony).
2. *CPAs, EAs (and other federally authorized tax practitioners)*—need to know a) how to explain the §7525 privilege to clients; b) when a client may be able to assert the privilege (what is considered a confidential communication, what types of tax work are covered, what documents are covered); c) what they should do if the IRS requests information or testimony that appears to be privileged; d) when a *Kovel* arrangement[2] should still be used; e) whether a *Kovel* arrangement will apply to advisers hired by the CPA or EA, f) whether the work-product doctrine might apply when the privilege does not apply; g) what actions to take so that the client's privilege is not inadvertently waived by the practitioner (such as notations on fax cover letters, e-mail messages, and file memos; and office procedures to control access to files); h) when to refer a client to an attorney; i) how the privilege applies to business clients; and j) to have clients agree to cover practitioner costs of protecting the client's privilege (should be included in the engagement letter).
3. *Attorneys*—need to know a) how to explain the differences in how the §7525 privilege operates when the client deals with a CPA or EA versus dealing with an attorney providing legal advice (including the tax shelter exception to the §7525 privilege); b) when to still use a *Kovel* arrangement when working with a CPA or EA; and c) whether it is advisable to have non-attorney colleagues in the office who are involved with tax clients become EAs.
4. *IRS personnel*—need to know a) how §7525 works, b) how the §7525 privilege differs from the attorney-client privilege, c) how to determine if the privilege has been waived through disclosure on the tax return, or during the audit process, or in some other manner.

G. Privilege Review—Purpose/Rationale/Authority

1. *Rationale behind the attorney-client privilege*—"The purpose of the privilege is to encourage clients to make full disclosure to their attorneys." *Fisher v. U.S.*, 425 U.S. 391 (1976).

   The purpose of the privilege "is to encourage full and frank communications between attorneys and their clients and thereby promote broader public interests in the observance of

law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client. ... 'The lawyer-client privilege rests on the need for the advocate and counselor to know all that relates to the client's reasons for seeking representation if the professional mission is to be carried out.'" *Upjohn Co. v. U.S.*, 449 U.S. 383 (1981).

Following are frequently cited quotes from *U.S. v. United Shoe Machinery Corporation,* 89 F. Supp. 357 (D.C. MA 1950), that address the purpose and operation of the attorney-client privilege:

> "The rule which allows a client to prevent the disclosure of information which he gave to his attorney for the purpose of securing legal assistance is founded upon the belief that it is necessary 'in the interest and administration of justice.' ... As stated in the Comment to Rule 210 of the A.L.I. Model Code of Evidence: 'In a society as complicated in structure as ours and governed by laws as complex and detailed as to be imposed upon us, expert legal advice is essential. To the furnishing of such advice the fullest freedom and honesty of communication of pertinent facts is a prerequisite. To induce clients to make such communications, the privilege to prevent their later disclosure is said by courts and commentators to be a necessity. The social good derived from the proper performance of the functions of lawyers acting for their clients is believed to outweigh the harm that may come from the suppression of the evidence in specific cases.' ... But the privilege should be strictly construed in accordance with its object." ...

> "The privilege only applies if (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 primarily 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."

2. *Source*—The attorney-client privilege stems from common law, as further interpreted by the courts. This privilege, as applied today, is addressed in Federal Rule of Evidence 501—"Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law."

H. Privilege Review—Selected Reminders From the Courts

1. *Taxpayer must prove privilege exists—* The proponent of the privilege has the burden of proving that it exists, that the particular communications at issue are privileged, and that the privilege was not waived. "Any disclosure inconsistent with maintaining the confidential nature of the attorney-client relationship waives the attorney-client privilege. Any voluntary disclosure by the client to a third party waives the privilege not only as to the specific

communication disclosed, but often as to all other communications relating to the same subject matter." *U.S. v. Jones*, 696 F.2d 1069, 1072 (4th Cir. 1982). Also see later discussion of waiver.

2. *Intent for confidentiality—* The "attorney-client privilege protects only those papers or communications prepared by the client for *confidential* communication to the attorney, or by the attorney to record *confidential* communications." *U.S. v. Merrell*, 303 F.Supp. 490 (N.D. NY 1969).

3. *Communication must be in line with the purpose of the privilege—* As stated earlier from the *Fisher* case, the purpose of the privilege is "to encourage clients to make full disclosure to their attorneys." In *U.S. v. Ackert*, 99-1 USTC ¶50,298, 83 AFTR2d 99-1040 (2d Cir. 1999), the court ruled that an attorney's communication with an investment banker to better understand a deal the banker was trying to structure for the attorney's employer was not privileged. "[T]he privilege protects communications between a client and an attorney, not communications that prove important to an attorney's legal advice to a client. Thus, a communication between an attorney and client may be privileged even if it turns out to be unimportant to the legal services provided. … Conversely, a communication between an attorney and a third party does not become shielded by the attorney-client privilege solely because the communication proves important to the attorney's ability to represent the client."

