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MAKING A LIST AND CHECKING IT TWICE: MUST TAX ATTORNEYS DIVULGE WHO'S NAUGHTY AND NICE?

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ABSTRACT: This article analyzes the ability of tax attorneys to shield a client's identity from disclosure to the Internal Revenue Service under the attorney-client privilege. The article concludes that, on policy grounds, the attorney-client privilege should be limited in the context of tax planning. Consequently, client identity should not be privileged irrespective of whether a tax shelter is involved. The article also concludes that the privilege would not be available under the current judicial approach to client identity questions. As a result, recent regulations requiring tax attorneys to maintain lists of clients engaging in specified tax motivated transactions represent an appropriate response to recent tax shelter activity.

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*He's making a list,
And checking it twice;
Gonna find out who's naughty and nice.
Santa Claus is coming to town.*¹

I. Introduction

It is common knowledge that St. Nicholas maintains a comprehensive “naughty and nice” list of everyone on the planet. For untold years the Internal Revenue Service (the “Service”) has sought access to Santa’s list for its own purposes, but it has been unsuccessful in locating the jolly old elf during his yearly nocturnal visit to this continent.² Recently, the Service has taken a new tack by requiring tax attorneys to maintain their own lists of “naughty” clients. The question is: Must practitioners produce these lists for the Service?

This article examines when, if ever, the attorney-client privilege should permit a tax practitioner to shield a client’s identity from the Service. This issue has arisen in connection with the Service’s ongoing efforts to combat the current wave of abusive tax shelter activity in the United States.³ The Service has issued regulations requiring attorneys and other advisors to maintain lists of clients undertaking certain types of tax motivated transactions⁴ and has taken

¹ J. Fred Coots & Henry Gillespie, *Santa Claus is Coming to Town* (1934).

² Even the advanced satellite and radar tracking systems of the North American Aerospace Defense Command (NORAD), which have been tasked with tracking Santa’s movements each December 24th for the last fifty years (<http://www.noradsanta.com>), have not enabled the Service to catch up with the elusive Mr. Claus.

³ U.S. Department of Treasury, *Bush Administration’s Aggressive Actions to Combat Abusive Tax Shelters*, TAX NOTES TODAY, Feb. 19, 2004, LEXIS 2004 TNT 34-19 [hereinafter *Aggressive Actions*] (discussing recent initiatives aimed at combating tax shelter activity); U.S. Department of Treasury, *Treasury White Paper on Corporate Tax Shelters*, TAX NOTES TODAY, July 2, 1999, LEXIS 1999 TNT 127-12, 127-13 [hereinafter *Treasury White Paper*] (discussing the tax shelter problem generally).

⁴ Treas. Reg. § 301.6112-1.

several prominent law and accounting firms to court seeking such client lists.⁵ This article analyzes the traditional judicial approach to the attorney-client privilege and concludes that a client's identity is unlikely to be protected in tax shelter transactions. Further, this article argues that, as a policy matter, the attorney-client privilege should be limited as it relates to client identity in *all* tax planning situations. This policy argument derives from the fact that the very existence of the attorney-client privilege reflects a societal judgment that its benefits outweigh its costs. However, given the self-assessment nature of the tax system, the societal interests at stake in tax planning situations are sufficiently different to warrant limiting the scope of the attorney-client privilege for all tax planning matters. Consequently, the Service's actions in seeking client identities from attorneys have been proper both under current law and from a broader policy perspective.

Part II of this article discusses the attorney-client privilege with a focus on the alternative approaches that have developed in the courts and academia for resolving when a client-identity privilege exists. Part III analyzes three situations under the tax law where courts have specifically faced the question of whether a client's identity is privileged. Part IV first examines the extent to which client identity in tax shelter transactions would be privileged under current law, and suggests a reading of the relevant case law that would generally preclude applying the privilege to tax shelter situations. Then this part examines whether the attorney-client privilege should be available from a policy perspective in tax planning situations generally. After distinguishing an existing academic theory for analyzing the client-identity privilege, this article argues that the policies underlying the attorney-client privilege require limiting the client-

⁵ See e.g., Internal Revenue Service, *Background Information: Strategy to Combat Abusive Avoidance Transactions*, TAX NOTES TODAY, Oct. 15, 2003, LEXIS 2003 TNT 200-13

identity privilege in all tax planning situations. Part V concludes that the Service's actions in pursuing client identities in tax shelter situations have been appropriate under the attorney-client privilege as it currently exists and are also justified from a policy perspective. Granting an identity privilege for tax planning would not promote the underlying policy goals of the attorney-client privilege and would work great harm to the fabric of the self-assessment tax system.

II. The Attorney-Client Privilege and Protection of a Client's Identity

A. *The Scope of the Attorney-Client Privilege*

The attorney-client privilege is one of the oldest evidentiary privileges recognized under the law.⁶ Despite its long history, the scope of the privilege is still evolving.⁷ Over time, while the privilege has remained, its justification has been the subject of considerable debate.⁸

(noting enforcement actions against the law firms of Sidley Austin Brown & Wood, and Jenkins & Gilchrist, as well as noting other enforcement activities).

⁶ 8 JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2290, at 543 (McNaughton rev. ed. 1961) (noting that the privilege can be found as far back as the reign of Queen Elizabeth); Geoffrey C. Hazard, Jr., *An Historical Perspective on the Attorney-Client Privilege*, 66 CAL. L. REV. 1061 (1978) (tracing the evolution of the attorney-client privilege); 2 CHRISTOPHER B. MUELLER & LAIRD C. KIRKPATRICK, FEDERAL EVIDENCE § 181, at 302 (2d ed. 1994) (noting that the privilege can be traced back to Roman and canon law).

⁷ Timothy P. Glynn, *Federalizing Privilege*, 52 AM. U. L. REV. 59, 60 (2002) ("The law of privilege varies greatly from state to state, federal circuit to federal circuit, and context to context, and its application often is unclear within particular jurisdictions and even within particular cases. Most strikingly, the conflicts and ambiguities are not relegated to the margins."); Kenneth S. Broun, *Giving Codification a Second Chance - Testimonial Privileges and the Federal Rules of Evidence*, 53 HASTINGS L.J. 769, 780 (2003) ("[Since the adoption of the Federal Rule of Evidence 501 the] federal law of attorney-client privilege has evolved in hundreds of cases at all federal court levels, led by the Supreme Court of the United States in four cases since 1976.") In 1975 Congress adopted the Federal Rules of Evidence (Public Law 93-595, 88 Stat. 1926 (1975)) which consciously left the law of evidentiary privileges to common-law development. Federal Rule of Evidence 501 provides that the federal common-law of privileges applies to federal-question and federal criminal cases, while state law privilege rules are applicable to cases in federal courts where state law is at issue. Consequently, for federal income tax issues it is the federal common-law attorney-client privilege that is applied.

⁸ See Hazard, *supra* note 6; Steven Bradford, *Conflict of Laws and the Attorney-Client Privilege: A Territorial Solution*, 52 U. PITT. L. REV. 909, 913-14 (1991) (describing the various

The modern formulation of the attorney-client privilege owes much to the views of Dean John Henry Wigmore and his highly influential treatise on the rules of evidence.⁹ Dean Wigmore defended the attorney-client privilege on the basis of practical concerns regarding the necessity of the privilege in promoting a free and frank discussion between clients and their attorneys.¹⁰ This utilitarian approach derived from his general method for analyzing all evidentiary privileges. More specifically, Wigmore identified four necessary elements for the recognition of any evidentiary privilege:

- (1) The communications must originate in a *confidence* that they will not be disclosed; (2) This element of *confidentiality must be essential* to the full and satisfactory maintenance of the relation between the parties; (3) The *relation* must be one which in the opinion of the community ought to be sedulously *fostered*; and (4) The *injury* that would inure to the relation by the disclosure of the communications must be *greater than the benefit* thereby gained for the correct disposal of litigation.¹¹

After finding that the attorney-client privilege satisfied all these conditions, Wigmore concluded that “[i]n order to promote freedom of consultation of legal advisers by clients, the apprehension

policy justifications for the attorney-client privilege); JOHN WILLIAM GERGACZ, ATTORNEY-CORPORATE CLIENT PRIVILEGE § 1.04 (3d ed. 2001) (same).

⁹ Edward J. Imwinkelried, *The Historical Cycle in the Law of Evidentiary Privileges: Will Instrumentalism Come into Conflict with the Modern Humanistic Theories?*, 55 ARK. L. REV. 241, 241 (2002) (“Theory plays such a prominent role in privilege doctrine in large part due to the continuing influence of that giant of American evidence law, Dean John Henry Wigmore. More specifically, theory has assumed a major role in this area because of the sway still exercised by Wigmore’s treatment of privilege doctrine in volume eight of his classic treatise.”) Wigmore’s continuing importance to privilege law is vividly demonstrated by the Supreme Court’s heavy reliance on Wigmore in its two most recent privilege decisions, *Jaffee v. Redmond*, 518 U.S. 1, 9 (1996) and *Swidler & Berlin v. United States*, 524 U.S. 399, 406 (1998).

¹⁰ WIGMORE, *supra* note 6, § 2291, at 545.

¹¹ *Id.* § 2285, at 527.

of compelled disclosure by the legal advisers must be removed; and hence the law must prohibit such disclosure except on the client's consent."¹²

For purposes of this article, the last two prongs of Wigmore's test are particularly germane. These requirements recognize that there are always winners and losers in any privilege question. By their very nature evidentiary privileges entail one party seeking the disclosure of information over another party's objection. If no privilege applies the adverse party may be harmed by the revelation of the confidence. Alternatively, if the privilege obtains then the requesting party will be denied access to information that could be highly relevant to the just administration of the law. But the winners and losers extend beyond the parties in any particular controversy. The very existence of an evidentiary privilege reflects a societal decision regarding whether a privilege is beneficial.¹³ Clearly society has a strong interest in compelling all persons with knowledge of the truth to make it known. However, there may well be competing societal interests that would be promoted by allowing such confidences to remain secret. Consequently, the law's recognition of an evidentiary privilege reflects a weighing of which position presents the greatest net benefit to society as a whole.

One hundred years after the first edition of Wigmore's treatise,¹⁴ the attorney-client privilege is still predominately defended based on this type of utilitarian weighing of

¹² *Id.* § 2291, at 545.

¹³ *See, e.g.,* *Elkins v. United States*, 364 U.S. 206, 234 (1960) (Frankfurter, J., dissenting) ("Limitations are properly placed upon the operation of this general principle only to the very limited extent that permitting a refusal to testify or excluding relevant evidence has a public good transcending the normally predominant principle of utilizing all rational means for ascertaining truth."); MCCORMICK ON EVIDENCE § 72 (John W. Strong et al. eds., 5th ed. 1999) [hereinafter MCCORMICK ON EVIDENCE] (noting that privilege rules protect societal interests at the cost of the efficient administration of justice).

¹⁴ JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW (1904).

competing societal interests.¹⁵ The privilege is justified because ensuring confidential client communications encourages clients to fully appraise their attorneys of all the facts necessary to address the legal issue at hand.¹⁶ Such open communications reap significant benefits for society as a whole by, among other things, strengthening our adversarial system of justice,¹⁷ enhancing

¹⁵ While various commentators have asserted non-utilitarian justifications for the attorney-client privilege, the utilitarian explanation remains the primary rationale. MCCORMICK ON EVIDENCE, *supra* note 13, § 87, at 344 (noting that the utilitarian purpose is the principal justification today); Note, *Attorney-Client and Work Product Protection in a Utilitarian World: An Argument for Recomparison*, 108 HARV. L. REV. 1697, 1703 (1995) (noting that modern trend is a utilitarian justification); Note, *Developments in the Law - Privileged Communication: Modes of Analysis: The Theories and Justifications of Privileged Communications*, 98 HARV. L. REV. 1471, 1486-87 (1985) [hereinafter *Privileged Communication*] (characterizing the privilege's utilitarian purpose as predominant); Glynn, *supra* note 7, 69 (“[N]one of [the non-utilitarian] justifications can fully explain the modern privilege, which applies in criminal and civil contexts, protects attorney-client communications made in and outside of litigation, is generally unqualified, and affords protection for both natural and corporate persons. Rather, the widely accepted, overarching purpose for the modern attorney-client privilege is utilitarian or instrumental.”). Non-utilitarian explanations for the attorney-client privilege are typically based on the theory that individual rights justify protecting attorney-client communications from disclosure. See, e.g., Steven Goode, *Identity, Fees, and the Attorney-Client Privilege*, 59 GEO. WASH. L. REV. 307, 312-319 (1991) (surveying various non-utilitarian theories for the attorney-client privilege). For instance, the attorney-client privilege can be said to protect an individual's right to privacy by preventing the disclosure of embarrassing personal information. David W. Louisell, *Confidentiality, Conformity and Confusion: Privileges in Federal Court Today*, 31 TUL. L. REV. 101, 110 (1956). Similarly, the attorney-client privilege can be seen as a powerful tool to promote individual autonomy. Ready access to legal champions can empower individuals without legal training to assert and defend their rights. Making communications privileged ensures that the dialogue between the attorney and client is frank and encourages individuals to explore their legal options with an advisor. Charles Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relation*, 85 YALE L.J. 1060, 1073 (1976). One problem with justifying the attorney-client privilege on the basis of individual liberty, is that this rationale for the privilege has little weight when a corporation or other juridical entity is the client. See GERGACZ, *supra* note 8, ¶ 1.04; James A. Gardner, *A Re-Evaluation of Attorney-Client Privilege (Part II)*, 8 VILL. L. REV. 447, 498 (1963); Elizabeth G. Thornburg, *Sanctifying Secrecy: The Mythology of the Corporate Attorney-Client Privilege*, 69 NOTRE DAME L. REV. 157, 185-86 (1993).

¹⁶ *Fisher v. United States*, 425 U.S. 391, 403 (1980) (“The purpose of the privilege is to encourage clients to make full disclosure to their attorneys.”).

¹⁷ *United States v. Zolin*, 491 U.S. 554, 562 (1989) (“open client and attorney communication [is central] to the proper functioning of our adversary system of justice”).

judicial efficiency,¹⁸ and promoting compliance with the law.¹⁹ If an attorney is in full command of all the relevant facts, she can better prepare the client's case, assert otherwise overlooked defenses, and prepare in advance for any damaging evidence.²⁰ Consequently, the adversarial system is more likely to result in the truth being revealed and injustices being avoided.²¹ When clients are encouraged to fully inform their legal advisors regarding the true facts, the attorney is in a much better position to realistically appraise the merits of the legal issue in question. Thus, the attorney is in a better able to propose appropriate settlements or to advise against litigation in the first instance, and judicial resources are thereby conserved. Finally, when a client is encouraged to reveal illegal or questionable plans to his attorney, the attorney is positioned to educate the client regarding the law's requirements and stands a much better chance of dissuading such actions before they are undertaken. The attorney-client privilege therefore can be said to promote compliance with the law.²² The Supreme Court has repeatedly asserted this purpose as the main societal goal served by the attorney-client privilege.²³ In light of the significant benefits to the legal system as a whole produced by the attorney-client privilege, the

¹⁸ Goode, *supra* note 15, at 315 ("trials proceed more smoothly and efficiently when the lawyers are fully appraised of the facts").

