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Solving The Privilege-Penalty Predicament: Part 1

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Law360, New York (June 26, 2017, 2:55 PM EDT) -- In 2014, in AD Investment,[1] the U.S. Tax Court held that by asserting penalty defenses, two partnerships waived the attorney-client privilege. Our purpose here is to examine the consequences and their effect on tax compliance and fairness in tax litigation.[2]

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From there, we offer a procedural solution to balance fairness to the IRS with fairness to the taxpayer, while fulfilling the congressional intent of using penalties to encourage voluntary compliance. Finally, we close with some best practices for taxpayers facing these issues.

The Case: AD Investment 2000 Fund

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AD Investment was one of a series of cases involving so-called “Son-of-BOSS” transactions. But, unlike many of those cases, the partnership challenged both the penalties and the merits.[3] And, unlike virtually all tax cases, the IRS had the burden of proof on both issues.[4]

How did the IRS get the burden of proof? After learning he was a target of a criminal investigation, the architect of the AD Investment (and several similar) transactions[5] “pled the fifth” and refused to testify.[6]

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This left the partnerships in a difficult position: without testimony of the individual with the most knowledge of the transactions, it would be difficult or impossible for them to meet their burden of proof.[7] Since the government refused to grant him immunity or to explain its refusal, the court shifted the burden of proof to the IRS.[8]

To meet its burden, the IRS sought six legal opinions on the AD Investment transactions.[9] It did not dispute that the opinions were privileged.[10] Instead, it argued that, by asserting reasonable cause and substantial authority defenses to penalties, the partnerships had waived privilege by putting the transaction architect’s beliefs and state of mind in issue.[11]

The court agreed, holding that both defenses put the partnerships’ beliefs and state of mind in issue.[12]

The court reasoned that "it [was] only fair" that the IRS be allowed access to the bases of the individual's beliefs, including the six opinions.[13] Thus the court gave the partnerships a choice: give up their defenses to penalties, or hand over the opinions.[14]

Eventually, the partnership chose not to waive its penalty defenses and instead, gave up its privilege. Not surprisingly, the IRS used the opinions at trial and the court featured them in its opinion on the merits.[15] Interestingly, the court did not discuss the opinions in its analysis of penalties.[16] Instead, it relied almost entirely on its prior holdings regarding other transactions designed by the same architect.[17]

The Problems: Purpose, Borrowed Wits and the Catch-22

So, if we assume the result is correct as a technical matter, the question becomes: Is AD Investment a good result? As we see it, there are at least three fundamental problems with the result.

First, it is at odds with the fundamental purposes of both penalties and privilege. Second, it allows the IRS to litigate "on wits borrowed from its adversary," using the advice and thoughts of taxpayers' attorneys against them. Third, it encourages the IRS to use penalties as a bargaining chip, to place taxpayers in a catch-22 between penalties and privilege.

Purpose

As the IRS recognizes in its own penalties manual, "[p]enalties exist to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue Code."[18]

The manual states that penalties should "[b]e severe enough to deter noncompliance, [e]ncourage noncompliant taxpayers to comply, [b]e objectively proportioned to the offense, and [b]e used as an opportunity to educate taxpayers and encourage their future compliance."[19] Further, the IRS recognizes that "[p]enalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system."[20]

The attorney-client privilege serves a similar purpose: it is one of the oldest tools for encouraging voluntary compliance with the law. It is the oldest evidentiary privilege, dating to the reign of Elizabeth I.[21] Since the late 1700's, courts have recognized that its purpose is to ensure freedom of consultation with legal advisors.[22]And that freedom promotes voluntary compliance with the law. As explained by Justice Rehnquist:[23]

Its purpose is to encourage full and frank communication between attorneys and their clients, and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed.

The tax practitioner privilege (the 7525 privilege) serves the same purpose. In 1998, Congress enacted it as a direct statutory analog to the attorney-client privilege. It gives the same protections as the attorney-client privilege to advice given by a federally authorized tax practitioner on certain federal tax matters in non-criminal proceedings before the IRS or in a federal court.[24]

It does not protect advice on state or foreign tax issues, and it does not apply to communications in connection with the promotion of a tax shelter.[25] Although its scope is more limited than the

attorney-client privilege, its purpose is the same: to promote voluntary compliance.

