Practice

By Charles P. Rettig

Hail to the Chiefs–Judicial Independence and the Interpretation of Sometimes-Complex Tax Concepts

James S. Eustice, Tax Leadership Award

In recognition of a major milestone for the tax law community—the 60th Anniversary of the Graduate Tax Program at the NYU School of Law—James S. Eustice (the Gerald L. Wallace Professor of Taxation in the NYU Graduate Tax Program) recently received the First Annual Graduate Tax Leadership Award. Henceforth, this Award will be conferred annually as the James S. Eustice Tax Leadership Award, recognizing outstanding leadership and extraordinary contributions to the tax community by an alumnus of the Graduate Tax Program at the NYU School of Law.

The NYU Graduate Tax Program was founded in 1945 by Gerald L. Wallace and a group of colleagues. The first publication of the NYU Tax Law Review occurred in 1946. Charlie Lyon, a former deputy prosecutor at the Nuremberg War Crimes Trials, an Assistant Attorney General of the United States at the age of 35 and a name partner in a New York firm now known as Skadden Arps, joined the faculty in the early 1950s. Jim Eustice joined in 1960. For over 60 years, NYU has been the leader in graduate tax education, continuing to produce the best and brightest tax academics, practitioners and government leaders, nationally and internationally. These "Titans of Tax"— Wallace, Lyon and Eustice— have trained more leading tax scholars than others could ever envision on the intricacies and complexities of the Internal Revenue Code ("the Code"). They also passed on a passion for the application and interpretation of complex tax statutes and concepts, within certain self-imposed limitations.

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Funding and Enforcement

These are interesting times! Congress fully intends for the IRS and the Department of Justice to exercise

their best efforts for the full and complete enforcement of the Internal Revenue laws, particularly with respect to listed and reportable transactions. During 1997 and 1998, Congress became heavily involved in the administration of tax law, leading to the enactment of the IRS Restructuring and Reform Act of 1998 (RRA '98),[1] neutering the most efficient, effective and respected taxing authority in the world. RRA '98 ripped the phones off the walls of the only realistic accounts receivable department within the United States government. The IRS is—and should remain—a nonpolitical, well-respected, well-funded tax enforcement authority.

Some might assert that Congress is again overly involved in the activities of the IRS and that Congress should simply provide appropriate funding for the IRS and move on. Listed and reportable transactions were not created in complete ignorance of the Code. They are typically founded within the complexities of the Code and its distinctions favoring certain types of transactions by practitioners having a great degree of knowledge about the Code and relevant case authorities. The greatest historical aspects of any tax plan have been invisibility and a low audit rate. If not subjected to an examination, almost any tax plan will prove successful.

How can the IRS realistically administer the complex provisions of the Code, subject to ever-changing judicial interpretations, when its senior representatives are regularly called to report to Congress? The trains simply cannot run on time if the organization remains underfunded, somewhat unprepared for the required task and a bit confused about its true mission. The IRS knows how to be effective; proper funding will lead to proper enforcement. Proper enforcement will enhance the integrity of the system of taxation in the United States, improving compliance at all levels. However, a potentially misguided or overly assertive enforcement mechanism responding to the whims of Congress, without a strong and independent judiciary, could actually undermine the integrity of our system of taxation.

Recently, in *BDO Sideman, LLP*, James F. Holderman, District Judge (District Court for the Northern District of Illinois, Eastern Division), was presented with a dispute involving 267 documents withheld from the IRS's scrutiny on the basis that the documents were privileged under the tax practitioner privilege set forth in Code Sec. 7525, the common law attorney-client privilege, as well as the work-product doctrine.[2] The Court reviewed a privilege log identifying the privilege assertion for each of the 267 withheld documents and also reviewed each document *in camera*. The documents were described as Opinion Letters and memoranda, drafts of Opinion Letters and memoranda, handwritten notes, e-mails, faxes, letters, summaries, typewritten notes and schedules. The Court determined that the documents were privileged and were not required to be disclosed to the government except for a single document in which the Court found a *prima facie* showing of the crime-fraud exception.