¹⁹ *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

²⁰ WIGMORE, *supra* note 6, § 2291, at 553; 24 WRIGHT & GRAHAM, *FEDERAL PRACTICE AND PROCEDURE* § 5472, at 85 (1986); Stern & Hoffman, *Privileged Informers: The Attorney Subpoena Problem and a Proposal for Reform*, 136 U. PA. L. REV. 1783, 1825-26 (1988).

²¹ Fred C. Zacharias, *Rethinking Confidentiality*, 74 IOWA L. REV. 351, 358 (1989).

²² *Upjohn*, 449 U.S. at 389 (privilege promotes "compliance with the ever growing and increasingly complex body of public law.").

²³ *Id.* at 392 (promoting full and frank communications between attorneys and their clients "encourages observance of the law and aids in the administration of justice"); *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348 (1985) ("[T]he attorney-client privilege serves the function of promoting full and frank communications between attorneys and their clients. It thereby encourages observance of the law and aids in the administration of justice."); *Zolin*, 491 U.S. at 562; *Swidler & Berlin v. United States*, 524 U.S. 399, 403 (1998).

traditional judgment of courts and legislatures has been that such benefits outweigh the competing societal interest of requiring the truth to always be made known.

Since society has determined that the benefits of the attorney-client privilege outweigh its societal costs, the question becomes how the privilege should be defined and where it should be limited to best reflect this societal cost-benefit analysis. The classic formulation of the attorney-client privilege is also directly attributable to Wigmore, who maintained that the privilege applies:

(1) Where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) except the protection be waived.²⁴

With this basic understanding of the attorney-client privilege and its present justification, the specific question of when a client's identity should be protected by the privilege can be undertaken.

B. Client Identity as a Privileged Communication

²⁴ WIGMORE, *supra* note 6, § 2292, at 554. The other oft quoted source for the elements of the attorney-client privilege is *United States v. United Shoe Machinery Corp*, 89 F. Supp. 357, 358-59 (D. Mass. 1950), where the court stated:

The privilege applies only if (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar . . . and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.

Almost every case examining whether a client's identity is considered privileged information starts with the proposition that such information is generally *not* privileged.²⁵ This basic rule is typically justified by reference to the *prima facie* requirements for applying the privilege. Thus it is argued that a client's identity does not meet the Wigmore requirements because: (1) a client's identity is typically conveyed to the attorney prior to the formation of the attorney-client relationship and therefore, since it is not information conveyed as part of the attorney-client relationship, it is not subject to protection;²⁶ and (2) a client's name is not eligible

²⁵ See *In re Grand Jury Subpoenas (Anderson)*, 906 F.2d 1485, 1488 (10th Cir. 1990) ("It is well recognized in every circuit, including our own, that the identity of an attorney's client and the source of payment for legal fees are not normally protected by the attorney-client privilege."). See also, *Tomlinson v. United States*, 93 F.2d 652, 655 (D.C. Cir. 1937); *Goddard v. United States*, 131 F.2d 220, 221 (5th Cir. 1942); *United States v. Pape*, 144 F.2d 778, 782 (1944); *Behrens v. Hironimus*, 170 F.2d 627, 628 (4th Cir. 1948); *Gretsky v. Miller*, 160 F. Supp. 914, 915 (D. Mass. 1958); *Colton v. United States*, 308 F.2d 633, 637 (2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963); *In re Semel*, 411 F.2d 195, 197 (3d Cir. 1969), *cert. denied*, 396 U.S. 905 (1969); *United States v. Tratner*, 511 F.2d 248, 252 (7th Cir. 1975); *In re Michaelson*, 511 F.2d 882, 888 (9th Cir. 1975); *In re Grand Jury Proceedings (Jones)*, 517 F.2d 666, 670 (5th Cir. 1975); *United States v. Hodge and Zweig*, 548 F.2d 1347, 1353 (9th Cir. 1977); *United States v. Strahl*, 590 F.2d 10, 11 (1st Cir. 1978); *In re Grand Jury Proceedings (Lawson)*, 600 F.2d 215, 218 (9th Cir. 1979); *In re Walsh*, 823 F.2d 489, 494 (7th Cir. 1980); *In re Grand Jury Investigation (Tinari)*, 631 F.2d 17, 19 (3d Cir. 1980), *cert. denied*, 449 U.S. 1083 (1980); *In re Grand Jury Witness (Salas & Waxman)*, 695 F.2d 359, 361 (9th Cir. 1982); *In re Lahodny*, 695 F.2d 363, 365 (9th Cir. 1982); *In re Grand Jury Proceedings (Pavlick)*, 680 F.2d 1026, 1027 (5th Cir. 1982); *In re Grand Jury Proceedings (Twist)*, 689 F.2d 1351, 1352 (11th Cir. 1982); *In re Grand Jury Proceedings in Matter of Freeman*, 708 F.2d 1571 (11th Cir. 1983); *In re Grand Jury Investigation No. 83-2-35 (Durant)*, 723 F.2d 447, 451-52 (6th Cir. 1983), *cert. denied*, 467 U.S. 1246 (1984); *In re Osterhoudt*, 722 F.2d 591, 592 (9th Cir. 1983); *In re Grand Jury Proceedings (85 Misc. 140)*, 791 F.2d 663, 665 (8th Cir. 1986); *In re Grand Jury Proceedings Subpoena to Testify to Wine*, 841 F.2d 230, 233 n.3 (8th Cir. 1988); *In re Grand Jury Proceedings 88-9 (Newton)*, 899 F.2d 1039, 1042 (11th Cir. 1990); *In re Horn*, 976 F.2d 1314, 1317 (9th Cir. 1992); *United States v. Ritchie*, 15 F.3d 592, 602 (6th Cir. 1994), *cert. denied*, 513 U.S. 868 (1994); *United States v. Sindel*, 53 F.3d 874, 876 (8th Cir. 1995).

²⁶ See, e.g., *In re Osterhoudt*, 722 F.2d 591, 592 (9th Cir. 1983); *Behrens v. Hironimus*, 170 F.2d 627, 628 (4th Cir. 1948); *People ex rel. Vogelstein v. Warden of County Jail*, 150 Misc. 714, 718, 270 N.Y.S. 362, 367 (N.Y. Sup. Ct.), *aff'd*, 242 A.D. 611, 271 N.Y.S. 1059 (N.Y. App. Div. 1934) ("The mere fact of the engagement of counsel is out of the rule because the privilege and duty of being silent do not arise until that fact is ascertained."); *Goode*, *supra* note 15, at 334-35 (noting the argument that "the attorney-client privilege presupposes an attorney-client

for protection under the attorney-client privilege since it is not typically conveyed with an expectation of confidentiality.²⁷ While these legal justifications have been questioned, this basic rule that the client identity is not privileged is firmly entrenched in the law.²⁸

Nevertheless, in a number of cases the courts have found a client's identity privileged despite the generally accepted rule to the contrary.²⁹ While the logic and reasoning underlying such decisions is often muddled, three, sometimes overlapping, approaches to the client-identity privilege question can be discerned:³⁰ (1) the legal advice exception; (2) the last link exception; and (3) the confidential communication exception. The legal advice exception maintains that a client's identity should be withheld when revealing the identity "would implicate the client in the very criminal activity for which the legal advice was sought."³¹ The

relationship. Statements of identity, which are preliminary to the formation of the relationship, are therefore not privileged.").

²⁷ WIGMORE, *supra* note 6, § 2313, at 609 ("The identity of the attorney's client . . . will seldom be a matter communicated in confidence because the procedure of litigation ordinarily presupposes a disclosure of these facts. Furthermore, so far as a client may in fact desire secrecy and may be able to secure action without appearing as a party to the proceedings, it would be improper to sanction such a wish. Every litigant is in justice entitled to know the identity of his opponents.").

²⁸ Seymour Glanzer & Paul R. Taskier, *Attorneys Before the Grand Jury: Assertion of the Attorney-Client Privilege to Protect a Client's Identity*, 75 J. CRIM. L. & CRIMINOLOGY 1070, 1078 (1984) ("And, it may be argued, that if the existence of the identity exclusion were to be weighed today, de novo and without the baggage of precedent, the important purpose of an inviolable attorney-client privilege would outweigh the inherited rationales of the past.").

²⁹ See generally, Diane M. Allen, *Attorney's Disclosure, in Federal Proceedings, of Identity of Client as Violating Attorney-Client Privilege*, 84 A.L.R. Fed. 852 (2003) and cases cited therein.

³⁰ See *In re Grand Jury Subpoenas (Anderson)*, 906 F.2d 1485, 1488 (10th Cir. 1990); *Privileged Communication*, *supra* note 15, at 1518-22; Goode, *supra* note 15, at 325-35; Matthew P. Harrington & Eric A. Lustig, *IRS Form 8300: The Attorney-Client Privilege And Tax Policy Become Casualties In The War Against Money Laundering*, 24 HOFSTRA L. REV. 623, 648-52(1996); Note, *Turning Lawyers into Witnesses: Does Forced Client Disclosure Breach the Attorney-Client Privilege?*, 30 SUFFOLK U. L. REV. 795, 816-17 (1997); Comment, *Legal and Professional Ethics: Protection of Client Identity*, 55 OKLA. L. REV. 297, 301-09 (2002); Allen, *supra* note 29.

³¹ *U.S. v. Hodge & Zweig*, 548 F.2d 1347, 1353 (9th Cir. 1977).

last link exception represents a narrowing of the legal advice exception by holding that client identity is only privileged if its revelation would supply “the last link in an existing chain of incriminating evidence likely to lead to the client’s indictment.”³² The confidential communication exception provides that a client’s identity is protected when such identification would be “in substance a disclosure of the confidential communication in the professional relationship between the client and the attorney.”³³

While courts often cite one or more of these exceptions when discussing client-identity privilege issues, the modern trend is to rely primarily on the confidential communication exception.³⁴ This trend recognizes that the first two exceptions focus on the incriminatory effect of disclosing the client’s name, rather than the policy of facilitating the free flow of information necessary for attorneys to provide competent legal advice.³⁵ While clients often convey incriminating facts to their attorneys, the attorney-client privilege shields this information from discovery because doing so promotes the larger societal goal of fostering compliance with the law. The incriminatory nature of any information conveyed is a purely secondary consideration compared to the larger policy goal underlying the attorney-client privilege. This can be seen in the exceptions to the attorney-client privilege. If applying the privilege does not further the policy goal of promoting compliance with the law in a particular situation, then often the privilege is not applied despite the fact that the information might be incriminating. For instance, the attorney-client privilege does not apply to confidential communications regarding a

³² In re Grand Jury Proceedings (Pavlick), 680 F.2d 1026, 1027 (5th Cir. 1982).

³³ In re Osterhoudt, 722 F.2d 591, 593 (9th Cir. 1983).

³⁴ MCCORMICK ON EVIDENCE § ___, at ___ (“Today, happily, there is a marked trend toward refocusing upon the essential purpose of the privilege by extending its protection to client identity and fee arrangements only if the net effect of the disclosure would be to reveal the nature of a client communication.”).

³⁵ See Goode, *supra* note 15, at 328-29; Harrington & Lustig, *supra* note 30, at 651.

future crime or continuing fraud.³⁶ Similarly, facts that an attorney discovers independently or from third parties are not protected from disclosure by the attorney-client privilege even if they are incriminating.³⁷

It is not the incriminatory nature of information that prompts society to grant the privilege; rather, it is promoting free communications with the goal of creating greater compliance with the law. Consequently, the mere fact that revealing the client's identity would tend to incriminate the client does not directly indicate that there is a confidential client communication at stake deserving of protection in the eyes of society.³⁸ For a client's identity to be privileged it must be shown that revealing the client's name would also reveal information conveyed confidentially to the attorney in seeking legal advice. Since the confidential communication exception focuses directly on this question, it is the approach most closely

³⁶ See WIGMORE, *supra* note 6, § 2298, at 573; *United States v. Zolin*, 491 U.S. 554, 562-63 (1989) ("The attorney-client privilege must necessarily protect the confidences of wrongdoers, but the reason for that protection -- the centrality of open client and attorney communication to the proper functioning of our adversary system of justice -- 'ceas[es] to operate at a certain point, namely, where the desired advice refers *not to prior wrongdoing*, but to *future wrongdoing*.'" (quoting Wigmore)).

³⁷ See, e.g., *In re Fischel*, 557 F.2d 209, 212 (9th Cir. 1977) ("[F]acts which an attorney receives from a third party about a client are not privileged. Extension of the privilege to this information would not serve to protect and foster the client's freedom of expression.").

³⁸ For instance, assume Joe works as a janitor. For the last two years he has reported his annual janitorial income of \$10,000 on his tax return. However, Joe is also engaged in an illegal activity that produces large amounts of cash which he does not report. As a personal matter unrelated to his illegal business, Joe hires an attorney to handle a complex child adoption case for him and pays the attorney \$100,000 in cash. Joe never reveals or discusses his illegal business with the attorney. The Service learns of the large cash payment and orders the attorney to reveal the identity of the payor. If Joe's identity is revealed the Service will check his past tax returns and see that Joe reported only \$20,000 of income over the last two years. Consequently, linking Joe to the large cash payment is highly incriminatory since it indicates he may have underreported his past income and it raises questions about whether the \$100,000 was obtained legally. Nevertheless, revealing Joe's identity does not reveal any confidential communication made to the attorney since Joe never retained the attorney to deal with his tax matters or his illegal business. In this case the confidential communication exception would not shield Joe's identity despite the incriminatory effect of the revelation.

aligned with the policy underlying the attorney-client privilege. The confidential communication exception typically applies where revealing the client's identity indicates the client's motive in seeking legal advice, and said motive in turn indicates that the client admitted his guilt to his attorney.

While the confidential communication exception is more attuned to the underlying policy of the attorney-client privilege than the other two exceptions, it unfortunately can lead to widely divergent results based on a particular court's view of whether revealing the attorney-client relationship actually results in a sufficiently clear inference regarding a client's motives for seeking legal assistance. In this regard it is interesting to contrast the similar cases of *In re Grand Jury Proceeding (Cherney)*³⁹ and *Vingelli v. United States*.⁴⁰

In *Cherney* a lawyer was paid by a third party to represent a defendant, Hrvatin, in a drug conspiracy trial. Several years later the attorney, Cherney, was subpoenaed by a grand jury and asked to divulge Hrvatin's benefactor. Cherney refused on the grounds that the benefactor's identity was protected by the attorney-client privilege. On *in camera* review, it was revealed to the court that the benefactor was a pre-existing client of Cherney's and that the pre-existing representation involved consultations regarding the benefactor's involvement in the same drug conspiracy in which Hrvatin had been charged. On these facts the Seventh Circuit affirmed the application of the attorney-client privilege to protect the benefactor's identity. The court believed that revealing the benefactor's identity in light of the already revealed facts would be tantamount to revealing the benefactor's motive (*i.e.*, to obtain advice about participation in a drug conspiracy) in retaining Cherney. Since this motive would itself have been a confidential

³⁹ 898 F.2d 565, 568 (7th Cir. 1990).

