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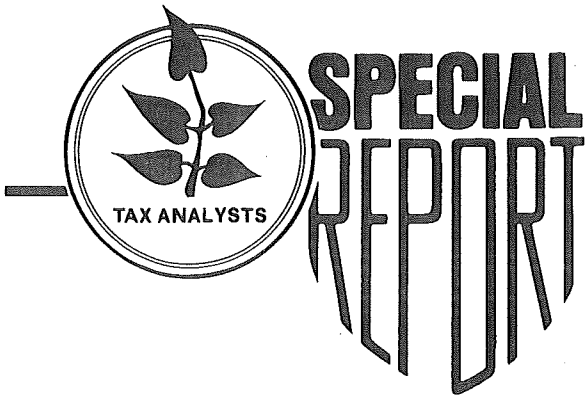

TAX ADVISOR-CLIENT PRIVILEGE: AN IDEA WHOSE TIME SHOULD NEVER COME

by Steve R. Johnson

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A provision of the IRS restructuring legislation passed by the House would create a new privilege. In noncriminal administrative proceedings, it would make client communications with nonattorney tax advisors confidential to the same extent that such communications with attorneys are confidential. Professor Johnson maintains that there is no need for the proposed new privilege and that it would produce little real benefit for taxpayers. Moreover, according to Professor Johnson, the new privilege, if enacted, would encourage taxpayer attempts to conceal information that should be produced, would complicate the role of nonattorney advisors in representing their clients, and would exacerbate friction between nonattorney advisors and attorneys. The author thanks Monica Howland, Aviva Orenstein, William Popkin, Alex Tanford, and Richard Westin for suggestions and comments.

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Section 341 of the IRS restructuring bill approved by the House[1] would create a limited privilege for client communications with nonattorney tax advisors. The new privilege has little to recommend it.

The widespread perception is that approval of this measure by the Senate too is a "done deal."[2] Against that backdrop, this article has two purposes. First, in the political process, expectations are not always actualized. This article explains why this particular deal should not be done, or should be undone. Second, should the measure nonetheless become law, this article will help participants in the tax system anticipate the disadvantages that predictably would attend the new privilege.

> ***The new privilege would be of practical benefit to taxpayers in so few situations that the notion is not worth bothering to enact.***

After describing the proposed new privilege, I will advance two main ideas. First, the new privilege would be of practical benefit to taxpayers in so few situations that the notion is not worth bothering to enact. Second, the privilege would cause new problems, or exacerbate old ones, to the disadvantage of sound tax administration and of taxpayers themselves.

I. The Proposed Privilege

In general, communications between an attorney and a client with respect to legal advice — including advice as to the meaning and application of the tax

[1]Internal Revenue Service Restructuring and Reform Act of 1997, H.R. 2676, 105th Cong., 1st Sess. (passed by House Nov. 5, 1997).

[2]The administration's position on section 341 has been equivocal. *See, e.g.*, "Roth Outlines 'Deficiencies' in IRS Reform Bill," *Tax Notes*, Nov. 17, 1997, p. 764 (administration urges "improvements in the measure"); "IRS Reform Is the Hot Topic," *Tax Notes*, Nov. 3, 1997, p. 518, at 519 (Treasury spokesperson states that Treasury and the IRS support the measure "as a whole").

prior written approval of the Chief, Examination Division."[12]

Given the Service's infrequent attempts to probe the contents of advisor-client communications, there is little need for the new privilege. "If it ain't broke, don't fix it."

B. Limits of the New Privilege

As proposed in section 341, the new privilege would be subject to important limitations and exceptions. For instance, the bill states that the privilege would apply "[i]n any noncriminal proceeding before the Internal Revenue Service." Thus, it would not apply in criminal proceedings before the IRS or in judicial cases of any kind (since those are proceedings before courts, not the IRS).[13]

Both of these limitations are significant. As to the first, since it is not always apparent which matters may later become criminal cases, advisors will have to exercise care in communicating with clients generally. The second is, if anything, even more important. In those few cases in which the IRS really seeks to learn the contents of taxpayer communications with nonattorney advisors, they still would be able to do so. Enactment of section 341 would only delay the IRS's inquiry, not prevent it; it would move the inquiry from the audit to the discovery phase of ensuing litigation. The new privilege would accomplish little.

Moreover, it is clear that section 341 would broaden the shield of protection only as to communicators involved, not as to contents protected. That is, a client's communication with a nonattorney tax advisor would be privileged only if and to the extent that that same communication would have been privileged had it been with an attorney.[14] Thus, existing limits on and exceptions to the attorney-client privilege in the tax area would similarly circumscribe the new advisor-client privilege.

