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'STARS' Wars—the Service Strikes Back at Taxpayer Claims of Privilege

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The first question asked by many a client at an initial consultation with an attorney, whether in the tax field or any other, is, "This is all privileged, right?" Indeed, the attorney-client privilege is the "oldest of the privileges for confidential communications known to the common law,"[1] and its application in the Federal tax area is well-recognized.[2] Other privileges, of more recent vintage, may also apply in Federal tax cases. For example, the "work product doctrine" is frequently asserted in Federal tax disputes,[3] and Section 7525 creates a privilege for communications between taxpayers and "federally authorized tax practitioners" (or "FATP's") that applies only in noncriminal tax matters before the Internal Revenue Service (the "IRS") and noncriminal tax proceedings in Federal court brought by or against the United States.

Although it is well-established that each of these three privileges—for attorney-client communications, for "work product," and for communications with a FATP—applies in Federal tax disputes, the precise scope of each privilege, the elements that must be shown to exist in order for it to apply, and the parameters of potential exceptions that may render the privilege inapplicable, are a fertile source of controversy between taxpayers and the Government. *Salem Financial Inc. v. U.S.*,[4] a recent decision of the Court of Federal Claims, addressed some important issues in the context of the taxpayer's assertion of each of the privileges as a defense to the Government's discovery requests, including:

- Whether the taxpayer waived the protection afforded by the work product doctrine with respect to documents containing tax reserve information, by having relied on certain communications as the basis for its defense against penalties asserted by the IRS.[5]

- Whether the attorney-client privilege applies to "purely legal advice."[6]

- Whether a special rule that renders communications with a FATP unprivileged, if those communications relate to the "promotion" of a tax shelter, applied to communications made in the course of *implementation* of the "promoted" transaction.

- Whether the taxpayer waived the FATP privilege with respect to certain communications, by having relied on other communications from the same FATP as the basis for its defense against penalties asserted by the IRS.

- Whether advice that was provided to the taxpayer by an individual who had been engaged by the taxpayer as its attorney at the time that the advice was given, but who had formerly been employed by the accounting firm that had "promoted" the transaction in issue to the taxpayer, constituted communications protected by the attorney-client privilege or merely a continuation of the unprivileged "promotional" relationship.

In this article, we discuss the Court of Federal Claims' analysis and resolution of these issues and identify some potential concerns arising from the holdings in *Salem Financial*.

Background

The substantive tax issues in *Salem Financial* involved the appropriate tax treatment of a complex transaction known as STARS ("Structured Trust Advantaged Repackaged Securities")[7] by means of which Salem Financial[8] claimed nearly half a billion dollars in foreign tax credits on its 2002-2007 U.S. income tax returns. Before entering into the STARS transaction, Salem Financial obtained tax advice from KPMG ("KPMG's pre-closing advice"), including a formal opinion stating that the IRS "should" accept the contemplated tax treatment of STARS. It appears that Salem Financial also obtained, before the STARS transaction closed, a similar opinion from the law firm Sidley Austin, although the Court never clearly specifies when that opinion was rendered.

Over some period of time following the close of the STARS transaction, the taxpayer requested, and KPMG provided, written communications containing legal advice regarding the impact of proposed changes in law on STARS and, ultimately, on the unwinding of the transaction ("KPMG's post-closing advice"). Also, following the close of the STARS transaction, the plaintiff requested, and the law firm McKee Nelson provided, legal advice regarding the unwinding of the STARS transaction (the "McKee post-closing advice"). The author of the McKee post-closing advice was, according to the Government, a tax attorney who had formerly been employed at KPMG, where he had been "involved in developing and marketing the STARS transaction."

As part of the preparation of its financial statements for the years 2002-2007, Salem Financial calculated its "tax reserves"—the estimated value of contingent tax liabilities attributable to the potential disallowance of specified tax reporting positions, including those related to the STARS transaction.[9] Salem Financial's tax reserve position with respect to the STARS transaction seems to have been based on a synthesis of the input of three distinct parties. First, Salem Financial itself analyzed "the technical legal merits of the [STARS] transaction." Second, Salem Financial's reserve position was "informed by advice of counsel." Finally, the reserve-setting process with respect to the STARS transaction "was based on the review of the technical merits of the transaction by PWC's [PricewaterhouseCoopers'] technical tax experts." In this regard, certain tax reserve documents containing "STARS-specific tax reserve information" were prepared.[10]

The IRS subsequently issued a Notice of Deficiency disallowing the foreign tax credits and other tax benefits claimed by Salem Financial from the STARS transaction and asserting a penalty, apparently the accuracy-related penalty of Section 6662(a) for the underpayment of taxes. Salem Financial paid the taxes, penalties, and deficiency interest asserted by the IRS and then filed a claim for refund with the IRS and, ultimately, a suit for refund in the Court of Federal Claims.