The statutory privilege is a creation of Congress set forth in Code Sec. 7525(a)(1), providing[3]:

> 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 an attorney shall also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

The classic definition of "attorney-client privilege" was first articulated by Dean Wigmore:

(1) Where legal advice of any kind is sought
(2) From a professional legal advisor in his capacity as such
(3) The communication related to that purpose
(4) Made in confidence
(5) By the client
(6) Are at his instance permanently protected
(7) From disclosure by himself or by the legal advisor
(8) Except where the protection is waived.[4]

The purpose of any privilege is to encourage full disclosure and to facilitate open communication between attorneys and their clients.[5] Privileges—as inhibitors to fact-finding—are to be narrowly construed.[6] The statutory privilege only applies to communications made on or after July 22, 1998.[7] Limitations on attorney-client privilege such as the crime-fraud exception, are incorporated into the statutory privilege through the application of common law interpretations of the attorney-client privilege.[8] Further, the phrase "tax advice" does not include communications regarding tax return preparation; it simply encompasses communications such as tax planning advice.[9]

In *BDO*, the government argued that the taxpayers could not assert privilege since they were involved in fraudulent transactions by purchasing illegal tax shelters from BDO, and that BDO and the taxpayers attempted to inappropriately conceal the transactions from the IRS. The IRS argued that BDO produced financial transactions, or "tax products," that it marketed to clients looking to evade their tax liabilities:

> The IRS referred to these transactions as "abusive," "pre-packaged," and "cookie-cutter" in an effort to brand BDO as the proprietor of off-shelf pre-packaged retail tax shelters sold to taxpayers for the singular unlawful purpose of evading tax liability.
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> In essence, the IRS alleges that everything done by BDO, the third-party law firms, and the [taxpayers] in these transactions, under the guise of a legitimate business purpose is nothing more than an attempt to cover-up the unlawful purpose of the tax shelters. The IRS asserts this type of cover-up is necessary because the allegedly illegal tax shelters produced and marketed by BDO are the same or substantially the same as ones that have been previously determined to have been abusive in published IRS Notices. The IRS concludes that since BDO and the [taxpayers] must be aware of the illegal nature of BDO's tax products, BDO and the [taxpayers] must be engaged in the practice of concealing its illegal activities and this deprives them of the benefits of attorney-client, tax practitioner and work-product privileges under the crime-fraud exception.[10]

Under the crime-fraud exception, otherwise-privileged communications lose their protected status if made for the purpose of receiving advice for the commission of a fraud or a crime.[11] In *BDO*, Judge Holderman determined that the IRS failed to present a *prima facie* case, stating:

> The Court is not prepared to accept the far-reaching and blanket assertions by the IRS at this time.

Further,

> The government has based its arguments for the application of the crime-fraud exception on what to this point is speculation and innuendo.

Finally,

> The fact that the IRS characterizes a business or individual's transactions as abusive and unlawful cookie-cutter tax shelters does not mean that this characterization is a proper conclusion as a matter of law.

Judge Holderman reviewed each document and made his determination that "tax advice" was involved. Judge Holderman acknowledged the positions of the government, together with the positions of the taxpayers and made an independent determination on a document-by-document basis. Nonlawyer practitioners must use caution when interacting with clients on matters purportedly within the purview of Code Sec. 7525. Correspondence and files should be clearly labeled as privileged and there should be separate, clear engagements for matters involving potentially privileged advice.

Where's the beef? Without any visible meat hanging on the bones, "speculation and innuendo" or "far-reaching and blanket assertions" of the "abusive," "pre-packaged" and "cookie-cutter" nature of transactions simply can't be anticipated to convince a federal court that the documents actually reviewed *in camera* are anything other than they appear to be—tax advice protected by Code Sec. 7525. Without being able to look at each document, the government was left to speculate as to their nature and substance.