So, the first problem with the result in AD Investment is that it pits these privileges against the penalty provisions in the Internal Revenue Code.

Borrowed Wits

It did not take long for some commentators to suggest that courts should extend AD Investment to the work product protection.[26] Applying AD Investment there creates a different problem.

The work product protection is intended to address the free-rider problem. Without it, during litigation, a party could require the other side to turn over the work of their attorneys in preparing a case. Doing so would allow them to learn the strength and weaknesses of the opponent's case directly from their opponent's counsel. As Justice Jackson explained:[27]

Discovery was hardly intended to enable a learned profession to perform its functions either without wits or on wits borrowed from the adversary.

Allowing the IRS to use penalties to force the taxpayer to turnover the work of their attorneys creates precisely the problem that Justice Jackson identified. The IRS learns the taxpayer's views and the strengths and weaknesses of the taxpayer's case from the taxpayer's own attorneys. The IRS then uses that information to develop its case on the merits.

So, the second problem with the result in AD Investment is that in encourages the IRS to develop its case on the wits borrowed from the taxpayer.

The Catch 22

Penalties are not intended to be a bargaining chip, be it for the substantive issues or for privilege. Indeed, the IRS's recently updated penalty policy states clearly, "penalties are not a 'bargaining point' in resolving the taxpayer's other tax adjustments."[28] And the IRS's own guidance admonishes examiners and managers that "[they] must not use penalties as a bargaining point in the development or processing of cases."[29]

Congress agrees. In 1998, to prevent examiners from using penalties as a bargaining chip, Congress imposed a managerial approval requirement for many penalties.[30] As the Second Circuit recently explained, "[t]he statute was meant to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle."[31] It cannot be that while penalties should not be used as leverage on the merits they should be allowed to be used as leverage to overcome privilege.

So, the third problem with the result in AD Investment is that it allows the IRS to use penalties as a bargaining chip, placing the taxpayer in a catch-22 between privilege and sizable financial penalties. Worse yet, as shown in AD Investment, waiving privilege is no guarantee that the taxpayer will avoid penalties — taxpayers still must prevail on penalties.

The second part of this article will examine how the problems described above can be addressed with separate trials and an efficient discovery process, and will summarize best practices for taxpayers and counsel faced with these issues in the Tax Court.

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[1] AD Investment 2000 Fund LLC v. Comm'r, 142 T.C. 248 (Apr. 16, 2014) (AD Investment I).

[2] Whether AD Investment is correct as a matter of waiver law is a separate question. See, e.g., Lee A. Sheppard, News Analysis: Tax Court Addresses Privilege in Shelter Penalties, Tax Notes (Apr. 28, 2014); Andrew Velarde, ABA Meeting: IRS, Practitioners Disagree on Privilege Case's Importance, Tax Notes (Sept. 22, 2014).

[3] Compare AD Investment 2000 Fund LLC v. Comm'r, T.C. Memo. 2015-223 (AD Investment II) and AD Investment 2000 Fund LLC v. Comm'r, T.C. Memo. 2016-226 (AD Investment III) with American Boat Co. LLC v. U.S., 583 F.3d 471, 474 (7th Cir. 2009); 106 LTD. v. Comm'r, 685 F.3d 84, 88 (D.C. Cir. 2012); and Alpha I LP v. U.S., 93 Fed. Cl. 280, 319 (2010).

[4] See Order, AD Investment 2000 Fund LLC v. Comm'r, Dkt. No. 9177-08, Index No. 74 (Sept. 19, 2013) (granting partnership's motion to shift the burden).

[5] See id. at 1; AD Investment II, slip op. at 4–5.

[6] Ironbridge Corp. v. Comm'r, T.C. Memo. 2012-158, slip op. at 3-4; The Markell Company Inc. v. Comm'r, T.C. Memo. 2014-86, slip op. at 4, 23 n.14; Humboldt Shelby Holding Corp. v. Comm'r, T.C. Memo. 2014-47, slip op. at 10–11; Order, AD Investment 2000 Fund v. Comm'r, Dkt. No. 9177-08, Index No. 55 (Nov. 20, 2012). The U.S. attorney had stated that it had no present intent to charge him, but refused to grant him immunity or explain the reasons for its denial.