Although the Court never clearly articulates Salem Financial's grounds for challenging the penalties, it appears that Salem Financial believed that it had had reasonable cause for the underpayment of taxes and had acted in good faith.[11] Salem Financial sought to establish both its reasonable cause for the underpayment of taxes and its having acted in good faith by showing that it had relied on advice from its various tax advisors when reporting the STARS transaction on its Federal income tax returns. In particular, Salem Financial was relying on documents embodying KPMG's pre-closing advice, as well as on the opinion from the Sidley Austin law firm, to establish reasonable cause and good faith. Moreover, Salem Financial provided the foregoing documents to PWC in order to obtain PWC's opinion regarding whether Salem Financial's "reliance on these opinions was reasonable," which PWC concluded it was ("PWC's advice").[12]

In the course of the discovery process in the Court of Federal Claims, the Government sought production of, among other things, "documents containing STARS-specific tax reserve information," documents containing purely legal advice, KPMG's post-closing advice, and the McKee post-closing advice.[13] The taxpayer refused to produce those four categories of documents, invoking variously the work product doctrine, the attorney-client privilege, and the FATP privilege. The Government moved the Court to compel Salem Financial to produce the withheld documents, asserting that the claimed privileges were inapplicable.

In its motion, the Government argued that:

- Documents containing tax reserve information were never protected by the work product doctrine, and that, even if the doctrine could sometimes apply to such documents, its protection had been waived in this case;

- The attorney-client privilege failed to protect certain communications from Salem Financial's counsel to Salem Financial because those documents contained only "purely legal advice;"

- The FATP privilege did not protect KPMG's post-closing advice, either because the statutory tax shelter promotion exception applied or because Salem Financial had waived the privilege by having handed over other documents related "to the same subject matter;" and

- The attorney-client privilege failed to protect the McKee post-closing advice since it was not legal advice, but rather advice from a person acting in a non-legal capacity.

Waiver of the Work Product Doctrine

In its motion, the Government sought to compel production of documents containing tax reserve information, and Salem Financial resisted such production on the grounds of the work product doctrine. The Court of Federal Claims concluded that Salem Financial had waived the protection of the work product doctrine with respect to the withheld documents containing tax reserve information because Salem Financial had disclosed (and thereby waived work product protection with respect to) portions of PWC's advice.[14] The Court of Federal Claims cited a decision of the Court of Appeals for the Federal Circuit that held that, "[w]hen a party waives work product protection, the waiver extends to all non-opinion work product concerning the same subject matter," and that articulated the policy behind the rule: "to prevent a party from using the advice he received as both a sword, by waiving privilege to favorable advice, and a shield, by asserting privilege to unfavorable advice."[15] Although Salem Financial tried to distinguish PWC's advice, with respect to which the work product doctrine had admittedly been waived, from the documents containing tax reserve information, on the basis that the former and the latter did not concern the same subject matter, the Court found the two sets of documents to be "inextricably intertwined."

The Court's discussion of the subject matter waiver exception to the work product doctrine never explicitly specifies the parameters of the "subject matter" that was shared by the documents giving rise to the waiver and the withheld documents containing tax reserve information. Certainly, the broad underlying subject matter of PWC's advice was the appropriate tax treatment of the STARS transaction, just as was the broad underlying subject matter of the withheld work product documents. However, other documents as to which Salem Financial asserted privilege undoubtedly also related, in some sense, to the tax treatment of the STARS transaction, and it is difficult to understand why, if such a general similarity of subject matter was sufficient to create a waiver of work product protection, the Court allowed any documents to continue to be protected by privilege (or, indeed, how privilege could be preserved in any case in which the taxpayer did not adopt an extremely aggressive approach toward withholding documents, so as to avoid assertions of waiver). It would have been helpful for the Court to explain in greater detail the similarities in subject matter between the documents giving rise to the waiver and the documents that were required to be disclosed as a result of the waiver.

Attorney-Client Privilege

In the case of the first category of documents with respect to which protection under the attorney-client privilege was challenged, those allegedly containing only "non-legal advice," the Court simply ordered the parties to use a "quick peek procedure" to resolve their disputes as to these documents. The Court then turned to the other categories.

Purely legal advice

In an odd contrast to the dispute regarding the production of documents that were asserted to contain only "non-legal advice," the Government also challenged Salem Financial's privilege claims with respect to other documents on the grounds that they contained only "purely legal advice and do not reveal confidential client communications"! The Court unenlighteningly summarized Salem Financial's defense to the Government's argument by quoting a witness who had testified on Salem Financial's behalf that these documents are "not something that you

would put in the category of pure legal advice." Although the Court deferred the evaluation of the parties' respective arguments on this issue, instead opting again for the "quick peek procedure," the Court did provide some discussion of the relevant principles governing this counterintuitive category of unprivileged communications.[16]

