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PRIVILEGE SHIELDS IN TAX LITIGATION: WHEN THE SWORD CUTS BOTH WAYS

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In litigation, there is supposed to be a balance between full discovery of relevant information and unimpeded access to legal advice. Protections against discovery, such as the attorney-client privilege and the work-product doctrine, are intended to encourage complete disclosure by clients to their attorneys in the context of an attorney-client relationship. While taxpayers may feel their privileges are eroding in the post-Fin-48 era, which has tipped the balance in favor of discovery, these protections still serve as an important line of defense against overbearing discovery.

In a Court of Federal Claims decision last year, *Deseret Management Corporation v. United States*,[1] the court examined the application of the attorney-client privilege, the work-product doctrine, and the deliberative-process privilege. What makes the *Deseret* decision somewhat unusual is that the privileges were asserted by the Internal Revenue Service ("IRS"), rather than by the taxpayer. The *Deseret* decision serves as a useful tool to reexamine the status of these three protections and how they are used in the context of tax controversies.

Background on *Deseret*

Deseret Management Corporation ("*Deseret*") alleged that the United States, acting through the IRS, erroneously assessed and illegally collected income taxes. During pre-trial discovery, Deseret requested that the IRS produce certain documents. The IRS opposed Deseret's request on the basis of various privileges including the attorney-client privilege, the work-product doctrine, the deliberative-process privilege, and the "personal privacy privilege." Deseret subsequently filed a motion to compel. The Court of Federal Claims conducted an *in camera* inspection of the documents and determined that most of the IRS's documents were non-discoverable on the basis of the first three privileges, but not the "personal privacy privilege" for which the IRS failed to provide any legal authority.

[1] *Deseret Mgmt. Corp. v. United States*, 76 Fed.Cl. 88 (Fed. Cl. 2007).

Attorney-Client Privilege

While the attorney-client privilege does not shield all communications between clients and their attorneys, the privilege is relatively broad. To properly invoke the attorney-client privilege, the asserting party must establish that: (1) he is or seeks to become a client of an attorney; (2) he is a person to whom a communication was made (a) he is a member of the bar of a court and (b) in connection with this communication he is acting as a lawyer; (3) the communication relates to a fact of which the attorney is informed by his client, without the presence of strangers, for the primary purpose of securing a legal opinion, legal services, or assistance in some legal proceeding; and (4) the privilege has been claimed and not waived by the client.[2] The court in *Deseret* determined that the IRS properly invoked the attorney-client privilege.

Practice Pointer: As the *Deseret* case illustrates, the privilege is applicable both to private persons and to government agencies with respect to communications with their respective attorneys provided the communication meets the prerequisites listed above. Taxpayers must be prepared not only to wield the privilege as a shield to vital information, but also for when the privilege may be asserted by a taxing authority.

The attorney-client privilege can similarly be waived by taxpayers and taxing authorities alike. Taxpayers may waive the privilege by voluntarily disclosing confidential information to a third party. For example, if a taxpayer shares a memorandum of law prepared by an attorney with the taxpayer's accountant, this generally waives the attorney-client privilege as to the issues addressed in the memo. Disclosure to an accountant will not waive privilege, however, if the accountant's assistance is deemed necessary to the lawyer's representation of the client.[3] The relevant inquiry is whether the accountant is assisting the attorney or providing accounting services to the client.

Work-Product Doctrine

The work-product doctrine is intended to "preserve a zone of privacy in which a lawyer can prepare and develop legal strategy 'with an eye toward litigation,' free from unnecessary intrusion by adversaries."[4] Under the federal work-product doctrine, documents and tangible things are privileged if they were prepared (i) "in anticipation of" litigation or for trial and (ii) by or for another party or by or for that other party's representative.[5] Documents covered by the federal work-product doctrine may be discoverable only on a showing that the party seeking discovery "has a 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

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[2] *Id*. at 90.

[3] *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

[4] *Deseret*, 76 Fed.Cl. at 92.