[7] See Order, AD Investment 2000 Fund LLC v. Comm'r, Dkt. No. 9177-08, Index No. 55 (Nov. 20, 2012).

[8] Order, AD Investment 2000 Fund LLC v. Comm'r, Dkt. No. 9177-08, Index No. 74, at 2 (Sept. 19, 2013).

[9] AD Investment I, 142 T.C. at 250.

[10] Id.

[11] Id.

[12] The court reasoned that once the partnerships' state of mind was at issue, "it [was] only fair that [the IRS] be allowed to inquire into the bases of that person's knowledge, understanding, and beliefs including the opinions (if considered)." AD Investment I, 142 T.C. at 257–258.

[13] AD Investment I, 142 T.C. at 257–258.

[14] Id. at 258 ("If petitioners persist in those defenses, it would be unfair to deprive respondent of

knowledge of the contents of the opinions and the opportunity to put those opinions into evidence. If petitioners persist, they sacrifice the privilege to withhold the contents of the opinions”).

[15] AD Investment II, T.C. Memo. 2015-223, slip op. at 11–12.

[16] AD Investment II, at 33–40.

[17] Id., slip op. at 39 (“[W]e reach the same conclusion here that we reached in Markell Co. v. Comm'r, at *38 and Humboldt Shelby Holding Corp. v. Comm’r, at *25.”); id., slip op. at 40 (“Mr. Haber would have relied on Helmer v. Comm’r ... along with various [IRC] provisions and judicial decisions. ... We have several times explained that Helmer is distinguishable and reliance on it is not reasonable.”). In describing the opinions, the court stated that “[t]he opinions ... rest[ed] on a number of questionable representations by Mr. Haber, namely that the corporations entered into the option spreads for substantial nontax business reasons and that the corporations contributed the option spreads to the LLCs for substantial nontax business reasons.” AD Investment II, T.C. Memo. 2015-223, slip op. at 12. The court also noted that “Mr. Haber represented for purposes of the opinions that purchasing and contributing the option spreads and then resigning from the LLCs were not part of a prearranged plan and that the corporations and the LLCs were in no way related: both false representations.” Id. The court did not, however, rely on or cite these findings in its discussion of the partnerships’ defenses to penalties. See id. at 38–40.

[18] I.R.M. pt. 20.1.1.2(1) (Feb. 22, 2008).

[19] I.R.M. pt. 20.1.1.2.1(8) (Nov. 25, 2011); see also I.R.M. pt. 20.1.5.1(2) (Dec. 13, 2016) (“Proper consideration and application of penalties will 1. Encourage voluntary compliance; 2. Provide clear guidance to taxpayers and practitioners; 3. Ensure consistent and fair treatment of the issues; and 4. Ensure that noncompliant behavior is penalized”).

[20] I.R.M. pt. 20.1.1.2.1(10) (Nov. 25, 2011).

[21] See Wigmore on Evidence: Evidence in Trials at Common Law § 2290 (Last Updated Apr. 2017) (“The history of this privilege goes back to the reign of Elizabeth I, where the privilege already appears as unquestioned. It is therefore the oldest of the privileges for confidential communications”).

[22] Id. at § 2291.

[23] UpJohn v. United States, 449 U.S. 383, 389 (1984).

[24] I.R.C. § 7525(a).

[25] I.R.C. §§ 7525(a)(3)(B), (b).

[26] See Lee A. Sheppard, News Analysis: Tax Court Addresses Privilege in Shelter Penalties, Tax Notes (Apr. 28, 2014).

[27] Hickman v. United States, 329 U.S. 495, 516 (1947) (Jackson, J. concurring).

[28] See I.R.M. pt. 1.2.20.1.1(9) NOTE, Policy Statement 20-1 (June 29, 2004); see also I.R.M. pt. 20.1.5.1(7) (Dec. 13, 2016).

[29] See I.R.M. pt. 20.1.5.1(7) (Dec. 13, 2016) (citing I.R.M. pt. 1.2.20.1.1(9), Policy Statement 20-1 (Formerly P-1-18)).

[30] See 26 U.S.C. § 6751(b)(1) ("No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate").

[31] Chai v. Comm'r, Dkt. 15-1653(L), slip op. at 60 (2nd Cir. Mar. 20, 2017).

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