In order to properly understand the "purely legal advice" issue in *Salem Financial*, one needs to look back to the controlling precedent in the Court of Appeals for the Federal Circuit, *American Standard, Inc., v. Pfizer, Inc.*[17] In *American Standard*, the Court of Appeals for the Federal Circuit laid down the rule that the attorney-client privilege applied to some, *but not all*, confidential communications from an attorney to a client. *American Standard* involved a patent dispute in which one of the parties, Biomet, Inc. ("Biomet"), owned a patent (the "'612 patent") the application for which had referred to an earlier, related patent owned by a third party (the "'123 patent"). Biomet had retained outside counsel to provide a "legal opinion" on the validity of the '123 patent (the "validity opinion"), and, in the course of discovery, Biomet turned over the validity opinion to counsel for the opposing party, American Standard. American Standard sought, and Biomet refused to produce, other documents that mentioned the '123 patent. In support of its motion to compel production, American Standard argued that, by having produced the validity opinion, Biomet had waived the attorney-client privilege with respect to other documents that mention the '123 patent. But the court from which the *American Standard* case had been appealed described the validity opinion as relying on only "non-confidential information gleaned from public records or documents."[18] Accordingly, "[b]ecause the record is devoid of any indication that the validity opinion *reveals the substance of a confidential communication by Biomet*,"[19] the Federal Circuit disagreed with American Standard and concluded that Biomet had not waived the attorney-client privilege by having produced the validity opinion, because that opinion itself was not protected by the privilege.

The Court of Federal Claims purported to direct the parties to apply these principles to the allegedly "purely legal" communications from counsel to Salem Financial. However, the description of the doctrine by the Court of Federal Claims contains an illustration that seems to shift the emphasis of the inquiry away from the content and sources of the communication and toward the circumstances that caused it to be made. Thus, the *Salem Financial* Court gives as an illustration of "purely legal advice" not protected by the attorney-client privilege "an unsolicited legal memorandum from an attorney to members of a trade association," and then emphasizes that "legal advice *in response to a client's request* would be privileged." (Emphasis added.) This articulation of the exclusion of "purely legal advice" from the protection of the attorney-client privilege appears to depart from Federal Circuit precedent, because it shifts the analysis from whether or not a communication from an attorney to a client reveals, "directly or indirectly, the substance of a confidential communication by the client," to simply whether or not the client requested the communication by the attorney.

We leave for another forum the question of whether, as a matter of policy, there should be any limitations on the applicability of privilege to confidential communications from attorney to client. However, even accepting the notion that there are such limitations, the test articulated by the Court of Federal Claims in *Salem Financial* appears to lead to different results from the Federal Circuit's test in many cases. Thus, under *Salem Financial*, unsolicited legal advice might fail to be protected from discovery by the attorney-client privilege even though it *does*

"reveal, directly or indirectly, the substance of a confidential communication by the client." One can imagine a situation where, in the course of an ongoing attorney-client relationship, the attorney, alert to a change in the law, is "proactive" and sends an unsolicited letter to the client that reveals "directly or indirectly, the substance of a [prior] confidential communication by the client." If that letter were to pertain to a matter coming before the Court of Federal Claims, the fact that the letter was unsolicited *should not*, as a matter of policy, cause the attorney-client privilege to fail to protect the letter from disclosure, but the words of the *Salem Financial* opinion could lead to the opposite result and require disclosure of the letter.

Conversely, when a client requests legal advice about the application of a particular law, the attorney may provide that legal advice in the form of a totally hypothetical fact pattern to which the attorney applies the relevant law. Such legal advice certainly reveals that the client sought legal advice but arguably does not "reveal, directly or indirectly, the *substance* of a confidential communication by the client." (Emphasis added.) Indeed, *American Standard* demonstrates that an attorney can provide legal advice specifically requested by the client, and, even though the requested legal advice reveals not only the broad area of law that the client is concerned about (patents) but also the client's specific concern (the validity of the '123 patent), such advice will not be protected by the attorney-client privilege in the Federal Circuit. In such case, the *Salem Financial* court's statements about the scope of the attorney-client privilege might result in the protecting of the document from disclosure, in apparent conflict with Federal Circuit precedent.

The FATP Privilege

Issues related to the application of Section 7525 also arose during discovery and are addressed in the *Salem Financial* opinion. Given the FATP privilege's youthfulness, it is hardly surprising that there are significant areas of disagreement among Federal courts as to its construction, and the Court of Federal Claims broke new ground on some of the Section 7525 issues.

Why Section 7525?

As discussed above, a common law privilege of confidentiality has long existed for communications between an attorney and client with respect to the legal advice given by the attorney to the client. But no such privilege traditionally existed for communications between other professionals, such as accountants and actuaries, and a client with respect to tax advice given by such professionals to the client.[20] Congress in 1998 created a privilege of confidentiality for non-attorney professionals and their clients.[21] Specifically, Section 7525 extends, with certain limitations, the common law attorney-client privilege of confidentiality to communications between taxpayers and FATP's, to the extent that the communications relate to advice given by the FATP with respect to a matter which is within the scope of the FATP's authority to practice before the IRS ("tax advice").[22] Congress intended that the two privileges, the attorney-client privilege and the FATP privilege, be coterminous, except with respect to one area—the promotion of tax shelters.

