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Decisions Underline Scope of IRS Summons Power

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A decision issued earlier this month in ongoing tax litigation by Valero Energy Corp. (Valero), seeking to limit the production of documents in response to Internal Revenue Service (IRS) summonses issued to one of its tax advisors, provides an opportunity to review rules relating to the permissible breadth of such summonses, including the "work product doctrine" and the privilege created by Internal Revenue Code (IRC) section 7525 for certain communications between tax practitioners and their clients.[1]

Although Valero was not entirely unsuccessful in its efforts to quash or limit the summonses, the District Court's conclusions in this decision and an earlier decision in 2007 (Valero I)[2] are noteworthy in affirming the broad scope of the IRS summons power and the important limitations on the ability of a taxpayer to shield discussions with its advisers from disclosure.

Background

Valero, a refiner and marketer of oil and gas products, acquired Ultramar Diamond Shamrock Corporation (Diamond Shamrock), a Canadian company, by merger on December 31, 2001. A series of restructuring and refinancing transactions in 2002 involving Valero and Canadian subsidiaries acquired by it in the merger were reflected on Valero's tax returns as having resulted in foreign currency losses, which losses in turn resulted in a claimed Federal income tax savings of approximately $46,000,000 for Valero in 2002.

Arthur Andersen LLP (Andersen) was retained by Valero in 2001 to provide United States and Canadian tax advice in connection with the merger, and Andersen reviewed work performed by Ernst & Young (E&Y) in connection with the Canadian restructuring and refinancing.

During November 2006, in connection with an IRS examination of the Federal tax liability of Valero and its subsidiaries for 2002 and 2003, the IRS issued an administrative summons to Valero and Andersen, followed by a second, clarifying summons that sought "[a]ll documents . . . related to, or reflecting, tax planning, tax research or tax analysis, by or for [Diamond Shamrock] (including any of its subsidiaries or partnerships, both domestic and foreign) and [Valero] (including any of its subsidiaries or partnerships, both domestic and foreign) in connection with their 2001, 2002 and 2003 Canadian and U.S. income taxes . . . ."

Valero sought to quash the summons as vague and overbroad. It also asserted that certain of the documents requested by the IRS were subject to the work product privilege, and that certain documents were not subject to production because they were confidential communications between a taxpayer and a "federally authorized tax practitioner" (FATP) for the purposes of obtaining tax advice, and therefore protected from disclosure under IRC section 7525.

'Valero I'

As a preliminary matter, the District Court observed that an IRS summons must be enforced if it meets four requirements: the investigation underlying the summons has a legitimate purpose; the information sought may be relevant to that purpose; the IRS does not already have the information; and the IRS has followed the appropriate procedural steps for issuing a summons. The court also noted that the government's hurdle to prove a *prima facie* case for production was not a high one—the government need only show that the information sought "may be relevant" to its legitimate purpose.

Based on an affidavit of an IRS agent involved in the examination, which described some of the claimed losses that the IRS was investigating, the court concluded that the government's investigation had a legitimate purpose and that the summons should be enforced. Accordingly, the court directed Valero to turn over non-privileged documents and a privilege log with respect to any documents subject to a claim of privilege, and to provide to the court copies of the allegedly privileged documents for an *in camera* review by the court to determine whether any privilege applied.

Work product doctrine. In response to Valero's argument that certain

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documents prepared by Andersen were protected from disclosure under the work product doctrine, the court noted, based on controlling Seventh Circuit precedent quoted in the decision, that "[t]he doctrine applies . . . only when 'the document can fairly be said to have been prepared or obtained *because* of the prospect of litigation.'"

Thus, the fact that Valero had the possibility of litigation in mind was insufficient. In order to prevail on the applicability of the work product doctrine, Valero would have to establish that Andersen prepared the materials because Valero or Andersen anticipated litigation.

After a review of an affidavit provided by the Director of Tax for Valero (Tax Director), the court concluded that the documents were best categorized as having been prepared in the ordinary course of business, with the possibility of future litigation being a secondary motivation at best. Valero accordingly failed to establish the requisite element of causation, and therefore failed to establish the applicability of the work product doctrine.

Tax practitioner privilege. Valero further argued that many of the documents were protected under the privilege created by IRC section 7525 to protect communications between a FATP authorized to practice before the IRS with respect to tax matters (such as a certified public accountant or an "enrolled agent") to the same extent that the attorney-client privilege protects the confidentiality of certain communications between a taxpayer and an attorney.

In support of the application of the tax practitioner privilege, Valero presented declarations of the Tax Director and of the Anderson tax partner (a FATP) responsible for the tax advice at issue, to the effect that Valero sought confidential tax advice from Andersen in connection with several transactions relating to the merger of Diamond Shamrock with Valero and that it was intended that such advice be confidential.

The government argued that Valero had failed to produce an engagement letter describing the terms of the engagement by Valero of Andersen; but the court concluded that a written agreement was unnecessary to the existence of the privilege and that the declarations of the Tax Director and of the Andersen tax partner sufficed to establish that the tax practitioner privilege could apply to certain of the communications.