4. *Substance protected, rather than particular words or facts—* "The privilege attaches to the substance of a communication and not to the particular words used to express the communication's content." Thus, a client likely waives the privilege with respect to workpapers supporting amounts on an amended return, once the return is filed. *U.S. v. Cote*, 456 F.2d 142, 145 (8th Cir. 1972).

   "The privilege only protects disclosure of communications; it does not protect disclosure of the underlying facts by those who communicated with the attorneys:

   > "[T]he protection of the privilege extends only to communications and not to facts. A fact is one thing and a communication concerning that fact is an entirely different thing. The client cannot be compelled to answer the question, 'What did you say or write to the attorney?' but may not refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communications to his attorney." *Philadelphia v. Westinghouse Electric Corp.*, 205 F.Supp. 830, 831 (ED Pa. 1962).

   "See also *Diversified Industries*, 572 F.2d, at 611; State ex rel. *Dudek v. Circuit Court*, 34 Wis.2d 559, 580, 150 N.W. 2d 387, 399 (1967) ("the courts have noted that a party cannot conceal a fact merely by revealing it to his lawyer")." *Upjohn Co. v. U.S.*, 449 U.S. 383, 396-397 (1981).

   The "attorney-client privilege protects communications rather than information; the privilege does not impede disclosure of information except to the extent that the disclosure would reveal confidential communications. ... Thus, the fact that certain information in the documents might ultimately be disclosed to AG employees did not mean that the communications to [the law firm] were foreclosed from protection by the privilege as a matter of law. Nor did the fact that certain information might later be disclosed to others create the factual inference that the communications were not intended to be confidential at the time they were made. If confidentiality were not intended, of course, the privilege

would not attach, ...; but we see no indication that confidentiality was not intended. For example, although some of the documents appear to be drafts of communications the final version of which might eventually be sent to other persons, and as distributed would not be privileged, we see no basis in the record for inferring that AG did not intend that the drafts—which reflect its confidential requests for legal advice and were not distributed—to be confidential. Confidentially may also, of course be waived; but we see no indication that a waiver has yet occurred." *In re Grand Jury Subpoena Duces Tecum Dated September 15, 1983, Marc Rich & Co. A.G. v. U.S.*, 731 F.2d 1032 (2d Cir. 1984).

5. *Pre-existing documents*—Generally, pre-existing documents are not covered by the privilege. "Insofar as the papers include pre-existing documents and financial records not prepared by the [client] for the purpose of communicating with their lawyers in confidence, their contents have acquired no special protection from the simple fact of being turned over to an attorney. It is only if the client could have refused to produce such papers that the attorney may do so when they have passed into his possession. ... Any other rule would permit a person to prevent disclosure of any of his papers by the simple expedient of keeping them in the possession of his attorney." *Colton v. U.S.*, 306 F.2d 633, 639 (2d Cir. 1962), cert. denied 371 U.S. 951 (1963).

   "This Court and the lower courts have thus uniformly held that pre-existing documents which could have been obtained by court process from the client when he was in possession may also be obtained from the attorney by similar process following transfer by the client in order to obtain more informed legal advice." *Fisher, et al. v. U.S., et. al.*, 425 U.S. 391, 76-1 USTC ¶9353, 37 AFTR2d 76-1244 (USSC).

6. *Third party documents*—The privilege does not extend to information an attorney obtains from third parties. Neither does it extend to "documents prepared by third parties who are not acting as agents of the client or attorney." *U.S. v. Willis*, 565 F.Supp 1186, 83-1 USTC ¶9398, 52 AFTR2d 5537 (DC Iowa 1983).

7. *Kovel arrangement*—"What is vital to the privilege is that the communication be made in confidence for the purpose of obtaining legal advice from the lawyer. If what is sought is not legal advice but only accounting services, as in *Olender v. United States*, 210 F.2d 795, 805-806 (9 Cir. 1954), ... or if the advice sought is the accountant's rather than the lawyer's, no privilege exists." *U.S. v. Kovel*, 296 F.2d 918 (2d Cir. 1962).

   In a *Kovel* arrangement, the accountant is hired directly by the attorney and the accountant's workpapers are the property of the attorney. All communications between the attorney, accountant, and client must be kept confidential to fall under the attorney-client privilege.

   Situation where CPA was not hired by the attorney: "In the instant case, the record shows that Mr. Ryan was performing accounting services on behalf of petitioners, and that such services included representing petitioners before the IRS. If we were to allow petitioners to cloak the services of their accountant in the robe of the attorney-client privilege in the instant case merely because the accountant communicated with petitioners' attorneys during the course of an audit (an audit which the accountant was responsible for conducting), the privilege would be expanded beyond the parameters of its logic." *Bernardo v. Comm'r.*, 104 T.C. 677 (1995).