Full discussion of these limits and exceptions would duplicate work elsewhere[15] and would consume many pages. While there is broad agreement at the general level among the courts as to some of them, others are controversial. Moreover, even where general agreement exists, nuances and variations in doctrinal detail abound from circuit to circuit (and often within circuits). Privilege law is particularly situation-driven and is unfriendly terrain for lovers of bright lines.[16]

Still, it is appropriate to note that, at least as construed by many courts, significant constraints exist on the attorney-client privilege as to tax communications, so also would exist as to any new advisor-client privilege. Although others exist as well, I emphasize two areas in which at least some courts have found the attorney-client privilege inapplicable: (1) acts outside capacity as a lawyer and (2) nonconfidentiality and waiver.

(1) For attorney-client privilege to exist, the attorney must be acting as an attorney, not acting in some other capacity. Thus, under an advisor-client privilege, the advisor would have to be acting as an attorney acts in the tax area. That is, the advisor must be advising on the meaning and application of the tax laws, not assisting the client in some other fashion.

For instance:

- Privilege would not attach to communications that really are incident to rendition of financial accounting services, rather than rendition of tax advice.[17] For this reason, since tax-accrual workpapers are part of financial accounting services, not tax advice, section 341 would not overturn the *Arthur Young* decision.[18]

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[12]IRM 4024.4(5). Special coordination procedures for summonses and discovery involving tax-accrual workpapers also are imposed on IRS attorneys by the Chief Counsel Directives Manual. *See* C.C.D.M. (34)613(2)(i); (34)(12)36(2); (35)5(12)1(8); (35)5(12)2.2(6).

[13]Some appear to entertain the possibility that the new privilege might apply in court cases as well as in administrative proceedings. *See* "IRS Reform Is the Hot Topic," *Tax Notes*, Nov. 3, 1997, p. 518, at 519 (interchange at AICPA meeting). However, I see little prospect of that. (1) The statutory language is clear. (2) Section 341 would amend section 7602, not code sections dealing with judicial proceedings and not the Federal Rules of Evidence. (3) The House bill emanated from the Ways and Means Committee, and comparable legislation in the Senate would go through the Finance Committee. Neither of those committees has jurisdiction over rules of evidence. (4) Nothing in the now extant legislative history — the Joint Committee explanation, *see* note 6 *supra* — suggests applicability of the privilege once a matter gets into court.

[14]The statutory language is clear, as is the Joint Committee explanation:

> [T]he proposal would not otherwise modify the attorney-client privilege. Accordingly, the privilege of confidentiality under this proposal will apply in the same manner and with the same limitations as the attorney-client privilege of present law. The proposal does not extend the privilege of confidentiality to work product that would not be eligible for the privilege if prepared by an attorney.

(Footnote 14 continued in next column.)

Joint Committee on Taxation, *supra* note 6, para. 109.

[15]Discussions of the contours of the attorney-client privilege in tax controversies include Michael I. Saltzman, *IRS Practice and Procedure* para. 13.11[1] (2d ed. 1991 & 1997 Cum. Supp. no. 2); Marvin J. Garbis & James J. Keightley, "I.R.S. Information Gathering (Obligations, Defenses, and Privileges)," C985 *ALI-ABA* 315 (1994); Nancy I. Kenderdine, "The Internal Revenue Service Summons to Produce Documents: Powers, Procedures, and Taxpayer Defenses," 64 *Minn. L. Rev.* 73, 99-102 (1979).

[16]*See, e.g.*, Bruce Graves, "Attorney-Client Privilege in Preparation of Income Tax Returns: What Every Attorney-Preparer Should Know," 42 *Tax Law.* 577, 579 (1989) (referring to "the confusing and often times contradictory court decisions" as to the exception for communications dealing with tax-return preparation, as opposed to tax-advice rendition).

[17]*E.g., Olender v. United States*, 210 F.2d 795, 806 (9th Cir. 1954).

[18]*See* text accompanying notes 9 to 12 *supra*. A second reason why section 341 would not reverse *Arthur Young* is that, in that case, the IRS was engaged in a *criminal* investigation.

It is reasonable to expect that this tactic would be used by taxpayers more often were section 341 enacted. The more advisors potentially within the ambit of privilege, the greater the chance that a taxpayer could find one who would be willing to cooperate in a scheme to withhold information from the IRS based on an inappropriate claim of privilege.[27]

Moreover, accountants often interact with their clients in numerous ways — some involving financial accounting, some business advice, some tax advice, some tax return preparation, some a mix of functions. The number and diversity of these points of contact would complicate determining precisely to which function a given communication related. This would multiply opportunities for claiming that information divulged to the accountant for nonprivileged purposes was instead part of a chain of communications involving privileged tax advice.

