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Privilege in Tax Matters: Your Accountant v. Your Lawyer?

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It is the rare lawyer who has not been asked by a client sometime during a discussion, "This is all privileged, right?" The ability to preserve the confidentiality of communications is one of the cornerstones of the attorney-client relationship.

The creation, in 1998, of a privilege for CPAs and other federally authorized tax practitioners (hereinafter CPAs) marks a deviation from Congress's longstanding policy of letting the law governing privileged communications develop on a case-by-case basis. This new privilege now exists for certain tax-related communications between a taxpayer and a CPA "to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." The stated reasons for the creation of this privilege are that "a right to privileged communications between a taxpayer and his or her advisor should be available in noncriminal proceedings before the IRS and in noncriminal proceedings in Federal courts with respect to such matters where the IRS is a party, so long as the advisor is authorized to practice before the IRS" and that a "right to privileged communications in such situations should not depend upon whether the advisor is also licensed to practice law." The new privilege is codified in section 7525 of the Internal Revenue Code and applies to communications made after July 21, 1998.

A cursory reading of this provision and its legislative history would seem to indicate that attorneys and CPAs are now on an equal footing as far as privileged communications are concerned. However, more careful consideration of the legislative language and of the contexts in which a privilege may be asserted reveal that there are many circumstances in which the common-law attorney-client privilege is significantly more protective than the new statutory privilege.

Attorney-Client Privilege in the Tax World

Scholars differ about the history of the attorney-client privilege, its underlying policies, and its exact parameters,[1] particularly when the privilege will and will not apply in the context of tax advice and tax proceedings. It is clear, though, that the privilege can apply to some kinds of tax advice, such as advice given in connection with implementation of pending

[1] *See* C. Wright & K Graham, Federal Practice and Procedure § 5472, 5473.
Some issues surrounding application of the privilege to tax advice in connection with transactional matters are discussed in Kayle & Lee, *Point & Counterpoint: The Attorney-Client Privilege in Tax Matters*, ABA Section of Taxation Newsletter, Spring 2002, at 14.

transactions. Thus, correspondence between a taxpayer and its law firm concerning a tax opinion on a pending transaction has been held to be privileged.[2] Similarly, the IRS was denied the ability to enforce summonses issued to attorneys who represented a taxpayer in connection with the formation of a family limited partnership.[3] The privilege also applies to many communications between tax lawyers and their clients outside of the transactional setting, for example, to communications in the context of negotiation of a settlement of tax liabilities with the IRS.[4]

As a procedural matter, the privilege can be asserted in many court proceedings and in response to IRS summonses. For example, *United States v. Frederick*[5] considered whether communications to an attorney for use in return preparation and in defense of an audit were privileged. With respect to return preparation, the court noted that "a taxpayer must not be allowed, by hiring a lawyer to do the work that an accountant, or other tax return preparer, or the taxpayer himself, normally would do, to obtain greater protection from government investigators than a taxpayer who did not use a lawyer as his tax preparer." Even though "it cannot be assumed that everything the taxpayer gave [the lawyer] was intended to assist him in his tax-preparation function and so might be conveyed to the IRS" -- with the effect that the communication to the lawyer would be unprivileged -- "rather than in this legal-representative function," nevertheless, there was no privilege, as the taxpayers, by using their lawyer as their tax preparer, "ran the risk that [the lawyer's] legal cogitations born out of his legal representation of [the taxpayers] would creep into his [return preparation] worksheets and so become discoverable by the government."

The court found the audit-related communications to raise a more difficult issue, as an audit "is both a stage in the determination of tax liability, often leading to the submission of revised tax returns, and a possible antechamber to litigation." Different results as to privilege were called for by different types of audits. "When a revenue agent is merely verifying the accuracy of a return, often with the assistance of the taxpayer's accountant, this is accountants' work and it remains such even if the person rendering the assistance is a lawyer rather than an accountant.... If, however, the taxpayer is accompanied to the audit by a lawyer who is there to deal with issues of statutory interpretation or case law that the revenue agent may have raised in connection with his examination of the taxpayer's return, the lawyer is doing lawyer's work and the attorney-client privilege may attach." The taxpayers in *Frederick* were unfortunately not able to show that their lawyer's work fell into this second category.[6]

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2 *United States v. Telephone & Data Systems, Inc.*, 90 A.F.T.R.2d 2002-5828 (W.D. Wis. July 16, 2002); *Boca Investerings Partnership v. United States*, 31 F. Supp. 2d 9 (D.D.C. 1998).