8. *Non-individuals*—"The attorney-client privilege attaches to corporations as well as to individuals, and with regard to solvent corporations the power to waive the privilege rests with the corporations' management and is normally exercised by its officers and directors.

When control of the corporation passes to new management, the authority to assert and waive the privilege also passes, and the new managers may waive the privilege with respect to corporate communications made by former officers and directors." *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 434 (1985). Also see *Upjohn Co. v. U.S.*, 449 U.S. 383 (1981), and *Diversified Industries, Inc.*, 572 F.2d 596 (8th Cir. 1978).

9. *Work-product doctrine*—"The attorney-client privilege and the work product rule serve different objectives. The fact that a document does not come within the attorney-client privilege should not result in the deprivation of the protection accorded by [Federal rule of civil procedure] 26(b)(3)." *U.S. v. Adlman,* 134 F.3d 1194, 98-1 USTC ¶50,230, 81 AFTR2d 98-820 (2d Cir.), fn 4.

   Federal Rule of Civil Procedure 26(b)(3) provides that a "party may obtain discovery of documents and tangible things otherwise discoverable ... and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative ... only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation."

   See *U.S. v. Adlman, supra*, and *Hickman v. Taylor*, 329 U.S. 495 (1947).

   "The scope of the protection provided by the work product doctrine is broader than the protection afforded by the attorney-client privilege. ... The work product doctrine protects documents and other materials prepared in anticipation of litigation by a representative of a party, regardless of whether the representative was retained by the party directly or by his attorney." *Bernardo v. Comm'r.*, 104 T.C. 677 (1995).

   Audit possibility not sufficient: "[P]apers generated by an attorney who prepares a tax return are not within the work product privilege simply because there is always a possibility that the IRS might challenge a given return." *U.S. v. Davis*, 636 F.2d 1028, 1040, 81-1 USTC ¶9193, 47 AFTR2d 941 (5th Cir. 1981), cert. denied 454 U.S. 862 (1981).

   Tax accrual workpapers: These are not protected under the work-product doctrine because they are not prepared in anticipation of litigation, but for SEC and GAAP purposes. *U.S. v. Arthur Young & Co.,* 465 U.S. 805 (1984).

10. *Crime-fraud exception*—If the communication between the attorney and client is in furtherance of a crime or fraud, the privilege does not apply to protect the communication from disclosure. "The test for invoking the crime-fraud exception to the attorney-client privilege is whether there is "reasonable cause to believe that the attorney's services were utilized in furtherance of the ongoing unlawful scheme. ... the lawyers' innocence does not preserve the attorney-client privilege against the crime-fraud exception. The privilege is the client's, so 'it is the client's knowledge and intentions that are of paramount concern to the application of the crime-fraud exception; the attorney need know nothing about the client's ongoing or planned illicit activity for the exception to apply. It is therefore irrelevant ... that [the lawyers] may have been in the dark.'" *U.S. v. Tei Fu Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). Also see *In re Sealed Case*, 754 F.2d 395 (D.C. Cir. 1985). and *Coleman v.*

American Broadcasting, 106 F.R.D. 201 (DC DC 1985) which discuss whether and when this exception also applies to "other misconduct."

I. Waiver—Some Comments From the Courts

1. *Relevance*—If an otherwise privileged communication is somehow disclosed, generally, the privilege disappears; that is, it is waived. Thus, it is important for both the practitioner and client to protect the privileged communications from disclosure. There is some disagreement among the courts as to what type of conduct can cause the privilege to be waived. Also, particular facts and circumstances can be relevant. For example, there is no single rule as to whether inadvertent disclosure or compelled disclosure waives the privilege.[3] Thus, the practitioner and client should be sure that privileged written communications include a bold note that they are "privileged and confidential under IRC §7525," avoid handing over privileged documents to people outside the "magic circle", and be careful in answering questions posed by IRS employees.

   The "confidentiality of communications covered by the privilege must be jealously guarded by the holder of the privilege lest it be waived. The courts will grant no greater protection to those who assert the privilege than their own precautions warrant." *In re Sealed Case*, 877 F.2d 976 (DC App 1989).

   Below are some examples of how courts have addressed whether a client's privilege has been waived.