Tax shelter exception. The tax practitioner privilege does not apply to any written communication which is between a FATP and any person "in connection with the promotion of the direct or indirect participation of the person in any tax shelter."[3] The term "tax shelter" is defined for this purpose as including a partnership or other entity, investment plan or arrangement, or 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."[4] The government argued that the tax shelter exception to the tax practitioner privilege should result in the denial of Valero's claim for privilege for certain documents.

The court in Valero I found that the government's mere assertion that a transaction resulted in significant claimed tax benefits failed to show that a transaction had a significant purpose of tax avoidance or evasion, where the government failed to address any other non-tax purposes of the transaction (or lack thereof).

Also, the materials submitted by the government to the court in defense of the IRS summons did not provide a basis for concluding that the dealings between Valero and Andersen had anything to do with the "promotion" of participation in a tax shelter. Accordingly, the court found in Valero I that the government had failed to establish the applicability of the tax shelter exception to the tax practitioner privilege.

'Valero II'

After the court's initial decision, which (as described above) denied Valero's claim of work product protection, Valero informed the court and the government that Andersen had located approximately 20 boxes of documents potentially responsive to the summons. Upon review of the boxes, Valero produced approximately 200 pages of Andersen billing sheets and time records, but many of those pages were redacted on the basis of Valero's claim of tax practitioner privilege.

Valero also sought to withhold other documents from the government on the basis of tax practitioner privilege, and claimed attorney-client privilege with respect to a few documents.

The government contended that Valero was withholding documents not covered by the tax practitioner and attorney-client privileges, and that the attorney-client exception to the tax practitioner privilege applied.

Space constraints do not permit a full review in this article of the court's document-by-document discussion with respect to the applicability of the asserted privileges, but several broad points are worthy of particular note.

The court rejected Valero's redactions of Andersen billing records as being far too liberal, holding that the content of billing records was protected by privilege only insofar as it reflected confidential communications between Valero and Andersen. More specifically, the court found that Valero failed to meet its burden of showing that brief references to the work performed, such as by name of the project, the issue being worked on (e.g. "1033 issue" or "Section 987"), or the identity of the persons involved in the work, disclosed or otherwise reflected a confidential communication and were therefore privileged.

The court also found that Valero could not reasonably claim that fax cover sheets, containing nothing beyond information identifying the sender and recipient and their telephone numbers (and, in one case, a brief, non-substantive message), reflected confidential communications and were therefore privileged. Similarly, engagement letters that related only to state tax advice not subject to the statutory privilege or that described projects in very general terms only were found not to be privileged.

The court also noted that documents that concerned business or accounting advice or state tax issues were not subject to the statutory tax practitioner privilege. However, certain documents contained Canadian and U.S. tax advice that was so completely intermingled that each such document was found to be protected from disclosure in its entirety.

Finally, the court evaluated whether the tax shelter exception to the tax practitioner privilege applied to the set of documents before the court in the second dispute (distinct from the documents addressed in Valero I) and concluded that the government had met its burden of establishing that the exception applied. Specifically, the court found that various corporate resolutions and other documents, and the nature of the transactions effected by Valero-related entities on two dates in 2002, established the existence of a "circular, intracompany step plan" involving a circular flow of funds to generate foreign exchange losses, and Andersen's involvement in formulating that plan.

Valero attempted to rebut the government's showing of facts tending to indicate the existence of a plan with a significant purpose of tax avoidance by asserting that the transactions at issue had various legitimate business purposes.

The court concluded, however, following discussion of other cases concerning the definition of a "tax shelter," that it was not enough for the taxpayer to establish that the transactions had economic reality and were not driven solely by tax-avoidance concerns. Once the government made a *prima facie* case of a significant purpose of tax avoidance, the burden shifted to the taxpayer to show that tax avoidance was not ***a*** significant purpose of the transactions; and Valero failed to meet that burden.

The court also noted, in reaching this conclusion, the existence of several documents from Andersen that "referred to the need to imbue the planned transactions with one or more business purposes so that they would be less likely to draw the scrutiny of the IRS." Such advice suggested to the court that the tax avoidance objective for the transactions was established before any business purposes were identified.

The court also addressed Valero's contention that Andersen could not be viewed as acting in "promotion" of Valero's participation in a tax shelter, as required by the tax shelter exception to the tax practitioner privilege, because Andersen was merely reviewing work performed by E&Y in connection with the Canadian restructuring and refinancing of Valero. The court found, however, that the term "promotion" was not limited to someone who creates or markets a plan or arrangement that constitutes a "tax shelter" as defined for this purpose, but may include any other advisor that advises a client with respect to proposed transactions.

In this case, the court concluded that Andersen's role was not limited to the review of historical transactions and advice on the likely tax consequences thereof, but extended to advising Valero with respect to proposed transactions. On that basis, the court concluded that the government had sufficiently established that certain of Andersen's written communications were in connection with the promotion of the participation of Valero in a tax shelter and, therefore, were required to be produced.

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[1] *Valero Energy Corp. v. United States*, Docket no. 1:06-cv-06730 (N.D. Ill., Aug. 1, 2008).
[2] *Valero Energy Corp. v. United States*, 100 AFTR 2d 2007-6473 (N.D. Ill., Aug. 23, 2007).
[3] IRC §7525(b).
[4] IRC §6662(d)(2)(C)(ii).

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