⁴⁰ 992 F.2d 449 (2d Cir. 1993).

communication (*i.e.*, admitting complicity in the conspiracy to the attorney), the confidential communication exception applied.

In *Vingelli* the Second Circuit applied the confidential communication exception to a similar situation but reached the opposite result. In this case *Vingelli*, an attorney in Arizona, transmitted \$5,000 on behalf of a client to an attorney in Vermont to cover the legal defense of a defendant, Lovell, in a Vermont drug conspiracy case. A grand jury investigating the conspiracy learned of *Vingelli*'s role and demanded that *Vingelli* reveal the identity of Lovell's benefactor. *Vingelli* refused, asserting the attorney-client privilege. The Second Circuit held on these facts that revealing the benefactor's name would not necessarily reveal his motive in seeking *Vingelli*'s assistance. The court stated that since alternative inferences could be drawn (*e.g.*, that the benefactor, while wanting to help a friend or relative, wished to do so anonymously out of fear of guilt by association), revealing the benefactor's identity would not reveal the motive for seeking legal advice or even whether any legal advice was in fact sought by the benefactor.

The stark difference in results between *Cherney* and *Vingelli* seems to be directly attributable to the facts the attorneys revealed to the court about the actual nature of their consultations with the benefactor. In *Cherney* the *in camera* review of documents indicated that the benefactor was actually consulting *Cherney* independently regarding his actual involvement in the drug conspiracy. However, in *Vingelli* it appears that the attorney revealed to the court that the benefactor was a long time client who sought "advice concerning the ramifications of lending \$5,000 to a criminal defendant and having contacts with that defendant."⁴¹

⁴¹ *Id.* at 453.

The confidential communication exception provides a coherent analytical basis for applying the client-identity privilege since it focuses on whether any client communication would be implicitly revealed by revealing the client's identity.⁴² Nevertheless, the exception has been criticized as not fully adhering to the policy underlying the attorney-client privilege.⁴³ This criticism centers on the risk that clients will be dissuaded from seeking legal advice under the confidential communication exception. As discussed earlier, the ultimate goal of the attorney-client privilege is to promote compliance with the law.⁴⁴ This goal is achieved by fostering free and frank client communications, which in turn relies on clients being assured that their communications will be confidential. Implicit in this approach is the position that the attorney-client privilege should encourage potential clients to seek legal assistance in the first place. If potential clients are dissuaded from seeking legal advice, then there will be no frank communications and no attorney guidance to assist potential clients in complying with the law.

Criticisms of the confidential communication exception take two forms. The first focuses on the test's reliance on an *ex post* factual analysis. Since potential clients may be uncertain regarding whether their identity ultimately will be upheld as privileged under such a fact intensive inquiry, they may decide not to seek legal assistance.⁴⁵ The second line of criticism focuses on the reality that the exception would permit the government to engage in generalized "fishing expeditions" as a means of identifying candidates for future investigations

⁴² See Harrington & Lustig, *supra* note 30, at 651 ("the confidential communications exception seems to provide the soundest argument for protecting client identity").

⁴³ See Goode, *supra* note 15, at 332-33.

⁴⁴ See *supra* text accompanying notes 14-23.

⁴⁵ See, e.g., *Upjohn Co. v. United States*, 449 U.S. 383, 393 (1981) ("[Clients] must be able to predict with some degree of certainty whether particular discussions will be protected. An uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."); H. Lowell Brown, *The Crime-*

of wrongdoing.⁴⁶ For instance, assume that there have been a string of unsolved murders in Big City over the last year. The police, having run out of other leads, wish to obtain the client lists of the five most prominent homicide defense attorneys in the area. The attorneys refuse, claiming their clients' names are protected under the attorney-client privilege. A court applying the confidential communication exception could well find that revealing the clients' identities on these facts would not reveal their specific motives in seeking counsel or any other confidential client communication. However, if the government is successful in attempts to gain such information, potential clients are likely to be dissuaded from seeking legal advice for fear that the mere fact that they consulted an attorney could be used to single them out for government scrutiny.⁴⁷

In light of these criticisms, one commentator has proposed an alternative theory for resolving client-identity privilege issues, the "status-as-client" approach.⁴⁸ The status-as-client approach departs from the confidential communication exception by focusing on the risk that potential clients would be dissuaded from seeking legal advice if client-identity information is not privileged. Under this standard, a client's identity is privileged whenever the government's reason for seeking the information is to determine whether the client sought legal advice. When identity information is sought merely as a means of uncovering some other information, then the privilege would not apply even though an attorney is involved and the disclosure might be incriminating.

Fraud Exception to the Attorney-Client Privilege in the Context of Corporate Counseling, 87 KY. L. J. 1191, 1195-96 (1999); Glynn, *supra* note 7, at 62.

⁴⁶ Goode, *supra* note 15, at 332, 336.

⁴⁷ *Id.*

⁴⁸ *Id.*

Applying the status-as-client test to benefactor situations like *Cherney* and *Vingelli* will illustrate the approach. The benefactors in those cases were both clearly seeking independent legal advice from their attorneys. However, they were also using their attorneys as a means for providing legal assistance to a third party. If a grand jury were requesting information regarding clients that had consulted an attorney about involvement in drug trafficking, that would be impermissible as seeking to identify clients due to their status as clients. Since potential clients would be dissuaded from seeking legal advice in such situations for fear that their illegal activities could be discovered as a result, a client-identity privilege should apply.

However, if the grand jury merely wished to know who provided the funds to pay for another person's legal defense, such information would be discoverable under the status-as-client approach. This is true despite the fact that the grand jury's underlying reason for seeking this information is to locate a target for further investigation and that revealing the information may be highly incriminating. Allowing a client's identity to be discoverable in this situation does not in fact dissuade prospective clients from seeking *legal* advice. Their status as a seeker of purely legal advice is protected under the status-as-client approach since the government cannot directly seek that information. However, if they attempt to use their attorney in a non-legal capacity (*e.g.*, to transfer funds to another person), they risk having their identity exposed. Making identity information non-privileged in such cases dissuades the use of attorneys for non-legal purposes and limits the scope of the attorney-client privilege to purely matters of legal advice. Similarly, the status-as-client approach would prevent the government from undertaking fishing expeditions seeking to identify individuals for investigation based on the fact that they sought legal advice about their actions.

The status-as-client approach and the confidential communication exception both represent policy based approaches to resolving the client-identity privilege issue. However, in some cases these two theories reach opposite conclusions. While the status-as-client approach's focus on encouraging clients to seek counsel remedies one shortcoming of the confidential communication exception, the status-as-client approach itself fails to fully implement the policy underlying the attorney-client privilege in all cases. In particular, the status-as-client approach is premised on the assumption that a client's motive in seeking legal assistance is in fact a confidential communication deserving of societal protection.⁴⁹ Consequently, while both theories provide valuable insights into how the client-identity issue can be resolved, neither provides a complete answer by itself. Consequently, in the discussion that follows both the confidential communication exception and the status-as-client approach will be analyzed in the context of various tax related transactions.

III. Client-Identity Privilege in a Federal Income Tax Context

The question of whether an attorney must disclose a client's identity has arisen in a number of federal income tax situations. The following discussion will examine these areas in light of both the confidential communication exception and the status-as-client approach.

A. *Section 6050I Authorities*

In 1984, Congress enacted section 6050I of the Internal Revenue Code (the "Code"). Section 6050I provides that "any person who is engaged in a trade or business, and who in the course of such trade or business, receives more than \$10,000 in cash in one transaction (or two or more related transactions)" must disclose this fact and relevant identifying

⁴⁹ *Id.* at 333-35.

information to the Service.⁵⁰ This provision's original purpose was to combat underreporting of taxable income by persons with large cash incomes.⁵¹ However, Congress subsequently transformed the provision into a powerful tool for identifying individuals engaged in drug trafficking and other illegal activities by permitting the Service to share information obtained with other federal agencies engaged in criminal law enforcement activities.⁵² Since attorneys are engaged in a trade or business, any cash payments in excess of \$10,000 that they receive from clients must be disclosed to the Service pursuant to section 6050I. The statute contains no exclusion for payments made to attorneys, and despite intense pressure from the practicing bar,⁵³ neither Congress nor the Service has created such an exclusion in the twenty years since the provision was enacted.

Despite the absence of any attorney exception, through the mid-1990s attorneys frequently attempted to avoid disclosing the identity of their cash paying clients by asserting that such information was protected under the attorney-client privilege.⁵⁴ However, the courts routinely rejected any assertion of identity privilege on the grounds that a client's method of payment was not itself privileged information and that revealing the client's identity in

⁵⁰ I.R.C. § 6050I.

⁵¹ JOINT COMM. ON TAXATION, 98th Cong., 2d Sess., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 491 (Comm. Print 1984).

⁵² I.R.C. § 6103(i).

⁵³ Goode, *supra* note 15, at 310 (describing bar actions with respect to section 6050I); See Harrington & Lustig, *supra* note 30, at 624 (same); Note, *I.R.C. § 6050I and The Attorney-Client Privilege: The Misplaced Emphasis On Incrimination Over Confidentiality*, 1996 U. ILL. L. REV. 509, 512-13 (1996) (same).

⁵⁴ For a general discussion of the case law in this area see, Brian L. Porto, *Attorney-Client Privilege and the Reporting of Cash Transactions in Excess of \$10,000, as Required by § 6050I of the Internal Revenue Code*, 152 A.L.R. FED. 459, 474 (1999).

connection with revealing his mode of payment would not disclose any client confidential communication.⁵⁵ In this regard the Ninth Circuit went so far as to state:

Our case law spells out the narrow circumstances under which fee-payer identity and fee arrangements may be protected by the attorney-client privilege. Only in the extremely rare case will the receipt of cash for fees be so intertwined with the subject of representation as to obviate compliance with 6050I. We are hard pressed to imagine such a case, and decline to provide an illustration.⁵⁶

*United States v. Sindel*⁵⁷ is one of the few cases finding that the requirements of the confidential communication exception were satisfied in a section 6050I context. In *Sindel* an attorney reported certain cash transactions from two different clients to the Service but omitted any identifying information under a claim of privilege. The Eighth Circuit, after examining the attorney *in camera*, ruled that the attorney “could not release information about the payments on behalf of [the first client] without revealing the substance of a confidential communication.”⁵⁸ However, with respect to the second client the court ruled that no confidential communication would be disclosed if that client’s identity was revealed. The court gave no indication of what factors were revealed *in camera* that prompted the different conclusion with respect to the two

⁵⁵ See, e.g., *United States v. Goldberger & Dubin, P.C.*, 935 F.2d 501 (2d Cir. 1991); *United States v. Leventhal*, 961 F.2d 936 (11th Cir. 1992); *U.S. v. Blackman*, 72 F.3d 1418 (9th Cir. 1995); *United States v. Ritchie*, 15 F.3d 592, 601 (6th Cir. 1994), *cert. denied*, 513 U.S. 868 (1994).

⁵⁶ *Blackman*, 72 F.3d at 1426.

⁵⁷ 53 F.3d 874 (8th Cir. 1995). Client identity was also protected from section 6050I disclosure in *United States v. Gertner*, 873 F.Supp. 729 (D.Mass.), *aff’d in part*, 65 F.3d 963 (1st Cir. 1995). However, the district court there did not base its conclusion on the confidential communication exception. The basis for the district court’s attorney-client privilege position seems to have been that Constitutional considerations should inform the attorney-client privilege analysis when criminal actions are already proceeding against the undisclosed client. In any event, the court’s analysis of this issue was specifically identified as *dici* by the First Circuit on appeal. The First Circuit affirmed the case on the grounds that the Service had made procedural errors in issuing the summons requesting the client’s identity. *Gertner*, 65 F.3d 963, 972-73.

⁵⁸ *Sindel*, 53 F.3d at 876.

clients. Consequently, the case again illustrates that the *ex post* nature of the inquiry can lead to dramatically different results under the confidential communication exception.

The weight of decided case authority under section 6050I recognizes that client identity and fee information is generally outside the attorney-client privilege and only very rarely will the confidential communication exception apply to create protection.⁵⁹ The same resolution of these cases would be reached under the status-as-client approach. When the Service seeks to uncover the mode of a client's payment, it is not seeking to determine anything about the reasons that the client sought legal advice. Since clients desiring confidentiality for their identity can avoid any risk of identity disclosure by paying their legal bills in a form other than cash (*e.g.*, by using a personal check or a cashier's check), applying section 6050I to attorneys should not adversely impact the inclination of potential clients to seek legal advice.⁶⁰

B. *Anonymous TaxPayments*

Certainly the most famous client identity case involving federal income taxes is *Baird v. Koener*.⁶¹ In that case Baird, a tax attorney, was consulted by a general practice attorney representing several unidentified business people. The attorney revealed to Baird that

⁵⁹ See cases cited in note 55, *supra*. See also, Porto, *supra* note 54; Michael B. Himmel, *What Lawyers Need To Know About Accepting Cash From Clients*, 26 CHAMPION 12, 14 (June 2002) (surveying the case law and concluding that an attorney's "refusal to disclose a client's information [under section 6050I] will usually result in a court order compelling the attorney to disclose the information. Additionally, the attorney may face criminal and civil penalties.").

⁶⁰ Goode, *supra* note 15, at 351-52. However, cashier's checks, money orders and traveler's checks with face amounts of less than \$10,000 are treated as cash for the purposes of enforcing section 6050I. See Treas. Reg. § 1.6050I(c)(ii). Cashier's checks and similar instruments in amounts of \$10,000 or more are excluded since any bank issuing such instruments for cash would itself be required to file a report with the Service under section 6050I.