The "tax shelter promotion" exception to the FATP privilege

Although the '98 Act extended a privilege akin to the attorney-client privilege to communications of tax advice between a FATP and a taxpayer, Congress imposed a limitation that does not exist with respect to the common law attorney-client privilege. Specifically, in Section 7525(b), Congress excluded from the FATP privilege *written* communications between taxpayers and FATP's "in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662(d)(2)(C)(ii))" ("tax shelter promotion").[23] The Conference Committee Report states, in relevant part, "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."[24]

The substantive issue of whether the STARS transaction is a "tax shelter" is lurking within, but has not yet reached the surface of, the dispute between Salem Financial and the Government.[25] This issue impacts the course of discovery, however, because of Salem Financial's reliance on the FATP privilege and the Government's reliance on the tax shelter promotion exception to that privilege. In particular, the Government in *Salem Financial* sought to compel the plaintiff to produce six documents containing KPMG's post-closing advice, each of which the plaintiff asserted was protected by the FATP privilege. The Government contended that the six documents were written communications related to tax shelter promotion, and were accordingly subject to disclosure under Section 7525(b).

The documents contained advice that KPMG had proffered *after* the closing of the STARS transaction regarding the impact of proposed changes in law on STARS and, ultimately, on the unwinding of the transaction. The taxpayer took the position that the phrase "in connection with promotion" in Section 7525(b) referred only to communications made *before*[26] a transaction was undertaken. The Government, however, urged a definition of "in connection with promotion" that encompassed communications of encouragement with respect to, or activities in furtherance of, the participation in the tax shelter, communications that could occur in advance of, contemporaneously with, or even after, that participation.

The Court of Federal Claims did not directly address either whether or not the STARS transaction was a "tax shelter"—a matter in clear dispute between the parties—or whether or not KPMG had ever acted as a "promoter"—a point apparently conceded by the taxpayer. The Court assumed that the Government would prevail on those two issues, but held that the Government was seeking "to broaden the scope of the exception to the [FATP] privilege beyond its plain meaning." In the Court's view, the "in connection with promotion" phrase in the tax shelter promotion exception could not encompass "implementation"—communications from a FATP to a taxpayer made after the taxpayer enters into the tax shelter. The *Salem Financial* court, accordingly, took a taxpayer-friendly, expansive reading of the FATP privilege (and a correspondingly narrow reading of the tax shelter promotion exception to the FATP privilege). Some courts wrestling with technical issues arising under Section 7525 have been similarly willing to give the FATP privilege a broad reading, while others have exhibited a hostility to the privilege that has required the disclosure of many documents to the Government.[27]

Waiver of the FATP Privilege

Having held for the plaintiff with respect to the (non-)application of the tax shelter promotion exception to the FATP privilege, the Court of Federal Claims turned to the Government's alternative argument in support of its motion to compel production of the six documents embodying KPMG's post-closing advice—that Salem Financial had waived the FATP privilege with respect to those documents. The Government argued that the FATP privilege had been waived with respect to KPMG's *post*-closing advice because of Salem Financial's explicit waiver of the FATP privilege with respect to KPMG's *pre*-closing advice, on which Salem Financial was relying as a defense to IRS penalties.

The *Salem Financial* court referred to an earlier Court of Federal Claims opinion, *Evergreen Trading LLC v. U.S.*,[28] for the proposition that when a party waives the FATP privilege as to a particular communication, it also waives the privilege as to all communication involving "the same subject matter." The waiver with respect to the six documents embodying KPMG's post-closing advice thus depended only upon the court's finding that KPMG's post-closing advice involved "the same subject matter" as KPMG's pre-closing advice. The court chided the taxpayer for "attempting to disclose only advice favorable to its position while concurrently shielding advice … that may be unfavorable to its position" and concluded that "KPMG's pre- and post-closing advice appear to relate to the same subject matter: the proper tax treatment of STARS."

While the *Salem Financial* court accurately recited *Evergreen's* rule regarding waiver of the FATP privilege, the *Salem Financial* court omitted some relevant limitations laid down in *Evergreen*:

> [A]s the Federal Circuit has cautioned, this rule must not be too liberally invoked lest it swallow the privilege.… [C]ourts applying this rule have been careful not to define the "subject matter" of communications too broadly. In this regard, the Federal Circuit has advised — "[t]here is no bright line test for determining what constitutes the subject matter of a waiver, rather courts weigh the circumstances of the disclosure, the nature of the legal advice sought and the prejudice to the parties of permitting or prohibiting further disclosures. *(Internal citations omitted).*" Hence, just because a party discloses a communication covering one aspect of its case does not mean that it has waived the privilege as to communications involving the rest. It follows, *a fortiori*, that because a taxpayer has revealed otherwise protected communications regarding *one aspect of the tax planning that went into a transaction* does not necessarily mean that it has waived the privilege as to all aspects of that planning.

(Emphasis added.) The Salem Financial court's analysis of the issue of waiver of the FATP privilege thus raises several concerns.