[5] The work product doctrine as codified for the United States Court of Federal Claims in RCFC 26(b)(3) is identical to FRCP 26(b)(3).

means."[6] However, "the court shall protect against disclosure of mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation."[7]

In *Deseret*, the taxpayer sought to compel the production of documents the IRS created during the course of the audit, arguing that the documents were prepared in the ordinary course and not in anticipation of litigation. The IRS countered that they "reasonably anticipated litigation on the transaction at issue almost from the inception of the audit" because "[o]nce the audit has begun, the likelihood of litigation increases."[8] The court, relying on the decision of the Sixth Circuit Court of Appeals in *United States v. Roxworthy*,[9] held that the IRS's documents were produced in anticipation of litigation, and thus privileged, based on the size of the company being audited and the business significance of the transaction at issue.

In *Roxworthy*, the defendant represented Yum! Brands, Inc. ("Yum") in the capacity of Vice President of Tax. When the IRS served an informal request for production of documents, Yum declined to produce certain documents that it designated privileged under the work-product doctrine. The IRS filed the equivalent of a motion to compel production. In determining whether the documents at issue were prepared in "anticipation of litigation," the Sixth Circuit adopted the "because of" standard (which asks if the subject documents were prepared because of potential or anticipated litigation).[10]

Ultimately, the Sixth Circuit held that the parties anticipated litigation and thus the work-product doctrine protected certain internal memoranda prepared by a third-party accounting firm. The Sixth Circuit determined that the parties anticipated litigation because of the type of transaction at issue, the fact that the accountants advised the company that the IRS targets such transactions, and the certainty that the IRS would conduct a yearly audit given the company's size.

Practice Pointer: The work-product doctrine is important in state tax litigation as most jurisdictions have codified the doctrine. In some instances, this doctrine provides even greater protection for attorney work product than the federal rules.[11] Because the

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[6] *Deseret*, 76 Fed.Cl. at 92, citing RCFC(b)(3).

[7] *Id*.

[8] *Id*. at 93.

[9] *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006).

[10] The "because of" standard involves a two-prong test – one subjective, the other objective. The subjective test queries whether the refusing party had a subjective anticipation of litigation. The objective test inquires whether the party's subjective anticipation of litigation was objectively reasonable. Under the "because of" standard, documents can serve a dual purpose.

[11] *See, e.g*., New York State Civil Practice Law & Rules § 3101(c) (providing that "[t]he work product of an attorney shall not be obtainable.") and § 3101(d)(2) (providing that materials prepared in anticipation of litigation or for trial by of for another party, or by or for that party's representative, are only discoverable on showing that the requesting party has "a substantial need of the materials in the

work-product doctrine can be asserted by private persons and government agencies, tax cases on the work product issue can cut both ways. It is noteworthy that the IRS issued an Action on Decision stating its non-acquiescence in the *Roxworthy* case, while at the same time, citing *Roxworthy* to its advantage in *Deseret*.[12]

Deliberative-Process Privilege

The deliberative-process privilege ("DPP"),[13] although having been in existence for several decades, is likely the least familiar of the privileges. Its relevance, however, for taxpayers can be significant. The DPP is implicated in situations where a party seeks discovery from a government agency. Specifically, the DPP "covers documents reflecting advisory opinions, recommendations and deliberations comprising part of a process by which governmental decisions and policies are formulated."[14] This privilege creates an exclusive benefit to government agencies to decline to produce any documents that communicate the decision process used by the government to establish an agency policy or position.