⁶¹ 279 F.2d 623, 632-33 (9th Cir. 1960). See, *e.g.*, In re Grand Jury Investigation No. 83-2-35 (Durant), 723 F.2d 447, 452 (6th Cir. 1983), *cert. denied*, 467 U.S. 1246 (1984) (calling *Baird* "seminal"); *Privileged Communication*, *supra* note 15, at 1518 (noting that all the client identity exceptions can be traced to *Baird*); Glanzer & Taskier, *supra* note 28, at 1080 (*Baird* "seminal").

the accountants for these business people had determined that insufficient taxes had been paid for one or more prior years. While none of the business people were currently under audit by the Service, they wished to mitigate their exposure to interest, penalties, and perhaps criminal action by the Service if the underpayments were eventually discovered. Baird advised the attorney that the business people should remit the amount they believed owed to the Service on an anonymous basis. To this end, the attorney provided Baird with a cashier's check to cover the relevant amount, which Baird then transmitted to the Service with a cover letter of explanation. Baird never learned the identity of the business people involved. After receiving the remittance, the Service issued Baird a summons demanding he identify the clients on whose behalf the anonymous remittance was made. Baird refused, asserting that the attorney-client privilege applied.⁶²

In a decision containing language forming the genesis of all three judicially recognized client identity exceptions,⁶³ the Ninth Circuit found the privilege applicable and refused to force Baird to reveal the identity of the business people or their attorney. The court acknowledged that a client's identity is not normally privileged, but found that an exception existed when the purpose of requesting the client's identity was to obtain an admission of guilt.⁶⁴ In finding that this exception applied, the court stated:

The facts of the instant case bring it squarely within that exception to the general rule. Here money was received by the government,

⁶² Baird, 279 F.2d at 627.

⁶³ See, e.g., *In re Grand Jury Investigation No. 83-2-35 (Durant)*, 723 F.2d 447, 452 (6th Cir. 1983), *cert. denied*, 467 U.S. 1246 (1984) (noting that the legal advice, last link, and confidential communication exceptions all are traceable to *Baird*).

⁶⁴ While this exception was grounded in California state privilege law, the exception has now become part of the federal common law on the attorney-client privilege. California privilege law was applicable in *Baird* because it was decided prior to the adoption of Federal Rule of Evidence 501.

paid by persons *who thereby admitted* they had not paid a sufficient amount in income taxes some one or more years in the past. The names of the clients are useful to the government for but one purpose – to ascertain *which taxpayers think* they were delinquent, so that it may check the records for that one year or several years. The volunteer nature of the payment indicates a *belief by the taxpayers* that more taxes or interest or penalties are due than the sum previously paid, if any. It *indicates a feeling of guilt* for nonpayment of taxes, though whether it is criminal guilt is undisclosed. But it may well be the link that could form the chain of testimony necessary to convict an individual of a federal crime. *Certainly the payment and the feeling of guilt are the reasons the attorney here involved was employed --* to advise his clients what, under the circumstances, should be done.⁶⁵

Baird and other cases dealing with this situation⁶⁶ establish that client identity is generally protected when an attorney facilitates an anonymous restitution. This conclusion is easily reached under the logic of the confidential communication exception. Since revealing the client's identity is tantamount to revealing an admission of guilt by the client, the identity should be derivatively protected to avoid disclosing the clearly privileged admission of guilt.

Nevertheless, the status-as-client approach would reach the opposite conclusion in these cases.⁶⁷ While consulting an attorney regarding prior tax underpayments would be privileged absent other activities, employing the attorney for the non-legal function of actually delivering the payment would not be protected. Under the status-as-client approach a client could freely consult an attorney regarding the advisability of and best method for making a restitution payment without fear that her identity could be obtained from the attorney. However, if she then also employed the attorney as the means to facilitate the actual restitution, the status-as-client approach would allow her identity to be discovered since the attorney would be acting

⁶⁵ *Baird*, 279 F.2d at 633 (emphasis added, citations omitted).

⁶⁶ An identical result was reached by the Seventh Circuit regarding an anonymous tax payment in *Tillotson v. Boughner*, 350 F.2d 663 (7th Cir. 1965). *See also*, Silver, *Courts Are Upholding Attorney-Client Privilege in Anonymous Payment Situations*, 43 J. TAX'N 358 (1975).

as a mere “bagman” and not as a provider of a legal service. Consequently, the status-as-client approach would not dissuade potential clients from seeking counsel for legal advice but it would discourage them from also employing attorneys to perform non-legal tasks.

C. Identification of Clients Undertaking Specified Transactions

A third category of client identity cases arising under the federal income tax laws relates to situations where the Service knows that a questionable tax minimization transaction exists but it cannot readily identify the taxpayers involved. In such cases, the Service may attempt to extract client information from the tax attorneys involved in structuring the transaction. The law in this area is still developing and the case results are mixed.⁶⁸ This section will focus on describing how the existing case law in this area has applied the confidential communication exception. It will also discuss how the status-as-client approach would apply to this situation. This article’s critique of the law in this area is reserved for Part IV.

1. The Pro Taxpayer Authority: Liebman and Arthur Anderson

The case most frequently cited by tax practitioners seeking to avoid disclosing a client’s identity in tax planning situations is *United States v. Liebman*.⁶⁹ In *Liebman* a law firm specialized in investigating and evaluating tax advantaged partnership investments. The firm only charged clients a fee if they actually invested in the subject partnerships. Additionally, it

⁶⁷ Goode, *supra* note 15, at 339-40.

⁶⁸ Several provisions of the Code and associated regulations require the maintenance of investor lists for certain types of tax motivated transactions. While these provisions do not explicitly provide that they supercede the attorney-client privilege in the context of such transactions, it can be argued that in operation they do preclude the application of the confidential communication exception to such transactions. Since the resolution of this issue is unclear, the discussion in this section is premised on the continued availability of the confidential communication exception for transactions covered by these investor list maintenance rules. The impact of the listing requirements will be discussed in Part IV.A.2 and B.2, *infra*.

⁶⁹ 742 F.2d 807 (3d Cir. 1984).

was known by the Service, and admitted by the law firm, that the firm also advised clients that any fee paid was immediately deductible for tax purposes as a legal expense. The Service believed that such fees were in substance non-deductible brokerage charges. After unsuccessfully attempting to identify the partnerships involved or the clients who had paid fees to the law firm, the Service issued a summons to the law firm to compel disclosure of the clients who had paid fees in connection with partnership investments. The law firm asserted the attorney-client privilege and refused to disclose its clients' identities.

In finding that the attorney-client privilege protected the identity of the clients, the Third Circuit focused on the fact that since the Service already knew the content of the advice the law firm gave, it would be improper to force disclosure of the client's identity.

If the summons merely requested the names of clients who paid fees, the information would not be protected by the attorney-client privilege. However, the summons is more specific. The affidavit of the IRS agent supporting the request for the summons not only identifies the subject matter of the attorney-client communication, but also describes its substance. That is, the affidavit does more than identify the communications as relating to the deductibility of legal fees paid to Liebman & Flaster in connection with the acquisition of a real estate partnership interest. It goes on to reveal the content of the communication, namely that "taxpayers . . . were advised by Liebman & Flaster that the fee was deductible for income tax purposes." Thus, this case falls within the situation where "so much of the actual communication had already been established, that to disclose the client's name would disclose the essence of a confidential communication. . . ." See *United States v. Jeffers*, 532 F.2d 1101, 1115 (7th Cir. 1976) (and cases cited therein).⁷⁰

While essentially relying on a form of the confidential communication exception, the Third Circuit's logic is suspect in two regards. First, it implies that if the Service had merely *suspected* – and not actually known – that the law firm advised that the fees were deductible, the

clients' identities would not have been protected. This position has the potential for turning the purpose of the attorney-client privilege on its head. Normally a client's identity is not privileged, but the substance of the client's communications with an attorney is privileged. However, under the *Liebman* approach if a client and law firm decide that the client's identity is the more crucial information to be kept secret, they could apparently arrange for the substance of the representation and the advice given to become known, and then assert privilege for the client's identity.

Secondly, it is not clear why revealing the law firm's advice regarding deductibility revealed any confidential communication covered by the attorney-client privilege. Under the standard formulation of the attorney-client privilege, only communications *by the client* qualify for the privilege's protection.⁷¹ While legal advice received by a client is often *derivatively* privileged (since knowing the advice would typically implicitly reveal the client's concerns and motives in seeking the advice),⁷² it is not clear that that was the case in *Liebman*. The *Liebman* clients were seeking advice about the tax consequences of investing in certain partnerships. While the law firm apparently also advised them regarding the deductibility of the legal fees they paid to obtain the tax advice regarding the investment, revealing the deductibility

⁷⁰ *Id.* at 809 (some citations omitted).

⁷¹ WIGMORE, *supra* note 6, § 2292, at 554 (referring to communications made "by the client"); *United States v. United Shoe Machinery Corp.*, 89 F. Supp. 357, 358-59 (D. Mass. 1950) (same).

⁷² *See, e.g., EEOC v. Fina Oil & Chem. Co.*, 145 F.R.D. 74, 76 (E.D. Tex. 1992) ("In federal courts, [the] attorney-client privilege extends to confidential communications between [the] attorney and client only if the communications are based on confidential information provided by the client...."); *Soriano v. Treasure Chest Casino, Inc.* No. 95-3945, 1996 U.S. Dist. LEXIS 19185, at *5 (E.D. La. Dec. 23, 1996) ("[T]he attorney-client privilege between an attorney and a client protects communications only to the extent the communications may disclose confidential information provided by the client for the purpose of facilitating legal advice."); *Evans v. Atwood*, 177 F.R.D. 1, 5 (D.D.C. 1997) ("[If the client] sought the opinion

advice indicates nothing about any motives or information the client conveyed to the firm confidentially in connection with the investment advice. Indeed, it appears that the law firm supplied the same advice to all its fee paying clients regardless of particular client circumstances.

In *United States v. Arthur Andersen, L.L.P.*⁷³ the district court for the northern district of Illinois applied the confidential communication exception in a similar manner to initially rule that Arthur Anderson (“Anderson”) could shield the identity of its clients from the Service.⁷⁴ In this case, the Service sought to enforce a summons against Anderson requesting a list of all clients that undertook certain transactions for which the Service believed Anderson was required to maintain a list pursuant to the Code and regulations.⁷⁵ In finding that the attorney-client privilege⁷⁶ applied to protect the names of the Anderson clients, the court, after reviewing certain documents *in camera*, stated:

Turning to the question whether revealing the clients’ identities would reveal their motives for seeking tax advice, we believe that the documents support the Intervenor’s position that it would. The IRS is seeking information, including the identities of the Poes and the Does, in an effort to determine whether or not Anderson was complying with the IRS regulations governing potentially abusive tax shelters. . . . Under these circumstances, it is difficult to see how revealing the identities of the Poes and the Does could amount to anything less than a revelation of their motivations in seeking

without disclosing any confidential information, the existence of the opinion and its contents are not privileged.”).

⁷³ 273 F. Supp. 2d 955 (N.D. Ill., 2003), amended, 2003 U.S. Dist. LEXIS 14228 (N.D. Ill. August 15, 2003).

⁷⁴ *Id.* The district court subsequently amended its original opinion and required Anderson to reveal the identity of its clients in light of the Seventh Circuit’s decision in *United States v. BDO Seidman*, 337 F.3d 802 (7th Cir. 2003) , *cert. denied*, ___ U.S. ___ (2004). The *BDO Seidman* case is discussed in detail in Parts III.C.2 and IV.B.2., *infra*.

⁷⁵ For a discussion of the list maintenance requirements and their interplay with the attorney-client privilege, see Parts IV.A.2. and B.2., *infra*.

⁷⁶ While Anderson was an accounting firm not historically covered by the attorney-client privilege, section 7525 of the Code extends the common law attorney-client privilege to federally authorized tax practitioners for periods after July 22, 1998.

Andersen's tax advice -- to invest in potentially abusive tax shelters. This motivation, the "very substantive reason that the client sought . . . advice in the first place," is confidential and therefore privileged under section 7525. *Cherney*, 898 F.2d at 568.⁷⁷

Shortly after the district court issued its pro-taxpayer ruling in *Arthur Anderson*, the Seventh Circuit rejected applying the client-identity privilege to another similarly situated accounting firm in *United States v. BDO Seidman* (discussed below).⁷⁸ In light of this opinion, the district court reversed its prior decision and ordered Anderson to disclose the identities of its clients.⁷⁹ However, in doing so the district court interpreted the Seventh Circuit's opinion as holding that the confidential communication exception could never apply to transactions governed by the investor list maintenance requirements of the Code and regulations.⁸⁰ Consequently, the district court did not reverse its position regarding how the confidential communication exception would have applied if it were available in such situations. Given the procedural posture of the *BDO Seidman* case and the fact that the case discusses alternative rationales for its decision, it is unclear whether the Seventh Circuit intended the case to be read as pronouncing an inflexible "no privilege" rule for transactions potentially subject to the Code's listing requirements. Consequently, the following section will discuss how the Seventh Circuit applied the confidential communication exception in *BDO Seidman*. The court's alternative rationale based on the investor list requirements will be discussed in Part IV.B.2, *infra*.

⁷⁷ *Arthur Andersen*, 273 F. Supp. 2d at 959-60.

⁷⁸ 337 F.3d 802 (7th Cir. 2003), *cert. denied*, ___ U.S. ___ (2004).

⁷⁹ *United States v. Arthur Andersen, L.L.P.*, 2003 U.S. Dist. LEXIS 14228 (N.D. Ill. August 15, 2003).

⁸⁰ *Id.* at *20 ("Thus, it appears that the Seventh Circuit intended in *BDO* to pronounce a generally applicable prohibition on the assertion of the identity privilege in IRS summons enforcement actions that does not seem altered by differing factual scenarios.").

[Note to editors: This discussion may need to be expanded if pro-taxpayer decisions are rendered in the pending Jenkins or Sidley cases (discussed *infra*) prior to publication.]

2. *The Pre Government Authority: BDO Seidman*

In *United States v. BDO Seidman*⁸¹ the Seventh Circuit examined substantially the same issue as in the *Arthur Anderson* case. BDO Seidman (“BDO”), an accounting firm, advised a number of clients regarding certain transactions that the Service believed qualified as potentially abusive tax shelters covered by certain client list maintenance requirements under the Code and regulations. In an effort to determine BDO’s compliance with obligations under these rules, the Service issued summonses requesting the client lists for twenty specified types of transactions. Certain BDO clients intervened to prevent the disclosure of their identities asserting that such information was protected from disclosure by the attorney-client privilege.⁸² The district court found that the clients’ identities would not be privileged and denied the motion to intervene. On appeal, the Seventh Circuit remanded the case back to the district court for the limited purpose of making explicit factual findings regarding the nature of BDO’s relationship with the clients (*e.g.*, was it tax advice, tax return preparation, or some other service being provided by BDO) and whether any privileged information was involved. In particular, one of the specified factual inquiries was “whether, in light of the purpose and history of BDO’s representation as well as the description of the transactions in the IRS summonses, revealing the appellants’ identities to the IRS necessarily would reveal the appellants’ motive for seeking tax

⁸¹ 337 F.3d 802 (7th Cir. 2003), *cert. denied*, ___ U.S. ___ (2004).