First, the opinion omits any weighing of "the circumstances of the disclosure, the nature of the legal advice sought and the prejudice to the parties of permitting or prohibiting further disclosures." Instead of evaluating all of the circumstances relevant to whether a waiver had occurred, the *Salem Financial* court appears to have done no more than to rehash the "sword vs. shield" policy consideration informing the application of waiver of protection by the work

product doctrine. While the court focused on preventing the taxpayer from gaining an unfair advantage through the selective disclosure of documents in discovery, it neglected to consider whether there were any factors that might have negated the asserted waiver of the FATP privilege with respect to KPMG's post-closing advice.

Second, the court may have expanded the class of disclosures that potentially trigger a waiver. In *Evergreen*, the court had stated that, "because a taxpayer has revealed otherwise protected communications regarding *one aspect of the tax planning that went into a transaction* does not necessarily mean that it has waived the privilege as to *all aspects* of that planning" (emphasis added.). In contrast, the *Salem Financial* court found a waiver based on the more attenuated relationship between (revealed) tax planning that "went into [an actual] transaction" and (sought-to-be-protected) tax planning related to potential future transactions to be implemented in the case of possible changes in law or to effect an unwinding of the original transaction.

Third, the *Salem Financial* court's visceral discomfort with the taxpayer's "having its cake and eating it too" may have sprung from the natural assumption that KPMG's post-closing advice, disclosure of which was being resisted by the taxpayer, must have concluded that the appropriate tax treatment of the STARS transaction was unfavorable. Perhaps there was no good reason for the court to take the taxpayer's word that the documents discussed only the impact of proposed changes in law on STARS and, ultimately, on the unwinding of the transaction, but it was certainly not as clear as the court suggested that the taxpayer was seeking an unfair advantage.

Fourth, the court seemed to have failed to consider the impact that its view that KPMG's pre-closing advice constituted unprotected "promotion" of a tax shelter[29] should have had on the question of whether the taxpayer had waived the FATP privilege with respect to KPMG's post-closing advice. Waiver of a privilege normally occurs when a party discloses what would otherwise be confidential privileged communications,[30] and, in appropriate circumstances, that waiver can extend to other confidential privileged communications on the same "subject matter."[31] However, if the disclosed communication was not itself privileged—either because it was never confidential or because it was, as a promotional communication, beyond the scope of the statutory privilege—its disclosure should not constitute a "waiver" with respect to other, privileged communications.

The situation here is analogous to the one in the *American Standard* case, discussed above. American Standard was seeking from Biomet the disclosure of documents that mentioned the '123 patent. American Standard argued that Biomet had waived the attorney-client privilege with respect to such documents because Biomet had disclosed the validity opinion, which had referred to the '123 patent. The Court of Appeals concluded, however, that the validity opinion was never protected by the attorney client privilege because it was only "purely legal advice." And since the validity opinion was never protected by the attorney-client privilege, its disclosure could not possibly have caused the waiver of the attorney-client privilege with respect to other documents that mentioned the '123 patent. Likewise, in *Salem Financial*, the Court of Federal Claims characterized KPMG's pre-closing advice as "encouraging" the taxpayer's participation in the STARS transaction, implying that the Court may ultimately find that KPMG's pre-closing advice was "in connection with the promotion" of a "tax shelter." If the Court were to make that finding, it would follow that KPMG's pre-closing advice was, under Section 7525(b), never

protected by the FATP privilege. And if KPMG's pre-closing advice is not protected by the FATP privilege, then its disclosure could not cause the waiver of the FATP privilege with respect to KPMG's post-closing advice.[32]

Can an Advisor Change His Spots?

The FATP privilege, which can apply to attorneys who are acting as FATP's, but not in a strictly legal capacity, has an exception for tax shelter promotion, but the attorney-client privilege does not. Suppose an attorney who, as a FATP, provided tax advice to a client with respect to the promotion of a tax shelter later gives "legal" advice with respect to that same tax shelter and to that same client. Can that later advice be protected by the attorney-client privilege?

One tax attorney at KPMG "involved in developing and marketing the STARS transaction" subsequently left the accounting firm for a tax law firm, McKee Nelson. While at McKee Nelson, the attorney prepared six documents regarding the unwinding of the STARS transaction. The Court of Federal Claims found that the attorney, although he had once been a FATP promoting a tax shelter, later became a lawyer whose communications to the same taxpayer with respect to the same transaction were protected by the attorney-client privilege.

While the Court's conclusion on this issue was favorable to Salem Financial, had the attorney stayed at KPMG and made the very same later communications, the results would have been different. The Court had found that by waiving the FATP privilege with respect to KPMG's pre-closing advice, Salem Financial had waived it with respect to KPMG's post-closing advice, and there is no indication that the Court would not have included legal advice provided by KPMG attorneys within the waiver. Allowing the application of rules of privilege to be affected by the vagaries of a FATP's employment choices is likely to lead to unpleasant surprises.