Thus, it could be expected that, were section 341 enacted, there would be more taxpayer attempts to shield information the Service should be able to obtain, that these attempts would be harder to check, and that system costs of dealing with such efforts would increase. This is troubling because the results of audits are only as good as the information on which they are based.

B. Complication of Advisor's Role

As seen previously, the law of attorney-client privilege in the tax area is far from uncomplicated. There are exceptions (many ambiguous), nuances, and subtleties enough that even lawyers may be unsure whether privilege attaches in particular situations. Accountants and enrolled agents are even less prepared to make these judgments with confidence. No matter how expert they may be with respect to the Internal Revenue Code, such advisors have not been trained in privilege law and are unaccustomed to applying it. It is no derogation of these professionals to acknowledge this fact.

Section 341 would put nonattorney advisors in the uncomfortable position of deciding which communications with them are privileged and which are not.[28] Many such advisors, I suspect, would not feel their lives enhanced thereby. Undoubtedly, nonattorney advisors sometimes would try to avoid this problem by seeking advice from attorneys as to privilege questions, especially in what appear to be close cases. However, this would be no panacea. Miscalculations could occur as to what cases are close. Moreover, some clients would find it curious (at least) to have to pay their nonattorney advisors for advice and also to pay attorneys for advice as to whether the first advice is privileged.[29]

Another set of complications would arise at the strategic level. The degree of cooperation the taxpayer extends to the IRS during audit and administrative appeals can have significant practical and legal consequences.

> ***Section 341 would put nonattorney advisors in the uncomfortable position of deciding which communications with them are privileged and which are not.***

For instance, if, contrary to usual practice, the IRS does inquire into the contents of advisor-client communications and is rebuffed on grounds of privilege, the natural reaction for the Service would be to smell smoke and thus look even harder to find a fire. This suspicion could translate into a longer or more intense audit or less willingness on the part of the Service to concede or settle close issues.

In addition, the taxpayer's degree of cooperation is relevant to whether the taxpayer can recover litigation costs if she ultimately prevails[30] or to whether damages[31] or penalties[32] will be imposed on her (in addition to the deficiency) if she ultimately loses the case. Indeed, if another provision of H.R. 2676 were enacted, such cooperation could bear strongly on whether the taxpayer or the IRS is held to have the burden of proof at trial.[33] The taxpayer's refusal to provide information to the IRS

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[27]In theory, the IRS would have a lever to control such behavior. An advisor would be a "qualified individual" for privilege purposes only if she were "authorized to practice before the Internal Revenue Service." Thus, the IRS could remove flagrant offenders from the ambit of privilege by yanking their authorization to practice before it. However, such actions rarely are accepted meekly, and the ensuing litigation would be uncomfortable for everyone concerned. *See, e.g., Owrutsky v. Treasury Secretary*, 952 F.2d 1457 (4th Cir. 1991) (attorney de-authorized); *Forehand v. IRS*, 877 F. Supp. 592 (M.D. Ala. 1995) (suspension of return preparer from electronic filing program). Moreover, attempts by the Service to police this vigorously inevitably would raise concerns that it was trying to chill zealous representation of taxpayers by their nonattorney advisors.

[28]Strictly speaking, only the client herself or her attorney may assert a privilege. Section 341 is silent as to who could assert the new privilege, so presumably it would not change this general rule. Nonetheless, as a practical matter, we could expect that nonattorney advisors typically would do the asserting as to the new privilege in administrative proceedings.

(Footnote 28 continued in next column.)

(Certainly, it would be ironic if section 341 — intended to facilitate the client's choice between an attorney and a nonattorney tax advisor — required the client to hire a lawyer in order to assert that her communications with her nonlawyer advisor were privileged.) In any event, nonattorney advisors surely would be expected to tender their advice to the client as to when and whether the new privilege applies.

[29]The frequency of these problems would be reduced by the fact, noted previously, that the Service rarely inquires into the contents of advisor-client communications. But even as this fact diminishes the disadvantage of section 341 it also diminishes the need for section 341.

[30]*See* section 7430(b)(1).

[31]*See* section 6673(a)(1)(c).

[32]*See, e.g., Famularo v. Commissioner*, T.C. Memo. 1984-37, 47 T.C.M. (CCH) 948, 953-54.

[33]*See* new code section 7491(b)(2), as would be added by section 301, H.R. 2676 (burden of proof generally would be on the IRS at trial but only if "the taxpayer has fully cooperated with the [IRS] . . . including providing . . . access to all witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the [IRS]").

of recent suits and complaints has involved allegations by lawyers that nonattorney advisors have crossed the line and engaged in the unauthorized practice of law.[46]

Enactment of section 341 would escalate such conflict. To preserve their perceived marketing advantage, attorneys would seek ways to blunt or circumscribe section 341's impact. Accusing nonattorney tax advisors of engaging in the practice of law would be a natural line of attack.