⁸² As in the *Arthur Anderson* case, the attorney-client privilege was involved due to the application of section 7525 of the Code, which extends the attorney-client privilege to accountants providing tax advice after July 22, 1998.

advice or the substance of that advice.”⁸³ Through this limited remand, the Seventh Circuit essentially directed the district court to address the confidential communication exception as a factual matter.

In reviewing various documents *in camera*, the district court found that no identity privilege existed for most of the clients because (1) BDO was also representing them for tax return preparation purposes, or (2) the relevant engagement and consulting agreements specifically stated that BDO was not providing any legal or tax opinions to its clients. Since the statutory version of the attorney-client privilege applicable to accountants only covers “tax advice,” the privilege would not extend to these clients.⁸⁴ Since no documents were produced in respect of the remaining clients, the district court made no factual determinations regarding them.

Considering the case in light of these factual findings, the Seventh Circuit affirmed the district court’s original conclusion that the BDO clients had not established a colorable claim for client-identity privilege, and therefore could not intervene. In so doing it noted that the clients bore the burden of proving that a colorable claim existed. The district court’s factual findings, together with the clients bearing the burden of proof, arguably could have disposed of the case without further elaboration.⁸⁵ Nevertheless, the Seventh Circuit’s opinion discusses two distinct grounds for its conclusion. First, the court found that disclosing the clients’ identities on these facts would not reveal any privileged information under the

⁸³ United States v. BDO Seidman, 2002 U.S. App. LEXIS 28092, *3 (7th Cir. Ill., Dec. 18, 2002).

⁸⁴ I.R.C. § 7525.

⁸⁵ That is, since the district court found that BDO was not providing tax advice to most of the clients the section 7525 tax advice privilege would not apply. Similarly, since no documents

confidential communication exception. Second, the court noted that the existence of the Service's client list maintenance requirements for the types of transactions involved removed any expectation of confidentiality (a *prima facie* requirement for applying the attorney-client privilege) the clients might otherwise have had.⁸⁶

It is striking that the *BDO Seidman* court and the *Arthur Anderson* court could come to such opposite conclusions regarding the application of the confidential communication exception in two cases with such similar facts. The *Arthur Anderson* court found that "it is difficult to see how revealing the identities of the [clients] could amount to anything less than a revelation of their motivations in seeking Andersen's tax advice -- to invest in potentially abusive tax shelters."⁸⁷ The Seventh Circuit stated in *BDO Seidman* that "[d]isclosure of the identities of the Does will disclose to the IRS that the Does participated in one of the 20 types of tax shelters described in its summonses. *It is less than clear, however, as to what motive, or other confidential communication of tax advice, can be inferred from that information alone.*"⁸⁸

Since the facts were substantially the same in both cases, the differences in result must be explained on other grounds. The cynical view is that the courts here are simply taking advantage of the inherently factual nature of the confidential communication exception to reach different results in accord with their own personal biases. However, as discussed in Part IV.B.3. below, this article maintains that the divergent results derive from the two courts applying different legal standards in analyzing the motive question under the confidential communication exception. This article asserts that both *Liebman* and *Arthur Anderson* misconstrued the

were provided for the remaining unidentified clients, it could be argued that they did not meet their burden of proof.

⁸⁶ The court's second rationale is discussed in Part IV.B.2., *infra*.

⁸⁷ *Arthur Andersen*, 273 F. Supp. 2d at 959-60.

relevance of the motive inquiry and therefore were wrongly decided. Consequently, the confidential communication exception generally should not protect client identity in the context of tax planning advice.

Under the status-as-client approach, however, both *Liebman* and *Arthur Anderson* would be correctly decided, while the *BDO Seidman* decision would reach the wrong result. The Service in these cases is essentially seeking the identity of clients solely for the purpose of linking them with the legal advice they received regarding specific transactions. This is exactly the situation where the status-as-client approach maintains client identity should be protected since seeking a client's status as a client is likely to dissuade some potential clients from seeking legal advice.⁸⁹ As discussed in part IV.C. below, however, this article argues that the status-as-client approach reaches an incorrect conclusion when applied to tax planning situations.

IV. Applicability of Client-Identity Privilege in Tax Shelter and Tax Planning Situations

Now that the basics of the attorney-client privilege and the confidential communication exception have been covered both generally and as they apply in certain tax situations, an examination of the Service's efforts to co-opt attorneys as part of its battle against abusive tax shelters can be undertaken. Part IV.A. reviews the tax shelter industry and the relevant responses of the Service. Part IV.B. argues that the attorney-client privilege should not protect client identity in tax shelter situations and highlights the various arguments under current law supporting this view. Part IV.C. presents a policy based justification for generally denying the client-identity privilege in *all* tax planning situations.

⁸⁸ BDO Seidman, 337 F.3d at 812 (emphasis added).

⁸⁹ Indeed, in discussing *Liebman* in the context of the status-as-client approach Professor Goode goes so far as to declare that the result reached by the Third Circuit was "undoubtedly correct." Goode, *supra* note 15, at 332.

A. *Placing the Client Identity Debate in Context*

Before analyzing whether the Service's actions in attempting to force attorneys to reveal the identities of "naughty" clients engaging in potentially abusive tax motivated transactions are proper, it is necessary to briefly describe the nature of the tax shelter industry and the Service's responses to it.

1. *Tax Shelter Industry*

The 1990's saw a veritable explosion of tax shelter activity on behalf of corporations and high net worth individuals.⁹⁰ While the revenue loss from this activity is hard to determine, the losses to the fisc have certainly been in tens of billions per year.⁹¹ While these transactions assumed a variety of forms and exploited many disparate provisions of the Code,

⁹⁰ See generally, Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999); *Treasury White Paper*, *supra* note 3; *Testimony of Stefan F. Tucker on Behalf of the Section of Taxation, American Bar Association, Before the Subcommittee on Oversight of the U.S. House of Representatives on the Subject of the Revenue Provisions in President's Fiscal Year 2000 Budget* (Mar. 10, 1999), reprinted in 52 TAX LAW. 577 (1999); James P. Holden, 1999 Erwin N. Griswold Lecture Before the American College of Tax Counsel: *Dealing with the Aggressive Corporate Tax Shelter Problem*, 52 TAX LAW. 369 (1999); Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1998 at 198; James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 136 (2002); David Cay Johnston, *Sham Shelters for Business Flourish as Scrutiny Fades*, N.Y. TIMES, Dec. 19, 2000, at A1; David Cay Johnston, *Big Accounting Firm's Tax Plans Help the Wealthy Conceal Income*, N.Y. TIMES, June 20, 2002, at A1; Tom Herman, *Tax Report*, WALL ST. J., Feb. 10, 1999, at A1; Anita Raghavan & Jacob M. Schlesinger, *Cat and Mouse: Wall Street Concocts New Tax-Saving Ploy; Then It's Feds' Turn*, WALL ST. J., Nov. 6, 1997, at A4.

⁹¹ See Bankman, *supra* note 90, at 1776. In early 2000, the Commissioner of the Service stated that by closing down just a handful of identified tax-shelter structures, the projected revenue savings was almost \$80 billion over ten years. See Lawrence H. Summers, *Summers Speech on Corporate Tax Shelters*, TAX NOTES TODAY, Feb. 29, 2000, LEXIS 2000 TNT 40-34, at ¶ 8. Also a recent study found that while corporate profits for the 250 largest U.S. companies rose by 23.5 percent from 1996 through 1998, federal corporate income tax revenues over the same period rose by only 7.7 percent. See Robert S. McIntyre & T.D. Co Nguyen, *ITEP Report on Corporate Tax Avoidance*, TAX NOTES TODAY, Oct. 20, 2000, LEXIS 2000 TNT 204-25.

they shared a number of common characteristics.⁹² In particular, such transactions normally were (1) developed by a promoter and actively marketed to clients, (2) used a supporting legal opinion describing the technical legal arguments for the favorable tax treatment, but (3) reached a result so at odds with understood tax principles and policies that the position would certainly be challenged if discovered by the Service. Consequently, a key – if sometimes unstated – element prompting the growth of such transactions was a cost-benefit analysis premised on the low risk of the Service actually discovering the transaction.⁹³ Indeed, such transactions were often purposely structured to be highly complex so their purpose would not be immediately obvious to an examining agent, or were crafted in such a manner as to not be readily apparent on the face of the taxpayer’s tax return.⁹⁴ This, coupled with the very low tax return audit rate in recent years,⁹⁵ placed the Service at a severe disadvantage in challenging the legitimacy of such transactions.

2. Relevant Registration and Listing Requirements

The primary response by the Service and Congress to the tax shelter industry has been to increase the disclosure requirements for potentially abusive transactions so that the Service can more easily identify them and address any loopholes or uncertainties in the law that

⁹² See Bankman, *supra* note 90, at 1777; Richard Lavoie, *Deputizing the Gunslingers: Co-opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 VA. TAX REV. 43, 49-50 (2001).

⁹³ See Lavoie, *supra* note 92, at 53-55.

⁹⁴ Minority Staff of the Senate Governmental Affairs Permanent Investigations Subcommittee, *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals*, TAX NOTES TODAY, Nov. 19, 2003, LEXIS 2003 TNT 223-20, ¶ 40 [hereinafter *Tax Shelter Industry*]; Noel B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 57 TAX L. REV. ___, ___, (forthcoming 2004) (noting that tax shelters often intentionally employ complex structures to “obfuscate” transactions).

⁹⁵ The Service currently audits less than 0.6 percent of all income tax returns. Pamela J. Gardiner, *TIGTA Reviews IRS’s “Falling” Examination Rate*, TAX NOTES TODAY, June 25, 2002, LEXIS 2002 TNT 123-23. Even audits of large corporate taxpayers declined “significantly” between 1997 and 2002. JOINT COMM. ON TAXATION, REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE

promoters are exploiting with their transactions.⁹⁶ These efforts have placed the Service in direct conflict with attorneys and accountants over the scope of the attorney-client privilege as it applies to these transactions and the identity of their clients. This section describes the relevant disclosure provisions that are currently being applied to the tax shelter transactions.

The Service's anti-tax shelter disclosure efforts have their genesis in three sections of the Code: Sections 6011, 6111, and 6112. Section 6011 provides the Service with general authority to specify the information that must be supplied on federal tax returns. Using this authority, the Service now requires that taxpayers affirmatively disclose "reportable transactions" on their yearly tax returns using Form 8886. Sections 6111 and 6112 were originally enacted in 1984 to address a specific type of tax shelter activity prevalent in the 1970's and 1980's. Section 6111 requires organizers of tax shelters to register the shelter with the Service. However, the transactions specified as "tax shelters" for this purpose are fairly limited.⁹⁷ Consequently, the Service has had little success in applying these registration requirements to tax shelters developed in recent years. Section 6112 requires any "organizer" or "seller" of a "potentially abusive tax shelter" to maintain a list identifying all persons who acquired interests in the shelter together with "such other information as the Secretary may by regulations require." Such lists must be maintained for seven years and must be provided to the

IRS REFORM AND RESTRUCTURING ACT OF 1998, 37 (JCX-53-03) (2003) [available at, <http://www.house.gov/jct/x-53-03.pdf>].

⁹⁶ See *Aggressive Actions*, *supra* note 3. However, given the current climate regarding statutory interpretation, it can be argued that increased disclosure and reactive changes in the law will be insufficient to curb tax shelter activity. See, Richard Lavoie, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, 75 COLO. L. REV. 115, 152-54, 188 (2004).

⁹⁷ Generally section 6111 requires registration for (1) a narrow type of transaction used in the 1970's and 1980's and, after 1997 for (2) confidential corporate transactions that have a "significant purpose" of tax avoidance.

Service upon request.⁹⁸ Significantly, the definition of a “potentially abusive tax shelter” is left almost entirely up to the Service’s discretion. All that is required by statute is that the Service identify in its regulations the transaction as “having a potential for tax avoidance or evasion.” It is this broad grant of authority that the Service is primarily utilizing to force attorneys, accountants, and other promoters to identify clients participating in aggressive tax planning transactions.

The Service first issued expanded regulations under section 6112 in February of 2000.⁹⁹ These regulations have been modified several times in the last few years as the Service attempted to refine the types of transactions covered and the scope of the disclosure required. Consequently, this article will focus on the investor list regulations that are currently in effect.¹⁰⁰ The final regulations require an investor list to be maintained for (1) any tax shelter subject to registration under section 6111 or (2) any “reportable transaction.”¹⁰¹

As a general matter, a reportable transaction is any transaction falling into any one of the following categories:

1. any transaction that is the same or “substantially similar”¹⁰² to any transaction identified by the Service as a tax avoidance transaction in its published guidance (a “listed transaction”);

⁹⁸ Treas. Reg. § 301.6112-1.

⁹⁹ Treas. Dec. 8875, 65 Fed. Reg. 11211 (March 2, 2000).

¹⁰⁰ See Treas. Dec. 9046, 68 Fed. Reg. 10161 (March 4, 2003), as amended by, Treas. Dec. 9108, 68 Fed. Reg. 75128 (Dec. 30, 2003).

¹⁰¹ Treas. Reg. § 301.6112-1.

¹⁰² For these purposes “substantially similar” is defined broadly to mean any transaction that is expected to obtain the same or similar types of tax consequences and is either factually similar or based on a similar tax strategy. Treas. Reg. § 301.6112-1(d)(2), 1.6011-4(c)(4) The regulations also indicate that the phrase is to be construed broadly in favor of disclosure.

2. any transaction where an advisor receiving fees in excess of a threshold places limitations on the taxpayer's disclosure of the tax treatment or tax structure of the transaction to protect the confidentiality of the advisor's tax strategies (a "confidential transaction");
3. any transaction where the taxpayer has the right to a partial refund of certain fees or such fees are contingent on the realization of tax benefits by the taxpayer (a "contractual protection transaction");
4. any transactions generating tax losses in excess of certain thresholds for a single year or a combination of years (a "loss transaction");
5. any transaction where the amount of income, gain, expense, or loss for federal tax purposes from the transaction differs by more than \$10 million on a gross basis from the amount reportable for accounting purposes in any tax year (a "book-tax difference transaction"); or
6. any transaction resulting in the taxpayer claiming a tax credit exceeding \$250,000 if the underlying asset giving rise to the credit is held by the taxpayer for 45 days or less (a "brief asset holding period transaction").

While most commentators find these classifications of reportable transactions to be reasonable, the reach of who must maintain an investor list in respect of such transactions has given the practicing bar pause.¹⁰³ While the statute imposes the listing obligation on any person who "organizes" or "sells" a specified transaction, the regulations define an organizer or seller for these purposes to include any "material advisor." In general, a person is a material adviser if she will receive at least a minimum fee¹⁰⁴ and makes a "tax statement" regarding the transaction

¹⁰³ See, e.g., Steven M. Rosenthal and Jeanne K. Falstrom, *Me, A Material Adviser? What Now?*, 98 TAX NOTES 1749 (Mar. 17, 2003); Steven K. Hazen & Nancy H. Wojtas, *California Bar Attorneys Comment on Tax Shelter Reporting, List Maintenance Rules*, TAX NOTES TODAY, Jan. 21, 2004, LEXIS 2004 TNT 13-37.