Conclusion

The brief opinion in *Salem Financial* provides some novel departures on timely questions affecting the attorney-client, work product, and FATP privileges. Only time will tell if the idiosyncratic views of the Court of Federal Claims on some of these issues will be more broadly accepted.

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[1] *Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981) (*internal citation omitted*).

[2] Under Federal Rule of Evidence 501, issues of privilege "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," and Federal Rule of Evidence 502, relating to whether certain disclosures will result in a waiver of the "protection that applicable law provides for confidential attorney-client communications," presumes the existence and applicability of the privilege. Federal Rule of Evidence 1101(a) provides that the Federal Rules of Evidence apply in the United States district courts and in the Court of Federal Claims, and the attorney-client privilege is thus applicable in those courts. Section 7453 makes the "rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia" applicable in the Tax Court, and Rule 143(a) of the Tax Court Rules of Practice and Procedure (the "Tax Court Rules") provides that the rules to which Section 7453 refers "include" the Federal Rules of Evidence and "any rules of evidence generally applicable in the Federal courts," thereby extending the attorney-client privilege to the Tax Court.

In *Upjohn*, the Supreme Court applied the attorney-client privilege in the context of enforcement of an Internal Revenue Service ("IRS") summons issued under Section 7602(a) and explicitly recognized (in its discussion of the applicability of the "work product doctrine") that the Service's summons authority is limited by "traditional limitations and privileges," including the attorney-client privilege (citing *U.S. v. Euge*, 444 U.S. 707 (1980)). Moreover, Treasury Regulations recognize that the privilege may be applicable with respect to certain reporting requirements as well. *See, e.g.*, section 301.6112-1(e)(2), relating to claims of privilege in connection with the requirement that a "material advisor" with respect to a "reportable transaction" maintain and furnish to the IRS a list of advisees.

Distinct from the question of the forums in which the privilege may be asserted is whether there are communications made in the course of tax practice that are simply not privileged in the first place. In particular, the Service has sometimes challenged the application of the attorney-client privilege to communications made in the context of return preparation and audit representation. Federal tax return preparation has generally been considered by Federal courts not to constitute the provision of legal advice, with the result that the attorney-client privilege is necessarily inapplicable to tax return preparation. *See U.S. v. Frederick*, 182 F.3d 496 (7th Cir. 1999) (holding "dual-purpose document"—document prepared by attorney for use in preparing tax returns and subsequently used during audit—not privileged); *U.S. v. Bornstein*, 977 F.2d 112 (4th Cir. 1992); *U.S. v. Davis*, 636 F.2d 1028 (5th Cir. 1981); *Bria v. U.S.*, 89 A.F.T.R.2d (RIA) 2141 (D. Conn. 2002) (citing *Frederick* favorably). At least one Court of Appeals, however, has recognized that the privilege may, in appropriate circumstances, cover communications made in connection with the filing of tax returns. *See U.S. v. Abrahams*, 905 F.2d 1276 (9th Cir. 1990) ("[a]lthough communications made solely for tax return preparation are not privileged, communications to acquire legal advice about what to claim on tax returns may be privileged"). Similarly, some courts have recognized that communications between taxpayers and their attorneys for the purpose of obtaining legal advice in connection with an IRS audit may be covered by the privilege. *See U.S. v. Cote*, 456 F.2d 142 (8th Cir. 1972); *U.S. v Willis*, 565 F. Supp. 1186 (S.D. Iowa 1983).

[3] The "work product doctrine," originally articulated by the Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1947), protects generally "written statements, private memoranda and personal recollections prepared or formed by an adverse party's counsel in the course of his legal duties." 329 U.S. at 510. The doctrine's application in the context of discovery in the United States district courts is now codified in Federal Rule of Civil Procedure 26(b)(3)-(5). Notwithstanding the inapplicability of the Federal Rules of Civil Procedure in the Tax Court (and the absence of any comparable provisions in the Tax Court Rules), the "work product doctrine" is applied in the Tax Court as well, *see, e.g., Ratke v. Commissioner*, 129 T.C. 45 (2007), and the Supreme Court in *Upjohn* confirmed the doctrine's applicability as a defense to an IRS summons. (The "work product doctrine" is also codified in Rule 26(b)(3) of the Rules of the Court of Federal Claims.)

[4] 109 AFTR2d 2012-604 (Jan. 18, 2012).

[5] The Court also noted the existence of a question regarding whether *any* documents containing "tax reserve information" qualify for protection under the work product doctrine, but determined that it did not need to decide that question, in light of the Court's conclusion that the taxpayer waived whatever protection would otherwise have been applicable. (A leading case, *U.S. v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009), *cert. denied*, 130 S. Ct. 3320 (2010), holds that the work product doctrine does not apply to such documents, but the Court of Federal Claims indicated that it was "sympathetic" to the contrary view articulated in Judge Torruella's dissent in *Textron*.)

[6] In its discussion of the attorney-client privilege, the Court of Federal Claims also addressed briefly the question of whether particular communications with the taxpayer's attorneys related to protected "legal advice" or to unprotected advice on other matters, but the Court postponed decision on that matter until the parties had reviewed the relevant documents under a "quick peek" procedure. *See* Fed. R. Civ. Proc. 26(b)(2), Advisory Committee's Note, 2006 Amendments.

