

PUBLICATION

Unintended Waiver of Tax Practitioner and Work Product Privileges

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Taxpayers represented by legal counsel enjoy, in many situations, the protection of the attorney-client privilege with respect to tax advice. Other protections, such as the work-product doctrine, also provide a safeguard to the taxpayer with respect to materials prepared in anticipation of litigation. These protections in an attorney-client relationship vary in scope and application depending upon state law.

In addition to these state law protections, Section 7525 of the Internal Revenue Code (Code) provides in part that 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 communication between a taxpayer and any federally authorized tax practitioner as and to the extent provided in that Section. A "federally authorized tax practitioner" means any individual who is authorized under federal law to practice before the Internal Revenue Service (IRS), and can include attorneys, certified public accountants, as well as enrolled agents and actuaries.

Safeguarding these various protections is a paramount objective. Unfortunately, the loss of these protections often occurs inadvertently -- and with devastating consequences as demonstrated in the recent decision of *Salem Financial, Inc. v. United States* decided by the Court of Federal Claims.

The Salem Financial Litigation

This case was litigated by the IRS as a tax shelter case and involved a motion to compel various tax accrual workpapers. That motion was granted in part and denied in part by the court. Branch Investments, LLC, the predecessor-in-interest to Salem Financial Inc. (Taxpayer) engaged in a transaction known as Structured Trust Advantaged Repackaged Securities (STARS) which produced almost \$500 million in foreign income tax credits which Taxpayer used on tax returns from 2002 to 2007.

The IRS challenged the transaction and filed a notice of deficiency. Taxpayer paid applicable tax, penalties and interest and filed suit for a refund in the Court of Federal Claims. Procedurally, the IRS next filed a motion to compel Taxpayer to produce tax documents related to the transaction. Specifically, the IRS sought documents from three categories: (i) documents containing tax reserve information, (ii) documents withheld under the tax practitioner privilege, and (iii) documents withheld under the attorney client privilege.

Sword and Shield

Taxpayer asserted that the tax reserve workpapers were protected under the work product doctrine because they were prepared in anticipation of litigation. The IRS countered, based on federal case law precedent, by arguing that the workpapers were prepared not in anticipation of litigation, but rather created to satisfy financial reporting requirements. Alternatively, the IRS stated that Taxpayer waived protection when it asserted reliance on the tax reserve analysis performed by its independent auditors to avoid the imposition of penalties.

Although the court signaled its understanding of the policy rationales behind protecting tax reserve workpapers from discovery, the court punted on the issue as to whether the tax reserve workpapers were protected under the work product doctrine. Instead, the court decided that the entirety of the subject matter surrounding the

STARS transaction was made discoverable after reasoning that Taxpayer was not permitted to assert reliance on the auditor's analysis as a sword to mitigate penalties, while simultaneously asserting privilege to protect the tax reserve workpapers from discovery.

Again relying on federal case law precedent, the court stated that when privilege is waived as to some communications, privilege is lost as to all communications. The court additionally stated that privilege is waived if information is disclosed in a way inconsistent with keeping it from the adversary, such as using the information as an affirmative defense (i.e., that tax penalties should not be assessed). When waiver occurs, all non-opinion work product is waived in order to prevent a party from only disclosing information that supports its position while claiming privilege over those things that do not. The court noted that while there is no bright line test to determine what subject matter falls within the protection of the work-product doctrine, the goal according to case precedent is "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... ."

Two-Way Street

Taxpayer next asserted that six documents containing legal advice from one of its independent auditors were protected pursuant to the protection afforded to federal tax practitioners under Section 7525 of the Code. The IRS argued that (i) the documents were outside the protection of Section 7525 because the advice from the auditor was "in furtherance" of a tax shelter, or alternatively (ii) Taxpayer waived privilege by relying on the auditor's advice to avoid the imposition of penalties.

The court dismissed the notion that the post-closing advice regarding the change in tax law and the unwinding of the STARS transaction was in any way "in furtherance" of a tax shelter. The court however did determine that when Taxpayer asserted reliance on the auditor's post-closing advice as a defense against the imposition of penalties, Taxpayer waived the tax practitioner privilege. Similar to the conclusion reached by the court as to the tax reserve documents discussed above, the court stated that Taxpayer is not permitted to "disclose only advice favorable to its position while concurrently shielding advice concerning the same subject matter that may be unfavorable to its position."

Quick Peek

Taxpayer also asserted that approximately 400 documents were protected under the attorney-client privilege. In order to reduce the number of documents the IRS actually desired, the court ordered Taxpayer and IRS to employ a "quick peek" procedure advanced in the Federal Rules of Civil Procedure. One advantage to the "quick peek" is that such procedure enables the litigating parties to minimize the costs and delays associated with discovery and specifically determine which documents are substantive to the litigation.

Summary

The purpose of this Alert is not to analyze the full scope and application of the protections referenced in this Alert. However, taxpayers must exercise extreme caution in defending their tax positions against IRS scrutiny so as to minimize the possible unintended waiver of such protections. Should you have any questions regarding the *Salem Financial* decision or any of the protections referenced in this Alert, please contact an attorney in the Firm's Tax Department.