¹⁰⁴ The minimum fee varies depending on the type of person and reportable transaction involved. For a listed transaction the minimum fee is \$25,000 if solely corporate taxpayers are involved and \$10,000 otherwise. For all other types of reportable transactions the minimum fee is \$250,000 if solely corporate taxpayers are involved and \$50,000 otherwise. For these

to (or for the benefit of) a person participating in a reportable transaction.¹⁰⁵ A tax statement is any statement, written or oral, that relates to the tax aspect of a transaction that causes the transaction to be a reportable transaction.¹⁰⁶ As a result of this definition, most attorneys advising on the taxation of a reportable transaction would be material advisors required to maintain investor lists.¹⁰⁷

Finally, the regulations specify a wide variety of information that must be maintained as part of the investor list. In addition to the normal information that would be expected (*e.g.*, the investor's name, address, date of transaction and amount invested), the regulations require the material advisor to provide information regarding the structure and anticipated tax effect of the transaction, including:

1. a detailed description of each transaction that describes both the tax structure and its expected tax treatment;
2. a summary or schedule of the tax treatment that each person is intended or expected to derive from participation in each transaction, if known by the material adviser; and
3. copies of any written materials, including tax analyses or opinions, relating to each transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or might have acquired an interest in the transactions, or to their representatives, tax advisers, or agents, by the material adviser.

purposes all fees paid for any effectuating the transaction or providing other services or advice (whether or not tax advice) are included. Treas. Reg. § 301.6112-1(c)(3)(iii).

¹⁰⁵ Treas. Reg. § 301.6112-1(c)(3)(iii).

¹⁰⁶ Treas. Reg. § 301.6112-1(c)(2)(i).

¹⁰⁷ However, the regulations make clear that an advisor consulted after the purported benefit of the reportable transaction has already been reflected on a taxpayer's tax return would not be required to maintain an investor list. Treas. Reg. § 301.6112-1(c)(2)(iv).

Further, the Service maintains that when it requests a copy of the list an attorney can only assert the attorney-client privilege for information in the third category listed above.¹⁰⁸ Consequently, under the regulations the Service is essentially asserting that for reportable transactions a client's identity, as well as the structure and intended tax effect of the transaction actually entered into, can *never* be protected under the attorney-client privilege.

3. *Pending Identity Privilege Cases and Possible Legislation*

The Service's promulgation of these detailed investor list maintenance requirements were intended to provide a trail to potentially abusive transactions and the particular taxpayers engaging in them. However, these rules are only effective if promoters and taxpayers comply with their disclosure obligations. In point of fact, the promoters of tax shelter transactions have gone to great lengths to avoid complying with their reporting obligations under these rules.¹⁰⁹ Indeed, in one documented case an employee at a major accounting firm affirmatively advocated that the firm willfully ignore its reporting obligations based on a cost-benefit analysis showing that the profits from marketing the transaction would far outweigh any penalties owed if the non-reporting were discovered.¹¹⁰ As a result of what appears to have been widespread planning to avoid, or in some cases knowingly disregard, these listing and disclosure requirements, the Service began formal compliance audits of suspected promoters and began legal action to obtain client names in early 2002.¹¹¹ The *BDO Seidman* and *Arthur Anderson* cases arose out of attempts by the Service to enforce summonses requesting information

¹⁰⁸ See Treas. Reg. § 301.6112-1(g)(2); Treas. Dec. 9046, 68 Fed. Reg. 10161, 10163 (March 4, 2003) ("This change reflects the IRS and Treasury Department's belief that the other information covered by these regulations is not privileged.").

¹⁰⁹ *Tax Shelter Industry*, *supra* note 94, at ¶ 38-43, 257-80.

¹¹⁰ *Id.* at ¶ 39.

regarding allegedly reportable transactions issued in such compliance audits. At the same time, the Service also began compliance audits of several law firms. Two of these law firms (Jenkins & Gilchrest and Sidley, Austin, Brown & Wood) have refused to respond to summonses requesting the names of clients who consummated particular types of transactions by asserting that such information is protected by the attorney-client privilege.¹¹² While both these cases are pending in Illinois district courts, and therefore the Seventh Circuit's decision in *BDO Seidman* would be controlling precedent, the law firms maintain that their cases are different based both on the facts and because a law firm is involved rather than an accounting firm.

Finally, in its 2005 budget proposals the Bush Administration has suggested legislation to "clarify" that neither the attorney-client privilege nor the tax practitioner privilege under section 7525 apply to protect a client's identity from disclosure under the section 6112 investor list maintenance requirement.¹¹³ It is currently unclear whether this proposal ultimately will be enacted by Congress.

¹¹¹ *Aggressive Actions*, *supra* note 3, at ¶ 6. Indeed, in a prior article I advocated that the Service undertake just such compliance audits as a means of uncovering abusive transactions and providing an appropriate audit trail for the Service. Lavoie, *supra* note 92, at 87-88.

¹¹² *DOJ Files Petition to Enforce Summonses Issued to Jenkins & Gilchrist*, TAX NOTES TODAY, Aug. 15, 2003, LEXIS 2003 TNT 158-4 [hereinafter *Jenkins Petition*]; *Justice Petitions to Enforce John Doe Summons Against Sidley Austin*, TAX NOTES TODAY, Jan. 2, 2004, LEXIS 2004 TNT 1-15 [hereinafter *Sidley Petition*].

¹¹³ Neither section 6112 nor its legislative history specifically refer to the attorney-client privilege or how it might apply to an attorney required to maintain an investor list. The legislative history to section 6111, adopted at the same time as 6112, acknowledges that while attorneys would not normally be "organizers" of transactions for purposes of that provision, the Service has authority to treat them as organizers in appropriate cases. JOINT COMM. ON TAXATION, 98th Cong., 2d Sess., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 477 (Comm. Print 1984). Consequently, it is likely that Congress contemplated that the Service might require attorneys to maintain investor lists under section 6112 in some situations. However, in the absence of an explicit indication from Congress that the attorney-client privilege was to be superceded, the normal presumption would be that the privilege rules would continue to apply despite the fact that attorneys might generally

B. Attorney-Client Privilege Does Not Shield Identity in Tax Shelter Transactions

The prior discussion has outlined the basics of the attorney-client privilege and how the confidential communication exception has been applied in the client identity context. This section demonstrates that the client-identity privilege is unlikely to apply in tax shelter situations. In particular, at least one of the alternative rationales discussed below is likely to foreclose the application of the privilege.

1. Attorney Acting in Promoter Role

Client identity is normally not protected by the attorney-client privilege because the required conditions for applying the privilege are simply not present when identity itself is at issue. As we have seen, to make out a *prima facie* case for the privilege (1) a client (2) must have communicated, for the purpose of (3) seeking legal advice, (4) confidentially (5) with a lawyer in her attorney capacity.¹¹⁴ In the case of client identity, the argument can be made that a number of these prerequisites are not satisfied. For instance, it is sometimes maintained that since a client's identity is usually conveyed to the attorney as an introductory matter before the legal consultation begins, it is not conveyed confidentially nor is it conveyed to the attorney in her legal capacity since the attorney-client relationship has arguably not yet been formed when the information is conveyed.¹¹⁵ On a related theme, it can be asserted that the client's name is

be covered by the provision. This is similar to the situation under section 6050I (which was also enacted in 1984) where attorneys have an obligation to report large cash transactions, but where the courts nevertheless have still found it necessary to analyze whether the attorney-client privilege might be applicable before requiring disclosure. *See* Part III.A., *supra*.

¹¹⁴ WIGMORE, *supra* note 6, § 2292, at 554.

¹¹⁵ *See* sources cited in note 26, *supra*.

not communicated to the attorney in confidence because either the client is already known to the attorney or the identity will likely become known at some point in the representation.¹¹⁶

While such arguments are frequently criticized by commentators, they nevertheless appear to form the basis for the accepted position that, absent unusual circumstances, client identity is not covered by the attorney-client privilege.¹¹⁷ However, as we have seen, while client identity may not be privileged in its own right under the traditional formulation of the attorney-client privilege, the confidential communication exception can override this conclusion if revealing a client's name would derivatively reveal some other confidential communication covered by the privilege. Consequently, by themselves, none of these arguments could result in a conclusive determination that a particular client's identity is not privileged.

On the other hand, a conclusive determination could be reached in situations where it is shown that an attorney is acting in a non-legal capacity. In such circumstances neither the *prima facie* case nor the confidential communication exception can be satisfied because *none* of the communications between the attorney and the client would be eligible for protection. No true attorney-client relationship exists if the nature of their consultations are non-legal.

In a tax shelter situation, an attorney may be acting essentially as a promoter selling "cookie cutter" tax saving strategies to clients.¹¹⁸ As a result, attorneys actively engaging

¹¹⁶ WIGMORE, *supra* note 6, § 2313, at 609

¹¹⁷ *See, e.g.*, Glanzer & Taskier, *supra* note 28, at 1077-78.

¹¹⁸ *See, Tax Shelter Industry*, *supra* note 94, at ¶ 12 ("[T]he industry focus has expanded to developing a steady supply of generic "tax products" that can be aggressively marketed to multiple clients. In short, the tax shelter industry has moved from providing one-on-one tax

in tax shelter promotion may be particularly vulnerable to claims that no privilege exists for any communications associated with these transactions. Indeed, in its two pending enforcement actions against law firms the Service has stressed the promoter role of the firms.¹¹⁹ These law firms can be expected to deny promoter classification.¹²⁰ Alternatively, they can argue that even if some element of their relationship with clients was non-legal in nature, the fact that legal opinions were rendered to clients indicates that a legal relationship existed that could give rise to confidential communications covered by the privilege.

The main area where the courts have struggled with how the attorney-client privilege applies to mixed purpose relationships is in the context of in-house counsel, where business and legal advice are often mixed.¹²¹ The general rule arising out of this case law is that for the privilege to apply to a communication the “advice given must be predominantly legal, as opposed to business, in nature.”¹²²

advice in response to tax inquiries to also initiating, designing, and mass marketing tax shelter products.”). Indeed, in extreme cases where the attorney provides only a “canned” opinion to a client that is based on a hypothetical fact pattern, rather than specific facts communicated by the client, it could be legitimately argued that there are simply no client confidential communications that exist to be protected even if a true attorney-client relationship exists. See sources cited in note 72, *supra*.

¹¹⁹ See *Jenkins Petition*, *supra* note 112; *Sidley Petition*, *supra* note 112.

¹²⁰ See, e.g., William P. Durbin, *Jenkins & Gilchrist Accuses Government Of ‘End Run’ Around Client Confidentiality Principle*, TAX NOTES TODAY, Aug. 15, 2003, LEXIS 2003 TNT 158-22.

¹²¹ See generally, Grace M. Giesel, *The Legal Advice Requirement of the Attorney-Client Privilege: A Special Problem for In-House Counsel and Outside Attorneys Representing Corporations*, 48 MERCER L. REV. 1169 (1997) and the cases cited therein.

¹²² *Itoba, Ltd. v. LEP Group PLC*, 930 F. Supp. 36, 43 (D. Conn. 1996). See also *Sedco Int’l, S.A. v. Cory*, 683 F.2d 1201, 1205-06 (8th Cir.), *cert. denied*, 459 U.S. 1017 (1982) (“primarily legal advice”); *Griffith v. Davis*, 161 F.R.D. 687, 697 (C.D. Cal. 1995) (“primarily for the purpose of generating legal advice”) (quoting *McCaugherty v. Siffermann*, 132 F.R.D. 234, 238 (N.D. Cal. 1990)); *Pippenger v. Gruppe*, 883 F Supp. 1201, 1207 (S.D. Ind. 1994) (communications “primarily for the purpose of securing legal opinions and legal services”)

While it might seem easy for an outside law firm advising a client on tax matters to prove that their role was predominately legal (*e.g.*, the structuring of a transaction in light of tax considerations), a district court for the western district of North Carolina has found that the attorney-client privilege did not apply in a tax shelter context to a law firm acting as a promoter. In *John Doe v. Wachovia Corp.*,¹²³ the Service was investigating certain alleged tax shelter transactions advised on by the law firm of Jenkins & Gilchrist (“Jenkins”) and the accounting firm KPMG. As part of its investigation the Service attempted to obtain client list information from Jenkins and KPMG, but encountered delays in obtaining the information due to assertions of privilege.¹²⁴ Consequently, the Service requested that Wachovia, a large financial institution that facilitated these transactions for Jenkins and KPMG clients, provide information regarding the clients who consummated the subject transactions.¹²⁵ Wachovia determined that it legally needed to comply with the Service’s request. Several unidentified clients then sued Wachovia to enjoin it from disclosing their identities.¹²⁶ The various plaintiffs maintained either that (1) Wachovia had communicated confidential information to Jenkins and KPMG on their behalf and that forcing Wachovia to reveal their identities would reveal communications covered by the attorney-client privilege¹²⁷ or (2) that they had conveyed confidential information to Jenkins

(quoting *United States v. Loftin*, 518 F. Supp. 839, 846 (S.D.N.Y. 1981)); *Cuno, Inc. v. Pall Corp.*, 121 F.R.D. 198, 201 (E.D.N.Y. 1988)(“primary purpose of the communication”).

¹²³ 268 F. Supp. 2d 627 (W.D.N.C. 2003).

¹²⁴ See Sheryl Stratton, *Privilege Sidelines Shelter Actions, Gov’t Changes Tack*, 100 TAX NOTES 295 (July 21, 2003) (“A year after the IRS began taking shelter promoters to court, the summons enforcement actions are bogged down in litigation over privilege issues.”).

¹²⁵ Wachovia, 268 F. Supp. 2d at 629.

¹²⁶ As a result, the case has a somewhat unusual procedural posture in that neither the Service nor Jenkins were actual parties to the suit.

¹²⁷ Wachovia, 268 F. Supp. 2d at 629.

who then retained Wachovia and shared the information with it as part of facilitating the transactions.¹²⁸

Rather than engage in an examination of the underlying communications involved to determine whether the confidential communication exception applied, the district court concluded that the relationship between the unidentified clients and KPMG and Jenkins simply did not indicate the existence of any attorney-client relationship to which the privilege could obtain.¹²⁹ After detailing its examination of the various retention agreements between the parties, the court concluded:

J&G with whom [Plaintiffs] claim an attorney-client relationship, appears to have merely sold a package to them which contained a description of the transaction and a memorandum as to the potential tax consequences stemming from the transaction. The “Executive Summary” of the transaction contains a general description of how to structure such a transaction; there is nothing uniquely tied to the individual taxpayer’s financial situation. Indeed, no financial information pertaining to any taxpayer has been inserted into the formula. Nor is there any evidence that any individual taxpayer ever had so much as a conversation with an attorney at J&G. . . .

