ANTICIPATING THE AUDIT CALL

Thinking About Controversy at the Planning Stage

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Have you considered the effect of the attorney-client privilege on your practice? Do you feel comforted by the existence of the work-product doctrine? Regardless, keep in mind that preparation for a transfer tax audit or dispute truly begins at the estate planning level. When writing letters or internal memoranda, think about how that document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in tax litigation. Have you focused on all relevant reasons for the transaction? Or only the estate and gift tax savings that might be achieved through the transaction? Advise your client and his or her advisors, such as accountants or stockbrokers who are involved in the estate planning process, that their files may be subject to production in a tax audit or in litigation, or perhaps your client will wish to waive the relevant privileges and voluntarily produce those files.

Anticipate the Potential Audience During the Planning Stage

In cases in which the IRS questions the motives or business purpose for forming a closely held entity, the best evidence of those motives can come from the correspondence prepared in connection with the transaction at issue. Well-drafted, contemporaneous correspondence outlining the business and financial reasons (that is, the nontax reasons) for the transaction can serve as wonderful evidence to rebut an argument from the IRS that an entity lacks business purpose or was created as a device solely to avoid taxes.

More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such an IRS request can actually help the taxpayer state his or her case with the examiner or in litigation. With that goal in mind, while a planner works on a client's estate plan, he or she must assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, IRS counsel, or the finder of fact in tax litigation (perhaps a judge or even a jury).

Of course, certain documents may be withheld from production based on one or more applicable privileges. Thus, every estate planner should have a solid understanding of the relevant privileges.

Understand and Preserve All Privileges

All planners should have a general understanding of five types of privileges when representing their clients: (1) the attorney-client privilege, (2) the attorney work-product doctrine, (3) privileges extending to third parties who assist attorneys in rendering legal advice to their clients, (4) the tax practitioner's privilege, and (5) the doctor-patient privilege.

Attorney-Client Privilege

The attorney-client privilege exists to encourage the complete and truthful exchange of all sensitive information between a lawyer and his or her client, by ensuring that confidential information will remain in confidence. The attorney-client privilege generally protects the disclosure of confidential communications between counsel and the client made for the purpose of facilitating the rendition of legal advice. In addition, "[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when lawyers represent their clients in litigation." *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). Likewise, internal memoranda between attorneys in the same office representing the same client are covered by the attorney-client privilege. Interestingly, the attorney-client privilege survives death and belongs to the estate's personal representative. With that brief background, all estate planning lawyers should be aware of five important considerations involving clients' privileges:

1. *Confidence.* The communication must be made in confidence and be intended to remain in confidence. Any action inconsistent with the maintenance of a privilege may constitute waiver, and that waiver may extend to the entire subject matter. For example, a communication between a client and a lawyer *may not be* privileged if it is made in the presence of a third party who is outside of the privilege umbrella. Generally, no privilege attaches to any letter that shows a "cc" or "bcc" to someone outside the attorney-client relationship, and adding a "cc" to a lawyer extends no privilege to a letter to a third party. Communications with third parties such as accountants or financial advisors, however, made to "assist the attorney in rendering advice to the client" also are generally protected. How to ensure that communications with third parties such as accountants can be cloaked with the attorney-client privilege is discussed below.
2. *Bills and Invoices.* Danger arises when IRS agents ask for invoices relating to all payables, and attorneys' invoices describing all manner of confidential information are produced without thought given to privilege

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issues. Generally, receipt and payment of a lawyer's bill are not privileged, but the description of the legal services performed should be, assuming the privilege is not waived.

3. *Not Business Advice.* Some courts have found that the attorney-client privilege only extends to communications relating to soliciting and receiving *legal* advice—as opposed to general business advice. Distinguishing between business advice and legal advice is often difficult. What about dual purpose communications involving legal and business communications? The minority view is that any nonlegal purpose precludes the privilege, but the better view looks to the dominant purpose.

The work product of an attorney and the staff in anticipation of litigation is protected from disclosure.

4. *Generally Not Tax Return Preparation.* In many cases, lawyers may serve as preparers of tax returns. A question arises as to what extent the work performed by the lawyer/preparer may fall under the attorney-client privilege. Courts have disagreed on whether tax return preparation by a lawyer is privileged.
   a. *Not Legal Advice?* Some courts have held that the preparation of a tax return is not privileged because it is not the rendering of legal advice.
   b. *Not Confidential?* Some courts acknowledge an element of legal advice in the preparation of a tax return but deny privilege based on a lack of expectation of confidentiality or a waiver.
   c. *Separate Advice from Information Disclosed on Return.* Although the IRS has argued that information provided to an attorney for the purpose of preparing tax returns is outside of the scope of the privilege, other courts have rejected this contention, holding that material provided in the context of return preparation also may have been for the rendition of legal advice and may be protected by the privilege. See, e.g., *United States v. Davis,* 636 F.2d 1028, 1043 n.17 (5th Cir. 1981); *United States v. Abrahams,* 905 F.2d 1276, 1282–83 (9th Cir. 1990); *United States v. Bornstein,* 977 F.2d 112, 116–17 (4th Cir. 1992). Interestingly, because most of the landmark cases on this issue were decided before the recognition of a federal tax practitioner privilege, discussed below, this issue is far from resolved.
5. *Reliance on Tax Professional to Avoid Penalties.* Tax and estate planning lawyers must be aware that the client may wish to waive the attorney-client privilege in certain circumstances. For instance, to avoid the imposition of penalties, a client might assert the defense that the underpayment of tax was made in good faith and because of reasonable cause. Reliance on the advice of tax advisors constitutes reasonable cause and good faith if, under all of the circumstances, such reliance was reasonable and the taxpayer acted in good faith. To demonstrate reasonable reliance, the taxpayer may need to disclose what might otherwise be privileged information. Accordingly, each case should be considered on its own merits to determine whether the client will benefit from disclosure. This disclosure could include producing to the IRS all legal opinions and correspondence from the lawyer—a possibility that few lawyers consider when preparing opinion letters or other correspondence.