The U.S. Supreme Court has stated that the DPP "rests on the obvious realization that officials will not communicate candidly among themselves if each remark is a potential item of discovery and front page news, and its object is to enhance 'the quality of agency decision,' by protecting open and frank discussions among those who make them within the Government."[15] These "frank and open discussions within governmental agencies would be 'chilled' if the personal opinions and ideas of government personnel involved in the decision-making process were subject to public scrutiny."[16]

To take advantage of the DPP, the government agency asserting the privilege must demonstrate that the subject document is both "pre-decisional" and "deliberative." To be pre-decisional, the material must address activities that are antecedent to the

(continued…)

preparation of the case and is unable without undue hardship to obtain the substantial equivalent of the materials by other means."); *see also* California Code of Civil Procedure § 2018.030(a) (providing that "[a] writing that reflects an attorney's impressions, conclusions, opinions, or legal research or theories is not discoverable under any circumstances.") and § 2018.030(b) ("The work product of an attorney, other than a writing described in subdivision (a), is not discoverable unless the court determines that denial of discovery will unfairly prejudice the party seeking discovery in preparing that party's claim or defense or will result in an injustice.").

[12] *See* IRS Action on Decision, No. 2007-004, IRB No. 2007-40 (Oct. 1, 2007); *see also* "Ruling Has Not Resolved Work-Product Privilege Issue," *New York Law Journal*, Vol. 238 (Oct. 18, 2007).

[13] This privilege is also referred to as Executive Privilege.

[14] *Deseret*, 76 Fed.Cl. at 94.

[15] *Dep't of Interior and Bureau of Indian Affairs v. Klamath Water Users Protective Ass'n*, 532 U.S. 1, 8-9 (2001).

[16] *Greenpeace v. Nat'l Marine Fisheries Serv*., 198 F.R.D. 540, 543 (W.D. Wash. 2000).

adoption of an agency policy. To be deliberative, the material must address a direct part of the deliberative process in that it makes recommendations or expresses opinions on legal or policy matters. A party may overcome the privilege by showing that the evidentiary need outweighs the hardship that disclosure of such information may cause to the government agency.[17] The court in Deseret determined that the IRS properly invoked the DPP and the taxpayer did not meet its burden to overcome the privilege.

Practice Pointer: While the DPP may not be as widely asserted on the state level as it is at the federal level, taxpayers should know when it can be asserted and its limiting effects on discovery. For example, where a policy position is unclear, taxpayers would find it beneficial to be able to view documents that discuss the purpose or meaning of such policy position (especially if different views were expressed within the agency). If asserted, the DPP could preclude the discovery of such information unless the taxpayer can show that the evidentiary need outweighs the hardship to the government agency.

Preserving Privilege and Winning the Battle of Full Disclosure

Discovery is one of the most critical phases of the litigation process. Rather than waiting until tax litigation is in full swing before considering privilege issues, taxpayers should take precautions against unnecessarily waiving privilege in their daily practice. For example, on a rolling basis, identify documents that are confidential or privileged. Most attorneys will mark documents as privileged and confidential, but not always. Consider limiting who in the company has access to legal correspondence to reduce the risk of disclosure. In certain situations, oral communication from an attorney may be more advisable than written communication. Before giving *any* correspondence received from an attorney to a third party, talk to the attorney about possible implications. There likely are alternatives to providing privileged information to third parties (this issue is especially important in light of Fin-48).

Taxpayers and tax advisers should be careful to act in a manner that preserves the work-product privilege to the greatest extent possible. For example, if during the course of an audit the taxpayer identifies a noteworthy issue of disagreement, taxpayers should take care to protect documents they or their representatives prepare relating to that issue.

If a taxpayer is interested in obtaining information from a taxing authority prior to litigation, the taxpayer may consider using the state equivalent of the Freedom of Information Act ("Act"). While a public information request does not circumvent the work-product privilege or the DPP when invoked, under the Act, the taxpayer may be able to obtain relevant documents from the state prior to the state determining that litigation is forthcoming (or prior to an agency asserting the DPP).■

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[17] *Deseret*, 76 Fed.Cl. at 96; *see Ferrell v. United States Department of Housing and Urban Development*, 177 F.R.D. 425 (N.D.Ill 1998) (discussing the five-factor paradigm for determining if there is a "particularized need" for documents).

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