Indeed, the same description and opinion memorandum was distributed throughout the country to taxpayers. Moreover, it was delivered, not by J&G, but by Wachovia. “The attorney-client privilege is not intended to permit ‘an attorney to conduct his client’s business affairs in secret.’” [In re Grand Jury Subpoena, 204 F.3d 516, 522 (4th Cir. 2000)] (quoting In re Grand Jury Subpoenas (Hirsch), 803 F.2d 493, 496 (9th Cir. 1986)). And, ‘a client may not “buy” a privilege by retaining an attorney to do something that a non-lawyer could do just as well.’” Id., at 523 (quoting Federal Rules of Evidence Manual 698 (7th Ed. 1998)). Indeed, in this case there is no evidence that J&G was (1) retained by the client, as opposed to by Wachovia; (2) contacted by the client, except through Wachovia; (3) providing legal advice based

¹²⁸ *Id.* at 630.

¹²⁹ *Id.* at 633 (“[T]he issue is whether [the Plaintiffs] had an attorney-client relationship with J&G. The Court cannot conclude that such a relationship existed.”).

on individual financial information, as opposed to selling a tax advantaged structure; and (4) by the terms of its own agreement, acting as an attorney for the “client.” The Court finds that the taxpayers cannot manipulate the privilege in such a manner.¹³⁰

The court’s position seems to have been influenced at least in part by language in the retention agreements that required the clients to keep the tax strategies presented to them confidential for the benefit of Jenkins in protecting these proprietary transactions, a fact clearly not indicative of a normal attorney-client relationship. While the facts described by the *Wachovia* court are somewhat extreme (*e.g.* the issuance of “cookie cutter” opinions without any client specific facts or even evidence that the clients spoke with the Jenkins attorneys), the marketing of tax shelters has become such a lucrative business for certain law firms that such apparently extreme facts may turn out to be somewhat common. Even in less extreme situations, it is possible to see how a court could find that the predominate purpose of the relationship between a client and a promoting attorney would be a non-legal one.

Courts could also reach the opposite conclusion though. For instance, in *Liebman* the Third Circuit explicitly rejected the argument that the client-identity privilege would not apply if the attorney was also acting in a non-legal capacity. In that case the Service maintained that the law firm was acting as a broker in selling tax advantaged partnerships and therefore the attorney-client privilege could not apply to the identity of the clients. The Third Circuit rejected this contention on the ground that even if a non-legal relationship also existed, that would not foreclose asserting the privilege for the law firm’s legal conclusion that fees paid by clients were

¹³⁰ *Id.* at 634-35.

deductible.¹³¹ However, the *Liebman* court's authority for this position (*NLRB v. Harvey*¹³²) is unpersuasive.

In *Harvey* an attorney hired a detective at an unidentified client's request to follow a union organizer. When several employees of a local company were fired after speaking with this organizer, the National Labor Relations Board began an investigation and ordered the attorney to reveal his client. The Fourth Circuit noted that merely using an attorney to hire a detective as a means to shield the activity from scrutiny would be an improper use of the attorney-client privilege. In remanding back to the district court for purposes of holding a detailed evidentiary hearing on the question, the court directed:

If the District Judge finds from the nature and character of Harvey's employment that Harvey was retained by his client to render a legal opinion, perform a legal service or afford representation in legal proceedings and *as an incident to this employment* he hired the detective, the privilege should be recognized. On the contrary, if Harvey was engaged to obtain information for his client without being retained to furnish a legal opinion, services or representation, in connection with the request for information, the privilege does not exist and he must disclose the name of his client and comply with the subpoena.¹³³

The language of the *Harvey* court indicates that the client's identity would be privileged if the non-legal services were incidental to the legal employment. This accords with the predominate purpose approach which generally governs whether particular communications are protected by the attorney-client privilege in mixed motive situations.¹³⁴ Consequently, to read *Harvey* as announcing a categorical rule that client identity is privileged as long as any legal services are undertaken, as the *Liebman* decision does, seems questionable.

¹³¹ *Liebman*, 742 F.2d at 810 n.3.

¹³² 349 F.2d 900 (4th Cir. 1965).

In any event, it is clear that many situations exist where an attorney will advise a client regarding a reportable transaction without acting predominately as a promoter. Consequently, other rationales would be necessary to overcome a claim of identity privilege in such less extreme cases.

2. *No Reasonable Expectation of Confidentiality*

In order to establish a *prima facie* case for the attorney-client privilege it is necessary to show that the client expected his communications to be confidential.¹³⁵ Consequently, if taxpayers lack a legitimate expectation of privacy regarding tax shelter transactions, then there would be no privilege for their identity, the fact that they sought legal advice, or the nature of the tax shelter transaction. In light of the disclosure and investor list maintenance rules embodied in the Code and regulations, there is a strong argument that taxpayers cannot have a legitimate expectation of privacy for transactions likely to be covered by those rules.

Before turning to the impact of the list maintenance regulations, it is helpful to consider whether the fact that the taxpayer engages in a tax shelter is itself confidential information. Under the self-assessment tax system used in the United States, it is the taxpayer who must determine how the law applies to her circumstances and then she must report the positions taken to the Service by filing an annual tax return. Consequently, taxpayers understand that they must report their transactions and the claimed tax treatment (whether aggressive or not)

¹³³ *Id.* at 907 (emphasis added).

¹³⁴ *See* note 122, *supra*.

¹³⁵ *See, e.g.,* McDonald v. St. Joseph's Hosp. of Atlanta, Inc., No. C80-1295A, 1982 U.S. Dist. LEXIS 14662, at *11 (N.D. Ga. Sept. 20, 1982) ("The privilege does not attach unless the information and documents involved were intended as confidential communication at the time they were made.").

to the Service. Thus, the fact that a transaction is undertaken, and the tax consequences the taxpayer believes flow from it, are never matters that a taxpayer would expect to be confidential from the Service.

However, the mere fact that the underlying information is not confidential is generally not sufficient to reject an application of the attorney-client privilege.¹³⁶ By its nature the attorney-client privilege does not protect *facts* from discovery. Rather, it protects a client and his counsel from being forced to reveal that those facts were *communicated* to his attorney.¹³⁷ Thus, if a client saw Mr. X commit a crime and discusses the legal consequences of being an eyewitness to the crime with his attorney, the client cannot refuse to testify about Mr. X's actions by asserting the attorney-client privilege. However, the client can prevent his attorney from revealing that the client *communicated* his knowledge of Mr. X's actions to the attorney. Consequently, the relevant question in determining whether the client's confidential communication is privileged is whether the client legitimately expected that the attorney could not be forced to disclose that communication.

When a tax shelter is involved, answering that question requires an analysis of the impact of the disclosure rules under section 6112. If these rules, as implemented by the Service's regulations, remove any legitimate taxpayer expectation that an attorney would be able to keep the client's identity and the nature of the tax shelter transaction confidential from the

¹³⁶ Some courts have, however, misinterpreted the scope of the attorney-client privilege and found no privilege for the communication of non-confidential information. *See generally*, Paul R. Rice, *Attorney-Client Privilege: Continuing Confusion About Attorney Communications, Drafts, Pre-Existing Documents, And The Source Of The Facts Communicated*, 48 AM. U.L. REV. 967, 979 n. 53 (1999) (listing cases where courts have misapplied the attorney-client privilege in this context).

¹³⁷ *Id.* at 970 ("The basic privilege only protects client communications with the attorney; the privilege does not protect the underlying facts in these communications.").

Service, then no privilege can apply.¹³⁸ The Seventh Circuit, after an examination of the legislative history of section 6112 and the general policy of disclosure underlying the self-assessment tax system, has concluded that taxpayers in this situation generally cannot form a legitimate expectation of confidentiality.

[T]he Does' participation in potentially abusive tax shelters is information ordinarily subject to full disclosure under the federal tax law. Congress has determined that tax shelters are subject to special scrutiny, and anyone who organizes or sells an interest in tax shelters is required, pursuant to I.R.C. section 6112, to maintain a list identifying each person to whom such an interest was sold. This list-keeping provision precludes the Does from establishing an expectation of confidentiality in their communications with BDO, an essential element of the attorney-client privilege and, by extension, the section 7525 privilege. At the time that the Does communicated their interest in participating in tax shelters that BDO organized or sold, the Does should have known that BDO was obligated to disclose the identity of clients engaging in such financial transactions. Because the Does cannot credibly argue that they expected that their participation in such transactions would not be disclosed, they cannot now establish that the documents responsive to the summonses, which do not contain any tax advice, reveal a confidential communication.¹³⁹

The Seventh Circuit's ruling is especially sweeping in light of the underlying factual background. Here, the relevant pleadings make clear that BDO maintained that many of the transactions were *not* reportable transactions subject to the investor list maintenance rules.¹⁴⁰

¹³⁸ Note that this argument does not require a finding that Congress intended section 6112 to supercede the attorney-client privilege. The premise of the argument here is that in light of the section 6112 regulations and the general requirement of taxpayer disclosure in our self-assessment tax system, taxpayers should have anticipated that attorneys could be forced to divulge information about reportable transactions and the clients involved in them. Consequently, while the attorney-client privilege is still potentially available despite the enactment of section 6112, the reality of how the Service has implemented that provision would normally negate a crucial element (*i.e.*, the expectation of confidentiality) that a taxpayer would need to prove for the privilege to apply.

¹³⁹ BDO Seidman, 337 F.3d at 812 (citations omitted).

¹⁴⁰ See, e.g., *IRS Agent Declaration In Support Of Justice Department BDO Seidman Enforcement Actions*, TAX NOTES TODAY, July 16, 2002, LEXIS 2002 TNT 136-7.

As a result, BDO presumably advised clients that it would not maintain a list and that the clients would not have to disclose the transactions on their own tax returns pursuant to section 6011 as reportable transactions. Indeed, actively avoiding the list maintenance requirements was essentially an industry pre-requisite for any promoted tax shelter transaction since clients would be reluctant to engage in transactions requiring explicit taxpayer and promoter disclosure.¹⁴¹ Consequently, the Seventh Circuit essentially held that even taxpayers who were advised that their transactions would not be covered by the listing rules still could not form a legitimate expectation of confidentiality. Presumably this sweeping conclusion is attributable to the broad reach of the section 6112 regulations, which can cause tax motivated transactions to retroactively become reportable transactions.¹⁴²

3. *No Privileged Client Communication is Revealed by Identifying Clients*

Assuming that, despite the forgoing arguments, a taxpayer can establish a *prima facie* case for applying the attorney-client privilege to tax shelter transaction, it is necessary to evaluate whether the confidential communication exception will protect the taxpayer's identity. While the outcome under the confidential communication exception often appears driven by an *ex post* evaluation of the relevant facts, the nature of the attorney-client relationship in tax planning situations is such that the specific factual background becomes less important. Essentially, when tax planning is involved there are very few instances where revealing a client's identity would reveal a motive actually eligible for protection under the attorney-client privilege.

¹⁴¹ See, *Tax Shelter Industry*, *supra* note 94, at ¶ 39.

¹⁴² In particular, the regulations require investor lists to be maintained for transactions that are "expected" to be reportable transactions and also applies retroactively to transactions that the Service eventually identifies as "listed transactions" in published guidance even if they would not have qualified as reportable transactions when originally entered into. Treas. Reg. § 301.6112-1(c)(2)(i)(A)-(B) and (b)(2)(iii).

The reason for this requires taking a closer examination of the proper legal standard involved in applying the confidential communication exception.

As commonly phrased, the confidential communication exception protects a client's identity when revealing that identity would reveal the client's motive for seeking legal advice. This formulation implicitly assumes that a client's motive in seeking advice is a confidential communication worthy of protection by the privilege. However, there are situations where merely knowing a client's motive in seeking legal advice does not reveal any confidential communication that should be protected by the attorney-client privilege. Consequently, this article asserts that under the confidential communication exception, the fact that a client's motive in seeking legal advice would be revealed should only be the first step in the analysis. To properly effectuate the purpose of the confidential communication exception, a court must also determine that such revealed motive *in fact* represents a confidential communication protected by the attorney-client privilege. This two step approach to analyzing motive when applying the confidential communication exception will be referred to as the "confidential motive requirement."

The confidential motive requirement can be used to explain the divergent results in the *BDO Seidman*, *Arthur Anderson* and *Liebman* cases. *Liebman* and *Arthur Anderson* were focused narrowly on whether *any* motive would be revealed (*e.g.*, a motive of aggressive tax planning), and upon finding such a motive these courts applied the client-identity privilege. The court in *BDO Seidman* appears to have gone further and questioned the relevance of the allegedly disclosed motive. While the court was not explicit in enunciating its logic, the language of the *BDO Seidman* opinion can be read as acknowledging the confidential motive requirement. In particular, the Seventh Circuit stated:

[T]he Does submit that the IRS' summonses set forth such detailed descriptions about suspect types of tax shelters under investigation that any document produced in response that also reveals a client's identity will inevitably reveal that client's motivation for seeking tax advice from BDO. The Does define their "*motive*" for retaining BDO's services as the "desire to engage in financial transactions which the government might later decide to be questionable, or . . . 'potentially abusive.'" Appellants' Br. at 16. Because a client's "*motive*" for seeking legal advice is considered a confidential communication, the Does contend that the section 7525 privilege should protect against the disclosure of their motive for seeking tax advice, a motive that would be known if their identities are revealed.

The Does have not established that a *confidential communication* will be disclosed if their identities are revealed in response to the summonses. Disclosure of the identities of the Does will disclose to the IRS that the Does participated in one of the 20 types of tax shelters described in its summonses. *It is less than clear, however, as to what motive, or other confidential communication of tax advice, can be inferred from that information alone.* Compared to the situations in the *Tillotson* and *Cherney* cases, where the Government already knew much about the substance of the communications between the attorney and his unidentified client, in this case the IRS *knows relatively little about the interactions between BDO and the Does, the nature of their relationship, or the substance of their conversations.*¹⁴³

This passage makes clear that the court understands that revealing the identities of BDO's clients will directly link them with particular transactions which the Service has identified as aggressive tax motivated transactions. The court also notes that the clients assert that engaging in such aggressive transactions constituted their motive in seeking BDO's advice. Nevertheless, the court finds that it is not clear that any *confidential* motive or advice protected by the attorney-client privilege would be disclosed by revealing the client's identities. The court is essentially indicating that the "motive" asserted by BDO's clients is not a confidential motive protected by the attorney-client privilege. The fact that the court places quotation marks around the term "motive" in discussing the position of the BDO clients further emphasizes this point.