2. *Meaning*—

   a. *"Magic circle"*: "[D]ecisions do tend to mark out, although not with perfect consistency, a small circle of "others" with whom information may be shared without loss of the privilege (*e.g.* secretaries, interpreters, counsel for a cooperating co-defendant, a parent present when a child consults a lawyer). Although the decisions often describe such situations as ones in which the client "intended" the disclosure to remain confidential, see, *e.g., Kevlik v. Goldstein*, 724 F.2d 844, 849 (1st Cir. 1984), the underlying concern is functional: that the lawyer be able to consult with others needed in the representation and that the client be allowed to bring closely related persons who are appropriate, even if not vital, to a consultation. ... An intent to maintain confidentiality is ordinarily necessary to continued protection, but it is not sufficient." *U.S. v. Massachusetts Institute of Technology*, 129 F.3d 681, 684, 97-2 USTC ¶50,955, 80 AFTR2d 7981 (1st Cir. 1997)

   b. *Prior disclosure to another government agency*: In *U.S. v. Massachusetts Institute of Technology*, 129 F.3d 681, 97-2 USTC ¶50,955, 80 AFTR2d 7981 (1st Cir. 1997), the IRS issued a summons for certain records relevant to its investigation into the tax-exempt status of MIT and payment of employment taxes. Some of these records had previously been provided by MIT to the Defense Contract Audit Agency within the Department of Defense. The IRS also sought the records from the DCAA, but the DCAA refused to provide them to the IRS without MIT's consent. The court held that disclosure to the DCAA caused MIT to forfeit the privilege with respect to those documents.

      In *Diversified Industries, Inc.* , 572 F.2d 596 (8th Cir. 1978), the court held that only a "limited " waiver of the privilege occurred when a corporation voluntarily surrendered

documents to the SEC pursuant to subpoena. The documents had been provided in a "separate and nonpublic SEC investigation."

c. *Compelled disclosure*: Some courts have held that a "compelled" disclosure does not serve to waive the privilege for all purposes. See *Transamerica Computer Company, Inc. v. IBM*, 573 F.2d 646 (9th Cir. 1978). Thus, when someone other than the IRS requests documents that are privileged under §7525, it would appear to be advisable to provide them per a summons or similar order, to attempt to try to best protect the §7525 privilege.

d. *Request by CID*: The §7525 privilege does not apply when communications are requested in a criminal matter before the IRS. It is not clear whether disclosure to CID in a criminal matter that is later converted to a civil matter waives the privilege with respect to the civil matter.

e. *Inadvertent disclosure*: There is no clear consensus as to whether an inadvertent disclosure waives the privilege. Thus, it is best to make all efforts to avoid any disclosure.

Disclosure due to "bureaucratic error" or human error, "simply reveals that someone in the company and thereby Company itself ... was careless with the confidentiality of its privileged communications. Normally the amount of care taken to ensure confidentiality reflects the importance of that confidentiality to the holder of the privilege. To hold, as we do, that an inadvertent disclosure will waive the privilege imposes a self-governing restraint on the freedom with which organizations such as corporations, unions, and the like label documents related to communications with counsel as privileged. To readily do so creates a greater risk of "inadvertent" disclosure by someone and thereby the danger that the "waiver" will extend to all related matters, perhaps causing grave injury to the organization. But that is as it should be. Otherwise, there is a temptation to seek artificially to expand the content of privileged matter. In other words, if a client wishes to preserve the privilege, it must treat the confidentiality of attorney-client communications like jewels—if not crown jewels. Short of court-compelled disclosure, ... or other equally extraordinary circumstances, we will not distinguish between various degrees of "voluntariness" in waivers of the attorney-client privilege." *In re Sealed Case*, 877 F.2d 976, 980 (DC App 1989).

f. *How much is waived?* In *In re Sealed Case*, 877 F.2d 976 (DC App 1989), the court held that disclosure of one memo constituted a waiver of all other communications related to the same subject matter. "[D]isclosure of any significant portion of a confidential communication waives the privilege as to the whole." *U.S. v. Davis*, 636 F.2d 1028, 1044, n. 18, 81-1 USTC ¶9193, 47 AFTR2d 941 (5th Cir. 1981), cert. denied 454 U.S. 862 (1981).

3. *Must timely assert privilege or it is waived*—Failure to timely object to the practitioner's testimony will most likely constitute a waiver of the privilege. "Failure to assert the privilege when the evidence was first presented constituted a voluntary waiver of the right." *U.S. v. Gurtner*, 474 F.2d 297, 299 (9th Cir. 1973).