[7] The transaction is alternatively known as the "Structured Repackaged Asset-Backed Trust Security" or "STRATS" transaction. According to http://www.investopedia.com (*last visited Feb. 21, 2012*), the transaction involves "a derivative product similar to an exchange-traded fund or American Depository Receipt, where the originator buys an asset, sets up a trust and then issues securities to investors … [w]ith [which] the investors can benefit from the underlying asset's performance. Structured products are those that combine two or more financial instruments, including at least one derivative."

It does not appear that the IRS has designated the STARS transaction as a "listed transaction" or as a "transaction of interest." *See* Treasury Regulations sections **1.6011-4(b)(2) and (6)** and Notice 2009-59, 2009-31 IRB 170 (July 15, 2009) (cumulative list of "listed transactions") and Notice 2009-55, 2009-31 IRB 170 (July 15, 2009) (cumulative list of "transactions of interest"). (Chronological lists of "listed transactions" and of "transactions of interest" can also be found on the IRS website, at http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html and at http://www.irs.gov/businesses/corporations/article/0,,id=204156,00.html, respectively (last visited Mar. 21, 2012)). The IRS's position in the *Salem Financial* case, however, is that the STARS transaction does fit within the broader definition of "tax shelter" found in Section 6662(d)(2)(C), *i.e.*, "a partnership or other entity, any 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."

[8] According to the Court, the taxpayer that actually claimed the relevant tax items was a "predecessor-in-interest" of the plaintiff's. For simplicity's sake, we refer to that predecessor as Salem Financial or as the taxpayer.

[9] For more information on tax reserves, see M. Lloyd, M. Gossart, and G. Fenton, "Understanding Tax Reserves and the Situations In Which They Arise," Tax Notes, July 6, 2009.

[10] The Court never affirmatively identifies the party or parties who created the tax reserve documents that Salem Financial had refused to produce to the Government.

[11] See Section 6664(c)(1).

[12] The Court's terse description of PWC's advice leaves several unanswered questions, such as whether that advice included an express expression of PWC's own opinion on the merits of Salem Financial's tax reporting of the STARS transaction, when—before Salem Financial filed its 2002-2007 returns or only after those returns were selected by the IRS for audit—PWC's advice was given, and for what purpose an adviser's views on the reasonableness of reliance on another's adviser's opinion were thought to be relevant.

[13] The Government also had sought the production, on the basis that they contained only non-legal advice, of certain other documents that Salem Financial had withheld under the attorney-client privilege. *See* footnote 6, above.

[14] *See* note 12, above. PWC apparently gave advice in several different contexts, and it is sometimes difficult to be sure of the Court's focus. For example, at the beginning of the second paragraph of the portion of the opinion headed "Documents Containing Tax Reserve Information," the Court states:

> [T]he Government contends that Plaintiff waived any work product protection that may have applied to the tax reserve documents by relying on advice from its outside financial auditor, [PWC], *concerning the reserves as a defense to IRS penalties*, and by allowing PWC employees to testify as to *the reasonableness of [taxpayer's] tax reserves*. [Emphasis added.]

[15] *In re EchoStar Comms. Corp.*, 448 F.3d 1294 (Fed. Cir. 2006).

[16] While the attorney-client privilege, in some form or another, may be ancient, "the nature and scope of the privilege have changed over the last two hundred years." Wright and Graham, *Fed. Pract. & Proc.*, vol. 24, § 5472, at 72. Originally, the privilege "only covered testimony by the lawyer concerning *communications from his client* with respect to pending litigation." (Emphasis added.) Id. at 73. The extension of the privilege to confidential *communications from the attorney* to the client, however, is part of the privilege's modernization. (All confidential communications from the client to the attorney are, of course, still protected by the privilege, so long as they relate to the seeking of "legal advice.") Thus, the issue regarding whether a confidential communication from the attorney of "purely legal advice" to the client is privileged falls within the larger issue relating to whether confidential attorney-to-client communications are always, sometimes, or never privileged.

[17] 828 F.2d 734 (Fed. Cir. 1987).

[18] 828 F.2d at 744 (*quoting* No. S 86-26 (N.D. Ind. 1986)).

[19] Unhappy with the lower court's "unfortunately succinct statement" in this regard, the *American Standard* court further described the validity opinion as follows:

> The "opinion letter" is not signed, is not addressed to Biomet or anyone else, and bears no letterhead or other indication of source. It discusses no prior action of Biomet and recommends no action to be taken by Biomet, but merely concludes that the **'123 patent** is invalid.

828 F.2d at 745. It is unclear what significance the *American Standard* court felt these additional facts held. Was the mere fact that the validity opinion relied on only "non-confidential information gleaned from public records or documents," enough to cause it to be "purely legal advice" not protected by the attorney-client privilege, or did the loss of the privilege's protection depend also upon the facts that the validity opinion was not signed, was not addressed, was not on letterhead, etc.?

