Forum

LOS ANGELES DAILY JOURNAL • FRIDAY, MAY 23, 2003 • PAGE 6

Privilege Lost

Pending Legislation Would Put Limits on Attorney-Client Confidentiality

By Bruce Givner

On Feb. 27, the U.S. Senate passed S476, titled the CARE Act of 2003. (That acronym stood for Charity Aid, Recovery and Empowerment Act in an earlier form of the bill.) The first six titles reflect the bill's purpose: "to provide incentives for charitable contributions by individuals and businesses, to improve the public disclosure of activities of exempt organizations and to enhance the ability of low-income Americans to gain financial security by building assets."

However, the seventh title, innocuously named "Revenue Provisions," contains proposals that would eliminate the attorney-client privilege in certain tax matters and give the Internal Revenue Service the power to impose six-figure fines on statutory tax-planning techniques.

The tax-practitioner privilege was one of a number of reforms that Congress added to the Internal Revenue Code in response to complaints about IRS dealings with taxpayers, especially overzealous actions to collect allegedly delinquent tax liabilities through the power to levy on taxpayers' property.

Congress' first response was the Taxpayer Bill of Rights, Pub. L. No. 100-647. The Taxpayer Bill of Rights II, Pub. L. No. 104-168, and the IRS Restructuring Act, Pub. L. No. 105-206, added more rights. Donald C. Alexander and Edwin P. Geils, "IRS Procedures: Examinations and Appeals," Paragraph I.E.1, at 623, Tax Management (BNA 2003).

Not quite five years ago, the IRS Restructuring Act added new Internal Revenue Code Section 7525. With certain limits, this section extended the attorney-client privilege of confidentiality to tax advice furnished to a client taxpayer (or potential client taxpayer) by anyone authorized under federal law to practice before the IRS, including attorneys, CPAs, enrolled agents and enrolled actuaries. Section 7525(a)(3)(B) defines "tax advice" as advice given about a matter within the scope of the individual's authority to practice before the IRS.

Currently, this privilege has three limits. First, a party may assert the privilege only in noncriminal proceedings before the IRS and in federal court where the IRS is a party. Second, it does not include return preparation services. *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999); *United States v. KPMG LLP*, 237 FSupp.2d 35 (D. D.C. 2002). Finally, and most germane to the pending bill, written communications with a corporation's representative related to the corporation's direct or indirect participation in a "tax shelter" are not privileged. Section 7525(b).

Section 706 of the new bill would amend Section 7525(b) in dramatic fashion. Titled "Section Not To Apply To Communications Regarding Corporate Tax Shelters," the amended section would be retitled "Section Not To Apply To Communications Regarding Tax Shelters," dropping the adjective "corporate." In other words, it will apply even to tax shelters for individuals.

Bruce Givner is a tax attorney in Los Angeles.

Lawyers in particular, and taxpayers generally, should ask why criminal defendants should have the benefit of the attorney-client privilege but those involved in tax planning should not.

If this limit is enacted, taxpayers will have even greater interest in who defines a "tax shelter." The current definition is in Internal Revenue Code Section 6662(d)(2)(C)(iii). "Tax shelter" includes any partnership, entity, plan or arrangement, "a significant purpose [of which] is the avoidance or evasion of Federal income tax." For reasons not immediately apparent, the bill would move the definition to a new Section 1274(b)(3)(C).

The label 'tax shelter' should not mean 'anything the IRS does not like.'

Existing Section 1274(b)(3)(B)(ii) also authorizes the treasury secretary to label as a "potentially abusive situation ... any other situation which" it "specifies by regulations as having potential for tax avoidance."

The IRS has issued Regulation 1.6011-4, which defines "reportable transactions" as those described in the regulation itself (e.g., confidential transactions), those with "contractual protection" and those with brief asset holding periods. The regulation also defines "listed transactions" as "the same as or substantially similar to one of the types of transactions that the [IRS] has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."

One indication of the problem facing taxpayers is that some of the "listed transactions" include structures clearly listed on the face of the code, including employee stock ownership plans (Rev. Rul. 2003-6); welfare benefit plans under Section 419 (Notice 2003-24); and Section 401(k) plans (Rev. Rul. 90-105).

Section 702 of the bill further illustrates the connection between infringing the privilege and tax shelters. This part of the bill would add a new Section 6707A to the code, which would impose a $50,000 penalty for failure to report a "reportable transaction" to the IRS.

If the "reportable transaction" is one that the IRS has labeled a "listed transaction," the penalty increases to $100,000. If the failure to report is by a "large entity" (gross receipts of more than $10 million) or "high net worth individual" (net worth exceeds $2 million), then the penalty increases to $200,000.

Compare these fines to those imposed for tax crime. Under Section 7203, it is a misdemeanor to willfully fail to pay any tax or estimated tax, make a return, keep any records or supply any information required to be supplied under the code. The maximum fine is $100,000 for individuals. That means the fine imposed on a "high net worth individual" for failure to report a transaction that the IRS does not like is higher than for this tax crime.

Not only is the IRS the sole authority to determine whether a transaction is "reportable" or "listed," but "any determination under [the proposed new section] may not be reviewed in any administrative or judicial proceeding." Proposed Section 6707A(d)(3). (This applies to individual returns due on April 15, 2004.)

Section 711 of the bill also would amend Section 6694(a) of the code, "Understatement of Taxpayer's Liability By Income Tax Return Preparer," in dramatic fashion. Subsection (a) is titled "Understatements Due To Unrealistic Positions" and imposes a $250 penalty if the preparer knew that any part of a tax understatement was because of a position that did "not [have] a realistic possibility of being sustained on its merits" and was undisclosed or frivolous. (The penalty is $1,000 if the preparer's intent was willful and included an intentional or reckless disregard of the rules.)

The bill would change Subsection (a)'s title to "Understatements Due To Improper Positions," increase the penalty to $1,000 and lower the standard. The penalty will apply if the preparer knows that any part of the understatement is because of a position in which the preparer did "not [have] a reasonable belief that the tax treatment in such position was more likely than not the proper treatment" and was undisclosed or lacked a reasonable basis for the tax treatment.

Another attack on tax advisers is contained in bill Section 703(c). It would amend code Section 6664 to specify that certain tax advisers and tax opinions may not be relied on in establishing whether a taxpayer has reasonable cause for taking a position.

Examples of disqualified tax advisers include those participating in the organization or promotion of the transaction or those who have a fee arrangement that is contingent on the intended tax benefits from the transaction being sustained.

Examples of disqualified tax opinions include those based on unreasonable factual or legal assumptions, those that rely unreasonably on the taxpayer's representations and those that fail "to meet any other requirement as the Secretary may provide." Proposed Section 6664(d)(3)(iii)(IV).

As a matter of public policy, few people have problems limiting reportable transactions or tax shelters determined by Congress to be such. However, the label "tax shelter" should not mean "anything the IRS does not like." Under one proposal, the IRS is prosecutor, judge, jury and executioner of the penalty because there is no right to judicial review.

Especially in light of the abuses determined in previous congressional hearings, giving the IRS the authority to unilaterally name "listed" transactions is a serious mistake. All tax planning would be susceptible to being labeled a "tax shelter." Congress has never gone this far.

Time after time, courts have confirmed the right of taxpayers to minimize their tax liability without fear of unreasonable IRS retribution. Recently, the U.S. Tax Court rejected yet another heavy-handed attempt by the IRS to limit a technique that Congress enacted but that the IRS just does not like. See *Wells Fargo & Co. v. Comm'r*, 120 T.C. No. 5 (Feb. 13, 2003). The proposed legislation would give the IRS a license to kill.