Section 341 itself provides such an opening. The new privilege would apply only to "tax advice furnished by any qualified individual (in a manner consistent with state law for such individual's profession)."[47] State laws typically prohibit nonlawyers from practicing law.[48] Thus, a successful complaint that a nonattorney advisor was engaged in the unauthorized practice of law when engaged in some tax function would not only raise the specter of sanctions on the advisor, it also would defeat attachment of the section 341 privilege.

The present state of the law admits of no decimal-point precision as to where acceptable tax practice by nonattorney advisors ends and unauthorized practice of law begins.[49] Yet, the very absence of certainty as to this matter would encourage attorneys to protect their business by bringing such complaints.[50]

If professional regulators and courts uphold such complaints, the rationale for section 341 would be further undercut: the limitation imposed by the parenthetical in the statute[51] would combine with the limitations discussed in Part II to make the new privilege a thin shield indeed. Communications with advisors would be protected under section 341's nonparenthetical language only when the advisor acts as an attorney. However, if the advisor's so acting is viewed as the unauthorized practice of law, the communications would be unprotected as a result of the parenthetical language. At the extreme, then, interpretation of all parts of section 341 could produce a null set.

Furthermore, whether such complaints succeed or fail, their effect would be corrosive. Lawyers bringing such suits and nonattorney advisors defending against them would set groups of tax advisors against each other. Coming at a time when tensions already are on the rise, enactment of section 341 would be an unfortunate additional irritant.

IV. Conclusion

There is no clear justification for section 341 — as both current IRS practice and the porous nature of the proposed privilege show. Also, enactment of section 341 would create or exacerbate problems, including attempts to conceal information, complication of tax advisors' roles, and heightened tensions between lawyers and other tax advisors. The Republic could survive these problems, of course, but — given the lack of benefit from the section — there is no good reason to accept them.

Congress should forgo this undesirable symbolic gesture. If it does not, participants in the tax system will need to anticipate the unintended adverse consequences of the new privilege.

ABA is considering establishing a task force on this situation. *Gibeaut, supra* note 39, at 45. *See also* Doug H. Moy, "Estate Planning: Charting a Smart Course for Your Clients," *National Public Accountant*, May 1, 1995, at 14 (discussing unauthorized practice of law by accountants in estate planning).

[46]Actions in Texas and Ohio have garnered particular attention. *See, e.g., Accounting Today*, Nov. 24, 1997, at 5. *See also Gammarino v. Hamilton County Bd. of Revision*, 684 N.E.2d 309 (Ohio 1997); *Sharon Village Ltd. v. Licking County Bd. of Revision*, 678 N.E.2d 932 (Ohio 1997); *In re Unauthorized Practice of Law Rules Proposed by South Carolina Bar*, 42 S.E.2d 123 (So. Car. 1992); *cf. CA Magazine*, Dec. 1995, at 18 (similar controversy in Canada).

[47]As to such rules governing accountants, see *Digest of State Accountancy Laws and State Board Regulations* (AICPA, NASBA 1992).

[48]*See generally* Deborah L. Rhode, "Policing the Professional Monopoly: A Constitutional and Empirical Analysis of Unauthorized Practice Prohibitions," 34 *Stan. L. Rev.* 1 (1981).

[49]*See generally* Bernard Wolfman, James P. Holden, and Deborah H. Schenk, *Ethical Problems in Federal Tax Practice* 378-428 (3d ed. 1995); Boris I. Bittker, "Does Tax Practice by Accountants Constitute the Unauthorized Practice of Law?" 25 *J. Tax.* 184 (1966); Matthew A. Melone, "Income Tax Practice and Certified Public Accountants: The Case for a Status Based Exemption From State Unauthorized Practice of Law Rules," 11 *Akron Tax J.* 47 (1995).

[50]I am struck by Melone's experience:

> Prior to my admission to the bar, I had been a practicing certified public accountant and, like many of my colleagues, did not believe that the scope of my profession's services in tax matters was subject to serious dispute [as constituting unauthorized practice of law]. However, exposure to attorneys, particularly those not in tax practice, has led me to conclude that the bar has not come to any universally agreed upon conclusions about the role that certified public accountants may properly play in tax matters.

Melone, *supra* note 49, at 47.

[51]The Joint Committee explanation, *see* note 6 *supra*, adds nothing to our understanding of the parenthetical. One may suspect that it was added to the language of the bill at least in part to defuse possible opposition from the bar.