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Solving The Privilege-Penalty Predicament: Part 2

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Law360, New York (June 27, 2017, 11:51 AM EDT) -- In 2014, in AD Investment, the U.S. Tax Court held that by asserting penalty defenses, two partnerships waived the attorney-client privilege. In the first part of this article, we examined the consequences of this ruling, and their effect on tax compliance and fairness in tax litigation.

In this installment, 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 Solutions: Separate Trials and Efficient Discovery

As is often the case in tax, one potential solution is timing. Under Tax Court Rule 141(b), the court can try the substantive issues and penalty defenses separately. Then, the court can delay discovery of the privileged materials until the penalty phase of the trial. And, for the procedurally creative judge, there are several ways to ensure that doing so is efficient.

Separate Trials

Tax Court Rule 141(b) provides that "in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition or economy" the court may "order a separate trial of any one or more claims, defenses, or issues. ..."[1] This rule is based on Federal Rule of Civil Procedure 42(b).[2] But, unlike Federal Rule 42(b), the Tax Court rule specifies "defenses" as an issue to be tried separately.[3]

While single trials are the norm,[4] only one of the Tax Court Rule 141(b) criteria (convenience, prejudice or economy) needs to be met for bifurcation.[5] The Tax Court regularly bifurcates trials on grounds of efficiency or judicial economy.[6] And district courts regularly bifurcate trials to prevent prejudice, especially on issues such as damages.[7]

Here, the prejudice is clear. One party, the IRS, has discretion to force the other to choose between privilege and paying substantial financial penalties. If the taxpayer chooses to sacrifice privilege, the IRS can turn the legal work of the taxpayer's counsel against them when litigating the merits of the deficiency. Faced with AD Investment, taxpayers may be prevented from getting the high-quality legal advice that privilege is intended to protect.

Beyond that, the prejudice created by the result in AD Investment is contrary to congressional intent for penalties. As discussed above, Congress put section 6751(b)(1) in place to prevent penalties from being used to pressure taxpayers. Instead, Congress intended for penalties to encourage compliance. So using penalties to destroy privilege — also intended to improve compliance — defeats Congress's purpose in having penalties in the first place.

Efficient Discovery

A likely complaint from the IRS is that separate trials would entail separate discovery and therefore be inefficient.

Taxpayers should be able to deal with this argument easily. First, the IRS frequently seeks to separate trials for factually distinct issues, and the issues here are likely to be different: (i) the merits dealing with the substance of the transactions and (ii) the penalty defenses on the actions and analysis of the taxpayer.

Second, there are a number of procedures the court could consider to increase efficiency. For example, the court could address all discovery issues, including ruling on waiver, before the trial on the merits. The court would need only to hold that ruling in abeyance until the penalty defense phase.

Another option would be to rule on all issues and to issue an order under Tax Court Rule 103(a)(10) to impound the documents until the penalty phase.[8] Or, more simply, the court could wait until after trial to see if the parties are able to resolve penalty issues without additional trial, alleviating the need to address the documents at all.

Lessons Learned and Best Practices

After AD Investment, the IRS has sought more and more documents, earlier and earlier in litigation.

So far, in summons enforcement actions, the district courts have been skeptical of the Tax Court's approach. In Eaton, the district court rejected an implied waiver argument out right.[9] And, more recently, in Micro Cap Kentucky, the district court refused to find waiver and held that waiver could apply only if the taxpayer persisted in the defense in the Tax Court.[10]

But delaying disclosure until Tax Court discovery may be little solace to a taxpayer who falls into the AD Investment trap. For that reason, if faced with the issue in the Tax Court, taxpayers should consider moving to try the penalty defense separately. In doing so, they should:

- Emphasize the purposes of penalties and privileges;
- Point out that, unlike the Federal Rules, the Tax Court Rules explicitly list "defenses" as an issue to potentially be tried separately;
- Be prepared to explain the potential abuses that can occur when privileged documents end up being used either as evidence on the merits or to help the IRS in preparing its case; and

- Be prepared to offer the court a practical, efficient plan for dealing with discovery issues for the penalty defense phase, if necessary.