Judge Holderman's opinion demonstrates the benefits of a strongly independent judicial review whenever there are disputed claims of privilege. Federal judges are to be respected for their independent and sometimes controversial determinations (*á la Schiavo, Xenon, Black & Decker, Coltec* and *G.E. Capital*). Should something be "abusive" simply because the government says so? Is every "listed transaction" abusive? "Abusive" is an emotional, not a legal, term. Should it be wrong for a taxpayer to take a position that the tax laws say what they say, and are to be applied literally? Is it abusive to interpret tax laws as they are written? Is it wrong for a taxpayer to structure their affairs so they pay the least tax possible? Many tax plans result from tax legislation designed and created by Congress with something else in mind. If that process generates unintended tax attributes, is the result "abusive"?

Judge Holderman did what he was supposed to do—he listened to the parties and then reviewed

each document before reaching his determination that Code Sec. 7525 protected substantially all of the documents at issue. We must believe that Judge Holderman properly concluded that the taxpayers engaged in a business relationship with BDO to receive tax advice, the type of advice Code Sec. 7525 was intended by Congress to protect. Similarly, we must wonder about the document possibly subject to disclosure within the purview of the crime-fraud exception. Can that single document ultimately provide the government access to the remaining—otherwise-privileged—documents?

Judge Holderman determined that Code Sec. 7525 applied to most of the documents reviewed by the court. As to the next set of documents to be reviewed by the next court, Code Sec. 7525 may not apply. *BDO* is factually specific and should not be read as closing the door to the government. The government will and should continue knocking, and will likely be successful as often as not. The only certainty is that the uncertainties of litigation will continue to fuel the fires of those involved, far into the future.

The enforcement mechanism of the government has substantially eliminated certain activities by professionals that should have been eliminated without the necessity of government involvement. Litigation of listed and reportable transactions will continue for many years and, in the process, various general tax concepts like Code Sec. 7525 will be pushed, pulled, twisted and burned. Some will survive; others may not. The Federal Courts will continue to impress and uphold the law as it is written, not as practitioners or the government want it written.

Many taxpayers are not afraid of litigation with the government and have determined that the cost of such litigation is immaterial when compared to the amounts involved. The system of tax administration in the United States requires a rational evaluation by taxpayers and the government of the realistic, potential hazards of litigation. At some point, the costs of such litigation in actual terms and in terms of resource use must be considered. The government will be litigating with resources deployed from already underfunded and understaffed areas of non-compliance. The costs of this redeployment won't be measured for years to come. Our system of tax administration should survive with a realistic allocation of resources and a realistic evaluation of litigation decisions. However, use of IRS and Department of Justice litigation resources for a substantial number of unresolved matters, otherwise capable of resolution, may later be subject to question.

Deployment of precious resources to one arena should not ignore the potential adverse tax compliance impact on in other arenas. Settlements should be designed to cause taxpayers sufficient distress precluding their future participation, but provide sufficient incentives to resolve the many open cases, enabling the government to return its troops to the matters for which they were intended. If government and private practitioners would only emulate the Titans of Tax—Wallace, Lyon and Eustice—this redeployment might not be necessary. Indeed, these are interesting times ...

Endnotes

1 IRS Restructuring and Reform Act of 1998 (P.L. 105-206).
2 *BDO Seidman, LLP, et al.*, DC Ill., 2005-1 USTC ¶50,264.
3 *R.A. Frederick*, CA-7, 99-1 USTC ¶50,465, 182 F3d 496, 500.
4 *J.J. Evans*, CA-7, 113 F3d 1457, 1461 (1997).
5 *BDO Seidman, LLP*, CA-7, 2003-2 USTC ¶50,582, 337 F3d 802, 810; *Swidler & Berlin*, SCt, 524 US 399, 118 SCt 2081 (1998).
6 *BDO Seidman, LLP, id.*, at 810–811; *S. Fisher*, 76-1 USTC ¶9353, 425 US 391, 403 (1976).
7 *Supra* note 2.
8 *Supra* note 5.
9 *KPMG, LLP*, DC D.C., 2003-1 USTC ¶50,174, at 4, 237, FSupp2d 35 ; *In re Grand Jury Proceedings*, CA-7, 2000-2 USTC ¶50,598, 220 F3d 568, 571; *Frederick, supra* note 3.
10 *BDO, supra* note 2.
11 *F.S. Zolin*, SCt, 89-1 USTC ¶9380, 491 US 554, 109 SCt 2619.