4. Expansion of privilege or work-product doctrine to avoid waiver:

a. *Joint defense privilege*—the joint defense privilege expands the application of the attorney-client privilege or the work-product doctrine in a situation where a

communication is shared between members of a joint defense. This doctrine applies where the parties are represented by separate counsel, but engage in a common legal enterprise. "The doctrine, however, protects communications between an individual and an attorney for another only when the communications are part of an 'on-going and joint effort to set up a common defense strategy.'" *Griffith v. Davis,* 161 F.R.D. 687 (CD CA 1995).

b. *Joint-client doctrine*—this doctrine may apply where tow clients share the same attorney. It does not create an independent privilege, but like the joint defense privilege, "depends upon a proper showing of other elements of the attorney-client privilege. Thus, the joint client doctrine typically has been applied to overcome what would otherwise have constituted a waiver of confidentiality because a communication had been shared between two clients." *Griffith v. Davis,* 161 F.R.D. 687 (CD CA 1995).

J. Dealing With §7525

1. *What is tax advice?*—

a. *IRSRRA'98 guidance*: Per §7525(a)(3)(B), tax advice is advice given with respect to matters under the IRC by an individual with respect to a matter within the scope of his authority to practice per federal regulation under §330 of Title 31 of the U.S. Code.

b. *Business advice versus legal advice*: Courts have noted that it is not always easy to distinguish legal advice from solely business advice. In *Diversified Industries, Inc.*, 572 F.2d 596 (8th Cir. 1978), the court quoted privilege expert Dean Wigmore: "It is not easy to frame a definite test for distinguishing *legal from nonlegal advice*. ... The most that can be said by way of generalization is that a matter committed to a professional legal adviser *is prima facie so committed for the sake of the legal advice* which may be more or less desirable for some aspect of the matter, and is therefore within the privilege unless it clearly appears to be lacking in aspects requiring legal advice. Obviously, much depends upon the circumstances of individual transactions."

NOTE: Matters submitted to a CPA are not clearly submitted solely for tax advice since a CPA is qualified to provide a variety of accounting and financial advice. Thus, it will likely be more difficult for CPAs to demonstrate that the advice sought was tax advice and not business advice (relative to an attorney providing legal advice). But, the *Diversified* court also noted: "The fact that the report contains some nonlegal matter does not destroy the privilege since it is insubstantial." Yet, another court stated: "The line between accounting work and legal work in the giving of tax advice is extremely difficult to draw. ... We have held that the preparation of tax returns is generally not legal advice within the scope of the privilege. ... Nevertheless, we would be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of litigation on it are not legal advice." *U.S. v. El Paso Co.*, 682 F.2d 530, 82-2 USTC ¶9534, 50 AFTR2d 82-5530 (5th Cir. 1982).[4]

Items that have been found to fall under legal advice include:

- Obtaining legal advice regarding the mechanics and consequences of alternative business strategies. *In re Grand Jury Investigation-Appeal of Schroeder*, 842 F.2d 1223 (11th Cir. 1987).

Items that were found not to fall under legal advice include:

- In-house counsel's document analyzing a proposed agreement from a financial perspective. *U.S. v. United Technologies Corp.*, 97-2 USTC ¶50,721, 80 AFTR2d 97-6614 (DC Ct).

c. *Tax preparation versus tax advice*: Tax preparation is not covered by the attorney-client privilege, and thus is not covered by the §7525 privilege (see Section D.). Thus, the question that will arise is where the line is to be drawn between tax prep and tax advice? For example, if a memo discusses the tax consequences of a transaction, the gray issues involved, and includes a calculation of the resulting gain which is then reported on the return, is any portion of the memo privileged? Should two memos have been prepared instead? Guidance on this issue would be helpful.

i. Reg. §1.7701-15(a)(2) defining a tax return preparer provides that a person who only gives advice on specific issues of law is generally, not considered a tax return preparer. Thus, arguably, advice prior to a transaction or filing of a return is not viewed as tax preparation.

ii. "[M]aterial contained in the work papers intended for disclosure in the tax returns would not be subject to the attorney-client privilege since it was "not intended to be confidential". On the other hand, it was recognized also that the work papers may contain information which will not be incorporated in the tax returns and which is protected by the attorney-client privilege." *U.S. v. Baucus*, 377 F.Supp 468, 74-2 USTC ¶9519, 34 AFTR2d 5449 (DC Mt 1974).

iii. "Although communications made *solely* for tax return preparation are not privileged, communications made to acquire legal advice about what to claim on tax returns may be privileged." *U.S. v. Abrahams*, 905 F.2d 1276, 90-1 USTC ¶50,310, 66 AFTR2d 5125 (9th Cir. 1990).

iv. "[T]here is a marked distinction between tax planning and income tax return preparation. Tax planning is concerned with current or future tax periods. It entails advising a client on how best to structure contemplated financial transactions, decisions, or occurrences from a tax consequences standpoint; the identification of the various means by which a particular tax objective of the client can be achieved; and other before-the-fact research and advice. ...