That said, while the arguments for separate trials are strong, taxpayers must be prepared for the possibility that the court will refuse.[11] This means that taxpayers must be prepared to make the penalty/privilege choice. And, in most cases, the choice will not be easy. Early consideration of a number of factors will help:

- How strong is the taxpayer's substantive case?
- How strong is the taxpayer's case for a penalty defense?
- Do the documents describe theories the IRS has yet to identify?
- Are there documents from which the IRS could cherry-pick statements to support its theories?
- Are there "drafts or incomplete analyses" that use impertinent language, misstate facts or law, or improperly apply the facts to the law?
- Is the IRS seeking so many privileged documents that, by using them the IRS will be able to disrupt the taxpayer's case presentation with side issues?
- Is there sufficient time to review the documents with an eye towards weighing the potential damage of disclosure as opposed to merely identifying privileged documents?
- Is there confidential information related to non-tax issues that could be harmful to the taxpayer if released?

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[1] See Tax Ct. R. 141(b); see also Tax Ct. R. 61(b) ("Any claim by or against a party may be severed and proceeded with separately").

[2] See Note to Tax Ct. R. 141(b), 60 T.C. 1057, 1133 (1973) ("Par. (b) is derived from FRCP 42(b). It conforms to present Tax Court practice").

[3] Compare Fed. R. Civ. P. 42(b) ("may order a separate trial of one or more separate issues, claims, crossclaims, counterclaims, or third-party claims") with Tax Ct. R. 141(b) ("may order a separate trial of any one or more claims, defenses, or issues").

[4] See, e.g., Penn LLC v. Prosper Bus. Development Corp., 2013 WL 4479216, slip op. at *5 (S.D. Ohio Aug. 20, 2013) ("Bifurcation is the exception, not the rule: as a general rule, disputes should be resolved in a single proceeding and a district court should bifurcate only in exceptional cases"); Moss, 344 F.2d at 26 ("Separation of issues 'should be resorted to only in the exercise of informed discretion and in a case and at a juncture which move the court to conclude that such action will really further convenience or avoid prejudice'") (quoting Frasier v. Twentieth Century-Fox Film Corp., 119 F. Supp. 495, 497 (D. Neb. 1954)).

[5] Saxion v. Titan-C-Manufacturing Inc., 86 F.3d 553 (6th Cir. 1996).

[6] See, e.g., Blasius v. Comm'r, T.C. Memo. 2005-214, slip op. at 3; Hall v. Comm'r, T.C. Memo. 2013-93, slip op. at 2–3.

[7] See, e.g., Beeck v. Aquaslide 'N' Dive Corp., 562 F.2d 537, 542 (8th Cir. 1977); Headfirst Baseball LLC, v. Elwood, 168 F. Supp. 3d. 236, 247 (D.D.C. 2016) (bifurcating issues of liability and damages); and Crown Cork & Seal Co. Inc. Master Retirement Trust v. Credit Suisse First Boston Corp., 288 F.R.D. 335 (S.D.N.Y. 2013) (trifurcating complex case along similar lines).

[8] See Tax Ct. R. 103(a)(10) (providing that the court may issue an order that "documents or records (including electronically stored information) be impounded by the Court to ensure their availability for purpose of review by the parties prior to trial and use at the trial").

[9] U.S. v. Eaton Corp, No. 1:12-mc-00024 (N.D. Ohio Aug. 15, 2012) ("T]he IRS has not persuasively demonstrated that [the taxpayer] has affirmatively raised claims that can only be disproven through disclosure of privileged documents").

[10] U.S. v. Micro Cap KY Ins. Co. Inc., No. 5:16-cv-00278 (E.D. Ky. Mar. 27, 2017) appeal filed No. 17-5611.

[11] See Moss, 344 F.2d at 26 ("Separation of issues 'should be resorted to only in the exercise of informed discretion and in a case and at a juncture which move the court to conclude that such action will really further convenience or avoid prejudice'") (quoting Frasier v. Twentieth Century-Fox Film Corp., 119 F. Supp. 495, 497 (D. Neb. 1954)).