Work-Product Doctrine

The work product of an attorney or his or her staff in anticipation of litigation is protected from disclosure. In fact, the attorney work-product doctrine is not a privilege, although some courts (and many practitioners) refer to it as one. The purpose of the work-product doctrine is to encourage lawyers to thoroughly prepare for litigation (whether pending or not) through investigation of the good and the bad, without fear of being forced to disclose their thoughts and analysis.

The doctrine is defined by the narrow scope of its exception in this passage from the Rules of Civil Procedure:

> [A] party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

Fed. R. Civ. P. 26(b)(3). Note that the protection extends beyond just the

work prepared by the attorney to work prepared by the client, and by the client's employees, staff, and other agents at the direction of the lawyer. The rule contemplates factual and opinion work product, although under unusual circumstances, factual work product is discoverable on the special showing described in the passage cited above. By comparison, opinion work product "enjoys a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances." *Cox v. Administrator U.S. Steel & Carnegie,* 17 F.3d 1386, 1422 (11th Cir. 1994), modified on reh'g by 30 F.3d 1347 (11th Cir. 1994) (quoting *In re Murphy,* 560 F.2d 326, 366 (8th Cir. 1977)).

Transactional lawyers should be aware that their work product may qualify for the protection; it is not necessary that litigation is certain. The required level of anticipation varies by court, but it is clear that in many jurisdictions, a court action need not be imminent. For example, courts have extended work-product doctrine protection even to proposed transactions. Recently, one district court found that the work-product doctrine applied to tax accrual work papers of a company because the company's counsel believed certain transactions entered into by the company would eventually be challenged by the IRS. *United States v. Textron,* 2007 TNT 169-1.

Privileges in the Appraisal Process

In the transfer tax area, valuation appraisals often serve as the basis for a taxpayer's position on the value of transferred property. Working with appraisers is an everyday event for most transaction-planning attorneys. On the other hand, working with appraisers can be something of a rarity for most clients, many of whom have dealt with appraisers only in the purchase of real estate.

In most cases, the attorney, rather than the client, should hire the appraiser for a planning transaction. The attorney can offer guidance to both the client and the appraiser on how similar transactions have been handled in the past by the IRS and the courts. Having the attorney hire the appraiser also will provide the taxpayer with an argument that any unused reports or correspondence is privileged, as the appraisal was intended to assist the attorney in rendering legal advice.

If the appraiser ultimately proposes a report used by the taxpayer, however, any documents in the appraiser's file, including correspondence, notes, or appraisal drafts, may be subject to disclosure to the IRS. Once again, consider who the audience ultimately may be and understand that the appraiser's file may be reviewed by the examining agent, an

appeals officer, district counsel, or the ultimate finder of fact in tax litigation. In all cases, the planning lawyer should have an oral discussion with the appraiser after he or she determines the value range but before he or she prepares a first draft of a written report so that differences of opinion or relevant law may be discussed freely. In large and/or complex valuation cases, the planning lawyer should consider engaging two appraisers: one to aid the lawyer in his or her analysis of the appraisal (whose work will not be disclosed) and one whose appraisal ultimately will be disclosed to the IRS.

The Tax Practitioner Privilege

Code § 7525(a)(1), enacted in 1998, extends the same common law protection of confidentiality between a taxpayer and an attorney to a communication between a taxpayer and any federally authorized tax practitioner involving tax advice that would have been privileged if it were a communication to an attorney. This privilege may be asserted only in

- noncriminal tax matters before the IRS and
- noncriminal tax proceedings in federal court brought by or against the United States.

Note that today's privileged communication may lose its Code § 7525 privilege when the IRS commences a criminal investigation tomorrow.

A "federally authorized tax practitioner" is any individual who is authorized to practice before the IRS if such practice is subject to federal regulation under 31 U.S.C. § 330. The protection is therefore extended to CPAs, enrolled agents, and enrolled actuaries. The term "tax advice" means any advice given within the scope of the individual's authority to practice before the IRS. In other words, the protection covers tax advice and tax representation. The privilege for tax advice is the same as if the individual were an attorney. This means, among other things, that arguably the privilege would not ordinarily attach to the preparation of tax returns.