"Income tax return preparation, on the other hand, involves closed tax periods and entails evaluating the tax consequences of previously-consummated transactions and occurrences; compiling the information pertinent to those transactions and events; categorizing, classifying, and otherwise organizing that information in a way which corresponds with the classifications and categories appearing on tax return forms; selecting among the various available tax forms; electing the most advantageous tax filing status; computing the final figures to be included on the taxpayer's return on the basis of the raw information available; completing the tax return; and other after-the-fact services ultimately aimed at satisfying the disclosure requirements for the tax period in question. Such information routinely furnished by taxpayers to their nonlawyer income tax return preparers probably will not be protected by the privilege.

"However, it should be noted that not all after-the-fact tax matters are to be regarded as falling within the income tax return preparation function. For

example, a taxpayer under civil or criminal tax investigation might well seek an attorney's counsel as to the prospects of civil or criminal liability and the best way for the client to avoid or minimize any such liability. In the example given, the Court would view the taxpayer to have sought "legal advice ... from a professional legal adviser in his capacity as such," within the meaning of the privilege. This would hold true, even though the attorney might ultimately advise the client to file an amended return. ... On the other hand, where no such investigation is pending or threatened, a lawyer's preparation of an amended tax return would probably not be viewed as falling outside the ambit of the tax return preparation function." *U.S. v. Willis*, 565 F.Supp 1186, 1191, 83-1 USTC ¶9398, 52 AFTR2d 5537 (DC Iowa 1983).

v. Amended returns—"Notwithstanding our recognition that the attorney-client privilege attached to the information contained in the accountant's workpapers under the circumstances existing here, we find that by filing the amended returns the taxpayers communicated, at least in part, the substance of that information to the government, and they must now disclose the detail underlying the reported data. ... Here, Cote, the accountant, testified that the information on his workpapers was later transcribed onto the amended returns which were filed by the taxpayers with the government. This disclosure effectively waived the privilege not only to the transmitted data but also as to the details underlying that information." *U.S. v. Cote*, 456 F.2d 142, 144-5 (8th Cir. 1972).

"Accounting services performed ancillary to legal advice may be within the attorney-client privilege. ... Preparation of tax returns may in some circumstances come within this category, as where a taxpayer's attorney has amended tax returns prepared after an IRS investigation into the originals has begun." *U.S. v. Davis*, 636 F.2d 1028, 1044, n. 17, 81-1 USTC ¶9193, 47 AFTR2d 941 (5th Cir. 1981), cert. denied 454 U.S. 862 (1981).

vi. Don't forget waiver—In distinguishing between tax advice and other work performed for a client by a CPA, don't forget that many types of documents prepared by a CPA for a client are not intended to be confidential, such as tax and business analysis performed for a prospectus. Thus, it would not be necessary to determine if it is privileged tax advice since it was not intended to be confidential in the first place.

2. *What is a tax shelter?*—The corporate tax shelter exception to the privilege with respect to written communications was added by the conference committee in completing the IRSRRA'98. The definition of *tax shelter* is the one at §6662(d)(2)(C)(iii) which was broadened by the TRA'97 (which also added the tax shelter registration requirements at §6111(d)). Prior to the TRA'97, a tax shelter meant some type of entity or plan where the principal purpose was the avoidance or evasion of federal income taxes. The TRA'97 changed "the principal purpose" to "a significant purpose." As of 12/23/98, no guidance has been issued under either revised §6662(d)(2) or new §6111(d). Such guidance would help to explain just how broad (or narrow), the tax shelter definition is intended to be. For example, it is unlikely that Congress intended that like-kind exchanges (§1031) are tax shelters—but what was intended?

The conference report does include an indication that a very broad scope was not intended: "The Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, the Conferees do not anticipate that the tax shelter limitation will adversely affect such routine relationships."

3. *What if IRS asks for documents or testimony that you believe are privileged?*—Bear in mind that it is up to the CPA and client to prove that a document or information is privileged. Per §10.20 of Circular 230(a), it is proper for a practitioner to refuse to turn over requested records or information if "he believes in good faith and on reasonable grounds that such record or information is privileged." Also, refusal to disclose a document or information on the good faith belief that it is privileged under §7525 should not cause a problem under the new burden of proof rule (§7491). That is, assertion of the privilege should not be treated as not cooperating with reasonable requests of the IRS. Hopefully, future regulations under these provisions will note this. Finally, refusal to disclose privileged communications should not result in any contempt charges (*U.S. v. Hankins*, 631 F.2d 360, 82-2 USTC ¶9637, 49 AFTR2d 82-921 (5th Cir. 1980).