3 *Segerstrom v. United States*, 87 A.F.T.R.2d 2001-1153 (N.D. Cal. 2001).

4 *United States v. McCorkle*, 74 A.F.T.R.2d 94-5323 (N.D. Ill. 1994).

5 182 F.3d 496 (7th Cir. 1999), *cert. denied*, 120 S. Ct. 1157 (2000).

6 *But See* (*Colton v. United States*, 306 F.2d 633 (2d Cir. 1962) ("There can, of course, be no question that the giving of tax advice and the preparation of tax returns ... are basically matters sufficiently within the professional competence of an attorney to make them prima facie subject to the attorney-client privilege") *and* (*United States v. Cote*, 456 F.2d 842 (8th Cir. 1972).

The Limits of Section 7525

Notwithstanding such limitations, the attorney-client privilege provides protection for many communications between attorneys and their clients in connection with tax matters. Can the same be said of the new privilege for CPAs? There are some areas where the new privilege clearly falls short, and others where there is significant doubt as to its scope.

The most significant limitations on the new privilege relate to the forums and circumstances in which it can be asserted. The attorney-client privilege is recognized by the Federal and all state courts and by Federal administrative agencies. By contrast, the legislative history of section 7525 fleshes out its mandate that the new privilege applies only in any noncriminal tax matter before the IRS and certain noncriminal tax proceeding in Federal court, stating:

> 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.[7]

In the current adversarial atmosphere exemplified by the Sarbanes-Oxley Act of 2002, many clients might prefer to receive legal advice relating to tax matters in a framework that will provide a privilege in all criminal, civil, and administrative proceedings, rather than in a relatively narrow category of civil tax proceedings. Although the Sarbanes-Oxley Act and related developments may themselves have the effect of limiting the attorney-client privilege, there will be advantages to communicating with a lawyer, rather than a CPA, as the section 7525 privilege is just a yet-more-limited version of whatever privilege would exist for communications between attorney and client.

The new privilege also does not apply to written communications in connection with the promotion of participation in any "tax shelter." As the IRS has been increasingly aggressive in pursuing taxpayers that participate in "tax shelters," it could be most disadvantageous to a corporation that had engaged in activity that was being challenged, to discover that its communications with a CPA were not privileged, where those same communications, had they been made to a lawyer, might have continued to be protected.

These are areas where section 7525 clearly does not apply. However, it is possible that the Government may contend for an even more limited scope to the privilege, by trying to narrow the definition of "tax advice." "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 before the IRS. Under Circular 230, "practice before the Internal Revenue Service" comprehends all matters connected with a presentation relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by that body, including preparing and filing documents,

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[7] H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess. 88 (1998)

corresponding, communicating, and representing a client at conferences, hearings, and meetings.[8] The mere preparation of returns *might* fall within practice before the IRS, but the giving of advice regarding the tax consequences of a proposed transaction, without communication or making any filings with the Service, clearly does not.

Is "tax advice" only advice given when there is actual practice before the IRS going on, for example, during an audit? Or does it include transactional advice, so long as the general subject of the advice is tax issues that could, at some later date, form the subject of practice before the IRS? Until this question is resolved, one cannot have great confidence that the new privilege will apply to advice given in connection with transaction planning and implementation or preparation of tax returns.

One final area of concern under the new privilege relates to how easily it may be waived. As discussed above, there are limitations on the applicability of the attorney-client privilege in the contexts of return preparation and, possibly, of "ordinary" audit representation. Were a client to make a communication to a CPA, who was simultaneously the client's return preparer, in connection with a matter intended to be within the scope of section 7525, the practitioner's status as return preparer might cause the communication to have, at least in part, an unprivileged purpose and therefore not to be privileged.

Conclusion

An important factor that enters into the choice of a tax advisor is the extent to which the confidentiality of communications with that advisor can be maintained. While Congress has created a limited privilege that is applicable to some communications between taxpayers and CPAs, the limitations on this new privilege insure that the confidentiality factor will continue to weigh in favor of using an attorney, at least in the most sensitive situations, rather than relying on a new privilege of uncertain scope to provide protection to confidential communications.

[8] 31 C.F.R § 10.2(d) (2002).