The Physician-Patient Privilege

IRS information requests increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. When the IRS is seeking to enforce a summons issued under federal statutory authority, however, federal privilege rules generally apply. When Congress adopted the final version of the new Federal Rules of Evidence in 1975, it rejected the nine enunciated privileges in the proposed rules (including a physician-patient privilege) in favor of a single rule authorizing federal courts to apply "common law principles—in the light of reason and experience" in determin-

ing whether a privilege exists under the common law. The Senate Report accompanying the adoption of the Rules indicates that Rule 501 "should be understood as reflecting the view that the recognition of a privilege based on a confidential relationship . . . should be determined on a case-by-case basis." S. Rep. No. 93-1277, at 13 (1974), reprinted in 1974 U.S.C.C.A.N. 7051, 7059. At least one circuit has held that there is no physician-patient privilege under federal law. See, e.g., *United States v. Moore,* 970 F.2d 48, 50 (5th Cir. 1992).

Although the Supreme Court has not yet directly addressed whether a federal physician-patient privilege exists, the Court has determined that federal courts should recognize a psychotherapist-patient privilege under Fed. R. Evid. 501. Id.; *Jaffee v. Redmond,* 518 U.S. 1, 10 (1996) (citation omitted), aff'g 516 U.S. 930 (1995). In *Jaffe,* the Supreme Court held that confidential communications between a licensed psychotherapist and a patient in the course of diagnosis or treatment are protected from compelled disclosure under Rule 501.

The *Kovel* Accountant: Solution?

Because of the limits of the tax practitioner privilege, the attorney (not the taxpayer) should consider engaging the accountant to make certain that the accountant's work product in assisting the attorney will remain confidential. This engagement is often termed a "*Kovel* agreement" named after the landmark case, *United States v. Kovel*. See, e.g., *United States v. Kovel,* 296 F.2d 918, 921 (2d Cir. 1961); *United States v. Cote,* 456 F.2d 142, 144 (8th Cir. 1972), aff'g 326 F. Supp. 444 (1971); *Cavallaro v. United States,* 284 F.3d 236, 246 (1st Cir. 2002), aff'g 153 F. Supp. 2d 52 (2001). Moreover, if the tax case becomes a criminal matter or if non-IRS matters arise, the communications may not remain privileged unless the attorney has hired the accountant. Communications made to an accountant who is assisting an attorney *in providing legal services* (not accounting services) to a client are protected by the attorney-client privilege. To ensure that the accountant is assisting the attorney in providing legal services, a written engagement letter can serve as helpful evidence to preserve the privilege. Such a letter should include terms that focus on:

- *Control*—That the accountant is engaged by the attorney and working under the attorney's direction.
- *Clarification That Accountant's Work Is Not Pure Return Preparation*—That the work is for the purpose of rendering legal advice, not simply for the preparation of tax returns. For example, the accountant is assisting the attorney in determining whether delinquent federal income tax returns should be prepared and filed and what positions to take on those returns.
- *Ownership*—That the work of the accountant belongs to the attorney.
- *Purpose*—That any communications to the accountant are made solely for the purpose of enabling the attorney to provide legal advice to the client.

The Effect of Asserting the Privilege on the Burden of Proof in Disputed Cases

In certain circumstances, the taxpayer can shift the burden of proof in transfer tax cases in the Tax Court from the taxpayer to the government.

To shift the burden of proof, the taxpayer must comply with the substantiation requirements of the Internal Revenue Code and keep all required records. In addition, the taxpayer must have cooperated with "reasonable requests" by the IRS for "witnesses, information, documents, meetings, and interviews" and must present "credible evidence" in court on the factual matters at issue. If all of these conditions are met, Code § 7491 provides that the burden of proof shifts to the IRS.

The Tax Court recently determined that a taxpayer did not fail to reasonably cooperate simply because it filed a motion to quash a summons that the IRS had issued to obtain certain documents during discovery. The court found that the taxpayer

> had a good faith belief that some of the documents respondent sought were irrelevant, sealed, or contained sensitive . . . business information and filed a motion to quash the summons to protect its rights. Once the court denied the estate's motion to quash the summons, the estate provided the documents respondent requested. Respondent has not argued that respondent's investigation was impaired by any lack of documentation.

Kohler v. Commissioner, 92 T.C.M. (CCH) 48, 52 (2006).

If the taxpayer complies with Code § 7491, the IRS has another litigation hazard to consider, which could aid in resolving more cases before trial.

Conclusion

In sum, there are numerous protections of communications among advisors and between advisors and their clients. To best protect those communications from discovery or, if produced, from misinterpretation, it is important to understand the differences among those protections and to ensure that the communications are documented in the context of the broader goals of the client, such that both tax and nontax reasons for the transaction are clearly indicated. Keeping these protections in mind at all times can assist the estate planner in advising his or her client and in accomplishing the client's goals. And, although privileges generally are thought to protect communications, anticipating that at some point the client might find it advantageous to waive these privileges and deliberately documenting communications that could be helpful in the event of a tax audit or dispute could be the linchpins for the client's case. ■