4. *Office procedure considerations in light of §7525*—The CPA plays an important role in helping to protect the client's §7525 privilege. Some office procedures may need to be modified to help ensure that the privilege is protected and not waived. Some things to consider include:[5]

   a. Educating all employees and contractors in your office about the privilege and how it operates.

   b. Ensuring that a CPA or EA (or attorney) is the person of primary responsibility on every engagement involving the rendering of tax advice. A non-CPA, such as an administrative person, or someone who has not yet completed the requirements to be a CPA or EA, should work under a CPA or EA on the engagement.

   c. Implementing a system to have "Privileged and Confidential under IRC §7525" noted on privileged documents. You might also want to note that certain documents are also protected under the work product doctrine. Consideration should also be given to protecting computer files and tax files to help ensure that the files are not being looked at by those without a need to know. The goal is to keep privileged communications confidential.

   d. Consider whether separate bills and files should be used to separate privileged tax advice from non-privileged tax preparation matters.

   e. Don't discuss tax advice in a public place. Also be sure that only parties within the "magic circle" or with a need to know are present during communications regarding tax advice.

   f. Consider when a *Kovel* arrangement should still be used where the CPA is hired by the attorney. This would be appropriate where the matter might end up being a criminal one, or involves non-tax advice. Also, consider where the CPA or EA might want to have advisers helping him enter into a *Kovel* arrangement for tax advice engagements.

   g. Make plans for ensuring that your clients understand this new privilege and how it differs from the attorney-client privilege. They should understand what types of

communications are and are not covered by the §7525 privilege and the importance of protecting the privilege by respecting the confidentiality of communications.

K. Miscellaneous Observations and Queries

- Will §7525 encourage more non-attorney tax practitioners to become CPAs or EAs?
- Will the states conform to §7525?
- What new problems might arise by extending an already limited privilege to CPAs and EAs with additional limitations on it?
- When will additional guidance be issued by the IRS, as well as by Congress and the states to address various privilege uncertainties with respect to electronic communications. Also, the following terms used in §7525 need clarification: tax advice, tax shelter, noncriminal tax matter before the IRS, written communication.
- Will Congress eventually repeal the corporate tax shelter restriction as unnecessary and unduly burdensome, as well as adding another distinction between being a client of an attorney versus a client of a CPA or EA? Or, will it (can it) be expanded to also cover attorneys?
- Will Congress remove the limitation of asserting the privilege in criminal matters in order to provide fuller protection to clients of CPAs and EAs?
- Would a better alternative to a limited privilege have been to reduce the Service's authority to summon certain documents (such as tax accrual workpapers and research memos)?

§7525 Confidentiality Privileges Relating to Taxpayer Communications

(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 noncriminal tax matter before the Internal Revenue Service, and

(B) any noncriminal 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).

(b) Section not to apply to communications regarding corporate tax shelter. 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)).

Committee Reports to P.L. 105-206 [IRSRRA'98 §3411]

House Report

Present Law

A common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. Communications protected by the attorney-client privilege must be based on facts of which the attorney is informed by the taxpayer, without the presence of strangers, for the purpose of securing the advice of the attorney. The privilege may not be claimed where the purpose of the communication is the commission of a crime or tort. The taxpayer must be, or be seeking to become, a client of the attorney.

The privilege of confidentiality applies only where the attorney is advising the client on legal matters. It does not apply in situations where the attorney is acting in other capacities. Thus, a taxpayer may not claim the benefits of the attorney-client privilege simply by hiring an attorney to perform some other function. For example, if an attorney is retained to prepare a tax return, the attorney-client privilege will not automatically apply to communications and documents generated in the course of preparing the return. The privilege of confidentiality also does not apply where an attorney that is licensed to practice another profession is performing such other profession. For example, if a taxpayer retains an attorney who is also licensed as a certified public accountant (CPA), the taxpayer may not assert the attorney-client privilege with regard to communications made and documents prepared by the attorney in his role as a CPA.

The attorney-client privilege is limited to communications between taxpayers and attorneys. No equivalent privilege is provided for communications between taxpayers and other professionals authorized to practice before the Internal Revenue Service, such as accountants or enrolled agents.

Reasons for Change

The Committee believes that a right to privileged communications between a taxpayer and his or her advisor should be available in noncriminal proceedings before the Internal Revenue Service, so long as the advisor is authorized to practice before the Internal Revenue Service. A right to privileged communications in such situations should not depend upon whether the advisor is also licensed to practice law. The Committee believes that it is appropriate to provide for this right within the Committee's jurisdiction, by applying it to noncriminal proceedings before the IRS.

Senate Report

Explanation of Provision

The provision extends the present law attorney-client privilege of confidentiality to tax advice that is furnished to a client-taxpayer (or potential client-taxpayer) by any individual who is authorized under Federal law to practice before the IRS if such practice is subject to regulation under section 330 of Title 31, United States Code. Individuals subject to regulation under section 330 of Title 31, United States Code include attorneys, certified public accountants, enrolled agents and enrolled actuaries. Tax advice means advice that is within the scope of authority for such individual's practice with respect to matters under Title 26 (the Internal Revenue Code). The privilege of confidentiality may be asserted in any noncriminal tax proceeding before the IRS, as well as in noncriminal tax proceedings in the Federal Courts where the IRS is a party to the proceeding.