[20] *See, e.g., Couch v. U.S.*, 409 U.S. 322 (1973).

[21] *See* IRS Restructuring and Reform Act of 1998, P.L. 105-206 (the "'98 Act"), sec. 3411(a), 112 Stat. 685, 750-51 (7/22/1998).

[22] *See* Section 7525(a)(3)(B). The FATP privilege may be asserted only in a noncriminal tax matter before the IRS or noncriminal tax proceeding in Federal court brought by or against the Government. *See* Section 7525(a)(2). An FATP is anyone authorized under section 330 of Title 31 of the U.S. Code to practice before the IRS, including attorneys, CPA's, enrolled agents, and enrolled actuaries. *See* Section 7525(a)(3)(A).

[23] As originally enacted, Section 7525(b) applied to except from the FATP privilege written communications in connection with the promotion of the participation of *corporations* in tax shelters. Congress later expanded the exception to cover written communications in connection with the promotion of the participation of corporate and non-corporate *persons* in tax shelters. *See* sec. 813(a) of the American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418, 1581 (10/22/2004) (the "'04 Act"), effective for communications made after Oct. 22, 2004 (*see* sec. 813(b) of the '04 Act).

[24] H. Conf. Rept., 105-599, at 269 (1998), 1998-3 C.B. 747, 1023.

[25] *See* footnote 7, above.

[26] Salem Financial had also received communications from KPMG before the closing of the STARS transaction. Although the Court did not explicitly make a finding in this regard, the Court appears to assume that KPMG's pre-closing advice, at least in part, constituted "promotion" and accordingly, to that extent, would not be protected under the FATP privilege if the STARS transaction were ultimately found to be a tax shelter. The Court was spared from having to reach a conclusion regarding whether KPMG's pre-closing advice was "promotion" of a "tax shelter" because Salem Financial had waived the FATP privilege with respect to it. The closest the Court came to finding that KPMG's pre-closing advice was, in fact, "promotion" was its characterization of at least some of it as relating to the "*developing and marketing* [of] the STARS transaction" (emphasis added).

[27] *Compare Countryside Limited Partnership v. Commissioner* 132 T.C. No. 17 (2009) (holding that an FATP's advice with respect to an alleged tax shelter, rendered before the taxpayer entered into the transaction, was not "in connection with promotion," but rather was part of the routine "long, close relationship" between the FATP and the taxpayer.) *with Valero Energy Corp. v. U.S.* 569 F.3d 626 (7th Cir. 2009), *rev'g* 102 AFTR2d 2008-5916 (N.D. Ill. 2008) (since the Section 6662(d)(2)(C)(ii) definition of "tax shelter," referenced in the tax shelter promotion exception, is itself broad, a broader reading of "in connection with promotion" as any furtherance or encouragement of participation in a tax shelter, even after the tax shelter has been entered into, is appropriate.). The *Salem Financial* opinion does not cite or discuss either of these cases. For more information on *Countryside* and *Valero*, see J. Sawyko, "The Tax Practitioner-Client Privilege: *Valero*'s Shortcomings and a Better Approach," 64 TAX LAWYER 2 (Winter 2011); P. Jones, "Courts Debate Practitioner Privilege and the Scope of the Tax Shelter Exception," 111 JTAX 4 (July 2009).

[28] 100 AFTR2d 2007-7163 (Ct. Fed. Cl. 2007).

[29] In the section of the Court's opinion under the heading, "Documents Withheld Under the Tax Practitioner Privilege," the Court wrote "Plaintiff cannot selectively disclose KPMG advice *encouraging* [the taxpayer] to utilize the STARS transaction …." (Emphasis added.)

[30] *Upjohn*, 449 U.S. at 389.

[31] *Evergreen*, 80 Fed. Cl. at 129.

[32] The fact that the taxpayer relied on KPMG's pre-closing advice as a defense to the IRS's asserted penalties is also curious. This case was apparently not subject to Section 6664(d), which explicitly prohibits a taxpayer from establishing reasonable cause against any asserted penalty imposed under Section 6662A for an understatement of income tax liability with respect to any "reportable transaction" or "listed transaction" by relying on the advice

of a "disqualified tax advisor." However, it still seems unlikely that a taxpayer's reliance on a "promoter's" advice would establish reasonable cause with respect to an underpayment. *See Tigers Eye Trading, LLC v. Commissioner*, T.C. Memo. 2009-121 (stating, with respect to taxpayers seeking to avoid liability for the accuracy-related penalty by showing reasonable reliance on a competent professional adviser, that "[c]ourts have routinely held that taxpayers could not reasonably rely on the advice of *promoters* or other advisers with an inherent conflict of interest such as one who financially benefits from the transaction" (internal citations omitted and emphasis added.); E. Pisem, "The Uncertain Boundary Between 'Partner-Level' and 'Partnership-Level' Defenses," 111 JTAX No. 3 (Sept. 2009).