The provision allows taxpayers to consult with other qualified tax advisors in the same manner they currently may consult with tax advisors that are licensed to practice law. The provision does not modify the attorney-client privilege of confidentiality, other than to extend it to other authorized practitioners. The privilege established by the provision applies only to the extent that communications would be privileged if they were between a taxpayer and an attorney. Accordingly, the privilege does not apply to any communication between a certified public accountant, enrolled agent, or enrolled actuary and such individual's client (or prospective client) if the communication would not have been privileged between an attorney and the attorney's client or prospective client. For example,

information disclosed to an attorney for the purpose of preparing a tax return is not privileged under present law. Such information would not be privileged under the provision whether it was disclosed to an attorney, certified public accountant, enrolled agent or enrolled actuary.

The privilege granted by the provision may only be asserted in noncriminal tax proceedings before the IRS and in the Federal Courts with regard to such noncriminal tax matters in proceedings where the IRS is a party. The privilege may not be asserted to prevent the disclosure of information to any regulatory body other than the IRS. The ability of any other regulatory body, including the Securities and Exchange Commission (SEC), to gain or compel information is unchanged by the provision. No privilege may be asserted under this provision by a taxpayer in dealings with such other regulatory bodies in an administrative or court proceeding.

Effective Date

The provision is effective with regard to communications made on or after the date of enactment.

Conference Report

The conference agreement follows the Senate amendment with a modification. The privilege of confidentiality created by this provision will not apply to any written communication between a federally authorized tax practitioner and any director, shareholder, officer, 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)).

A tax shelter for this purpose is any partnership, entity, plan, or arrangement a significant purpose of which is the avoidance or evasion of income tax. Tax shelters for which no privilege of confidentiality will apply include, but are not limited to, those required to be registered as confidential corporate tax shelter arrangements under section 6111(d). The Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, the Conferees do not anticipate that the tax shelter limitation will adversely affect such routine relationships.

The privilege created by this provision may be waived in the same manner as the attorney-client privilege. For example, if a taxpayer or federally authorized tax practitioner discloses to a third party the substance of a communication protected by the privilege, the privilege for that communication and any related communications is considered to be waived to the same extent and in the same manner as the privilege would be waived if the disclosure related to an attorney-client communication.

The conference agreement also clarifies that the privilege created by this provision may be asserted in noncriminal tax proceedings before the IRS and in the Federal courts with regard to a noncriminal tax proceeding where the United States is a party.

This provision relates only to matters of privileged communications. No inference is intended as to whether aspects of federal tax practice covered by the new privilege constitute the authorized or unauthorized practice of law under various State laws.

Effective date.—The provision is effective with regard to communications made on or after the date of enactment.

[1] The §7525 privilege would apply to an attorney providing tax advice to a taxpayer-client, in a setting in which legal advice is not provided, such as where the attorney works for a CPA firm. In this outline, reference to a CPA under §7525 also refers to other federally authorized tax practitioners under Circular 230.

[2] A *Kovel* arrangement refers to a situation where an attorney has hired another person, such as an accountant, to assist him or her in providing legal advice to a client. "Under certain circumstances, ... the privilege for communication with attorneys can extend to shield communications to others when the purpose of the communication is to assist the attorney in rendering advice to the client." *U.S. v. Adlman*, 68 F.3d 1495, 76 AFTR2d 95-7188 (2d Cir. 1995). Also see *U.S. v. Kovel*, 296 F.2d 918, 6201 USTC ¶9111, 9 AFTR2d 366 (2d Cir. 1961).

[3] The First Circuit has referred to waiver as "a loose and misleading label for what is in fact a collection of different rules addressed to different problems. Cases under this "waiver" heading include situations as divergent as an express and voluntary surrender of the privilege, partial disclosure of a privileged document, selective disclosure to some outsiders but not all, and inadvertent overhearing or disclosures." *U.S. v. Massachusetts Institute of Technology*, 129 F.3d 681, 684, 97-2 USTC ¶50,955, 80 AFTR2d 7981 (1st Cir. 1997).

[4] "The mere fact that business considerations are weighed in the rendering of legal advice does not vitiate the attorney-client privilege." *Coleman v. American Broadcasting*, 106 F.R.D. 201 (DC DC 1985)

[5] Also see Mendelson, Herskovitz, and Einhorn, "The New CPA-Client Confidentiality Privilege," *The Tax Adviser*, October 1998, page 676.