Similarly, by focusing on the relationship between the clients and the accounting firm the court is suggesting in this quotation that the mere disclosure of the *existence* of a tax planning relationship is not enough to invoke the confidential communication exception. There must be something more that ties the existence of the relationship to some confidential communication revealed within it. This need for some additional fact to link the clients' identities to a confidential communication is highlighted by the court's reference to *Cherney* and *Tillotson*. Both *Cherney* and *Tillotson*¹⁴⁴ involved situations where an action outside the mere fact of representation was relevant to finding that a confidential communication would be revealed. Thus in *Cherney* it was known that the unidentified client paid for the representation of a defendant in a drug conspiracy case and that the attorney acknowledged the client also consulted about his own involvement in the conspiracy. Revealing the client's name would have revealed the client's motive in seeking legal advice (*i.e.*, to get advice about his participation in the conspiracy), but this motive was itself confidential because it implicitly revealed the client's confidential admission to his attorney of actual involvement in the conspiracy. Similarly, in *Tillotson* the government was aware that a check for previously unpaid taxes had been delivered. In light of that fact, revealing the unidentified client would have revealed his motive for seeking legal counsel (*i.e.*, to get advice about past tax underpayments), but the motive was itself confidential because revealing it would implicitly disclose the client's confidential admission to his attorney of the past tax underpayments.

In *BDO Seidman*, however, revealing that a client sought tax planning advice and executed a transaction based on advice that the transaction would achieve a certain tax result

¹⁴³ BDO Seidman, 337 F.3d at 812 (emphasis added)

does not reveal any privileged confidential communication from the client to the tax advisor.

Taxes are such an important aspect of all transactions in the United States that it is fair to say almost no large or intricate transaction should be consummated without tax advice.¹⁴⁵ Nor is there anything nefarious that can be inferred from someone seeking tax planning advice in structuring their affairs, no matter how aggressive, as long as it is permissible under the law.¹⁴⁶ Under the confidential communication exception motive is only relevant to the extent that the confidential motive requirement is satisfied. This generally will require some additional fact to be known that, when linked with motive, amounts to the revelation of a confidential communication. Without some additional facts known by the Service that would reveal a

¹⁴⁴ Tillotson v. Boughner, 350 F.2d 663, 666 (7th Cir. 1965). Tillotson is an anonymous payment case decided by the Seventh Circuit with facts and conclusions virtually identical to the *Baird* decision discussed in Part III.B., *supra*.

¹⁴⁵ See, e.g., Bruce Kayle, *The Tax Adviser's Privilege in Transactional Matters: A Synopsis and a Suggestion*, 54 TAX LAW. 509, 551 (2001) (“[T]ax law is far more pervasive than any other area of law in the sense that it necessarily will affect virtually every individual and business enterprise in the country.”); Adam Chase, *Tax Planning for Same-Sex Couples*, 72 DENV. U.L. REV. 359, 360 (1995) (“Tax law touches almost every aspect of human conduct.”); Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129, 1151-52 (1996) (“[I]t might be argued that, because every aspect of the tax laws affects taxpayers’ incentives to some extent, all tax laws can be characterized plausibly as subsidies.”); Richard Lavoie, *A World of Taxpayers? It’s Not a Small World After All*, 70 UMKC L. REV. 545, 546 (2002) (“U.S. persons have become accustomed to the omnipresent nature of our tax laws”); Robert Gatter, *Human Subjects Research and Conflicts of Interest: Walking the Talk of Trust in Human Subjects Research: The Challenge of Regulating Financial Conflicts of Interest*, 52 EMORY L.J. 327, 387 (2003) (“[The Internal Revenue Code] attempts to direct how taxpayers should account for every aspect of their economic lives.”).

¹⁴⁶ See, e.g., Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935) (“Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”); Gregory v. Helvering, 293 U.S. 465, 469 (1935) (“The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”); Comm’r v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting opinion) (“Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions.”).

confidential *individualized* motive or communication between the client and advisor, there would be no basis for protecting the client's identity in a tax planning situation.¹⁴⁷ A client's identity should only be privileged if revealing it would disclose a motive that is *itself* a privileged confidential communication. A general motive to explore means of legal tax planning is not such a confidential communication, and therefore there is no basis to find the client's identity to be privileged under the confidential motive requirement.

Using the confidential motive requirement, most tax planning transactions would not be eligible for the confidential communication exception. If revealing a client's identity only reveals that the client consummated a particular transaction and that the client was advised that the transaction would have a certain tax effect, then the only inference of motive that could be drawn is that the client wished to engage in legal tax planning. The communication of this motive to an attorney should not be viewed as either confidential or legally relevant to any tax issue discussed with an attorney.¹⁴⁸ Without some other piece of information being known to the government, revealing the client's identity in a tax planning context discloses no confidential client communication and should not be protected by the attorney-client privilege.

¹⁴⁷ This is not to say that such a showing could never be made in a tax planning context. For instance, if the Service knew other facts which, when linked with the taxpayers seeking planning advice, revealed an actual confidential communication (*e.g.*, a subjective state of mind unique to the client, like statements acknowledging that a transaction lacked a business purpose or that the taxpayer was undertaking the transaction solely on the basis that it was unlikely to be detected on audit), then it would be possible for the privilege to apply. However, such situations are likely to be exceeding rare.

¹⁴⁸ While a client's subjective state of mind will sometimes be relevant in resolving a substantive tax question (*e.g.*, whether a good faith belief existed that a position was supportable, or whether a taxpayer willfully disregarding an accepted tax rule), subjective intent is not relevant to the resolution of most tax issues. Additionally, even where a taxpayer's intentions are relevant, a generalized motive to structure transactions so as to pay the minimum amount of tax permissible under the law is never a proscribed state of mind that would be relevant to resolving any tax issue.

On the other hand, in rare circumstances the confidential motive requirement might be satisfied even when an attorney is retained for tax planning advice. Assume for instance that Sam, an individual taxpayer, retains Linda, a tax attorney, to obtain advice on a proposed tax shelter transaction that a promoter has brought to Sam's attention. Linda's initial advice is that the transaction is *not* likely to achieve the tax results claimed by the promoter. Nevertheless, Sam decides to consummate the transaction and directs Linda to draft the legal documents necessary to implement the transaction. If the Service later learns that one of Linda's clients executed this transaction and it also knows that she advised *against* the transaction, then forcing her to reveal Sam's identity might well reveal a confidential client communication. Here, the Service knows more than just the nature of the transaction and that it was consummated. Knowing the additional fact that the transaction was undertaken *against* the advice of counsel might be relevant in proving Sam's state of mind if the Service asserted a penalty in connection with the transaction. Consequently, in this example the additional facts known by the Service about the substance of Linda's advice could support a conclusion that revealing Sam's identity would reveal a privileged confidential communication between Sam and Linda. Consequently, the confidential communication exception could apply since the confidential motive requirement would be satisfied. Nevertheless, such situations are likely to be quite rare.

Interpreting the confidential communication exception as including the confidential motive requirement would not alter the results in anonymous payment cases like *Baird* and *Tillotson*. In such cases, the additional fact that cash was paid to the Service would support the conclusion that revealing the client's identity would be tantamount to revealing a confidential admission of past improper behavior by the unidentified client. Similarly, the

confidential motive requirement would not force a client's identity to be revealed in non-planning tax situations. When a taxpayer seeks legal advice regarding already consummated and reported transactions, it is likely that the mere act of consultation could create an inference that the client believes improper reporting may have occurred in the past. Consequently, revealing a client's identity in such post-reporting situations requires a more detailed factual analysis to determine whether revealing the identity would reveal some confidential communication.

In light of this interpretation of the confidential communication exception's motive analysis, the results reached in both *Liebman* and *Arthur Anderson* were incorrect since they permitted tax advisors to shield their clients' identities when revealing those identities would not have disclosed any legally relevant or confidential client communication. Conversely, absent highly unusual facts, revealing a taxpayer's tax minimization motive by forcing an attorney to disclose a client's name in tax planning situations would not be privileged under the confidential communication exception since no legally relevant confidential motive would be involved.

4. *Tax Return Reporting May Nullify Privilege Claim*

The case law has long held that documents and communications directly related to an attorney's preparation of a tax return are generally not privileged.¹⁴⁹ While this exception has traditionally been fairly limited, a recent case has caused at least one commentator to argue that the attorney-client privilege never applies in tax cases since (1) tax advice is not legal advice, (2)

¹⁴⁹ See U.S. v. Lawless, 709 F.2d 485 (7th Cir. 1983). See also, Bruce Graves, *Attorney Client Privilege in Preparation of Income Tax Returns: What Every Attorney-Preparer Should Know*, 42 TAX LAW. 577 (1989); In re Grand Jury Investigation of Glen J. Schroeder, Jr., 842 F.2d 1223, 1224-25 (11th Cir. 1987); United States v. Davis, 636 F.2d 1028, 1039-40 (5th Cir. 1981); United States v. Gurtner, 474 F.2d 297, 299 (9th Cir. 1973); Canaday v. United States, 354 F.2d 849, 857 (8th Cir. 1966).

the information is not confidential, and (3) any privilege is waived when a position is ultimately reflected on a tax return.¹⁵⁰ While these arguments are not overly persuasive under current law, they will be examined briefly.

The first argument is that when a tax advisor acts as a return preparer she is not performing legal work covered by the attorney-client privilege. As traditionally applied, the return preparation limitation on the attorney-client privilege has only been used to require the disclosure of draft tax returns and documents or communications directly related to the preparation of the return.¹⁵¹ Thus, lawyers acting in a dual return preparer and legal capacity could continue to assert the attorney-client privilege for information communicated by the client to the lawyer for the purpose of obtaining her legal skills in interpreting how the law applied to a particular factual situation.¹⁵²

However, some have interpreted the recent case of *United States v. KPMG LLP*¹⁵³ as indicating a narrowing of the attorney-client privilege in this area.¹⁵⁴ That case involved the Service investigating investor list compliance at the accounting firm of KPMG, similar to the Service's investigations of Anderson and BDO discussed earlier. In reviewing a sampling of allegedly privileged documents, the district court found that KPMG opinion letters on

¹⁵⁰ Lee Sheppard, *No Privilege For Tax Planning*, 98 TAX NOTES 159, ____ (Jan. 13, 2003) (“The practice of tax is not the practice of law. . . . Neither [accountants nor attorneys] get[] any kind of privilege for confidential communications made in the practice of tax. It is the practice of tax, not whether the lawyer works for an accounting firm or a law firm, that prevents the privilege from applying.”).

¹⁵¹ See authorities cited in note 149, *supra*.

¹⁵² *United States v. Frederick*, 182 F.3d 496, 501 (7th Cir. 1999) (“[T]he tax preparer here was also the taxpayers’ lawyer, and it cannot be assumed that everything transmitted to him by the taxpayer was intended to assist him in his tax-preparation function and thus might be conveyed to the IRS, rather than in his legal-representation function.”).

¹⁵³ 237 F. Supp. 2d 35 (2002).

consummated transactions were not eligible for the tax practitioner privilege under section 7525 since they were prepared “in conjunction with the preparation of a tax return.”¹⁵⁵ However, the court also found that similar opinion letters on completed transactions issued by law firms *were* protected by the attorney-client privilege. While the court’s reasoning for the distinction is not explained in detail, the court apparently assumed that opinions regarding the proper tax treatment of a completed transaction made by the client’s tax return preparer should be treated as made in connection with preparing the tax return and therefore would not be privileged. On the other hand, similar opinions prepared by lawyers not directly involved in return preparation were assumed to have been made for the purpose of providing legal advice. Viewed in this light, there seems to be an increased risk that tax advisors who also actually prepare their clients’ tax returns may have a more difficult time asserting the attorney-client privilege for their work in interpreting the law than has been traditionally the case.

The second argument is that tax advisors who also prepare tax returns have no privilege because there was no expectation of confidentiality when the information was conveyed to the return preparer. Since information conveyed to a return preparer typically will be included on the tax return and disclosed to the Service, the taxpayer has no expectation of confidentiality when he conveys this information.¹⁵⁶ When the taxpayer’s legal advisor is also his return preparer, this mixed role may taint *all* information conveyed to the advisor as also relevant to the preparation of the tax return and therefore indicate that the taxpayer had no

¹⁵⁴ See Sheppard, *supra* note 150.

¹⁵⁵ *KMPG*, 237 F. Supp. at 42.

¹⁵⁶ See *Dorokee Co. v. United States*, 697 F.2d 277, 280 (10th Cir. 1983) (“Even those courts holding that the attorney-client privilege can arise from the preparation of income tax returns do not apply the privilege to documents given by a client to an attorney for inclusion in the client’s income tax return, because such information is obviously not intended to remain confidential.”).

legitimate expectation that *any* information provided to the advisor would be held as confidential. Typically, however, the courts have limited the application of this rule to factual information clearly intended to be included on the actual tax return.¹⁵⁷

The third argument that no privilege attaches if return preparation is involved is based on a waiver of the privilege. That is, by merely reporting a tax shelter transaction on a tax return the taxpayer could be seen as waiving his privilege regarding *any* advice he received that supports the position taken on the return. While the law currently does not support such a sweeping view,¹⁵⁸ a recent case has found that merely referring to the existence of a tax opinion on a transaction can operate as a waiver of the privilege. In *In re: G-I Holdings, Inc.*¹⁵⁹ the Service was litigating the tax liability of a debtor in bankruptcy. As part of that proceeding the Service sent the taxpayer a set of interrogatories. In them the Service asked whether the debtor claimed that it was not liable for penalties in connection with the Service's substantive tax claim. The debtor replied that it believed no penalty would be owed since the debtor acted in "good faith" with "reasonable cause."¹⁶⁰ The debtor went on to explain that it had consulted with outside legal advisors and others regarding the tax treatment reported on its return. Based on this statement the district court found that the debtor had waived any privilege to the opinions that it relied on in taking its tax return reporting position.¹⁶¹ Consequently, the mere indication to the

¹⁵⁷ See, e.g., *Frederick*, 182 F.3d 496; *United States v. Schlegel*, 313 F. Supp. 177, 179 (D. Neb. 1970) ("[A] more realistic rule would be that the client intends that only as much of the information will be conveyed to the government as the attorney concludes should be, and ultimately is, sent to the government.").

¹⁵⁸ See, e.g., *Colton v. United States*, 306 F.2d 633, 639 (2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963) (refusing to find waiver of memoranda and worksheets containing confidential data not already published on tax return).

¹⁵⁹ 218 F.R.D. 428 (D.N.J. 2003).

¹⁶⁰ Under section 6664 of the Code a taxpayer can avoid certain penalties if it shows it had reasonable cause for taking the position and acted in good faith.

¹⁶¹ *G-I Holdings*, 218 F.R.D. at 433.

Service that outside legal advice was obtained in taking a position and that it might be used ultimately to defend against the future assertion of penalties, may give rise to an immediate waiver of the privilege for that advice.

C. Attorney-Client Privilege Should Not Shield Identity in TaxPlanning Matters

Part IV.B. demonstrated that the client-identity privilege generally is not available in a tax shelter context under current law. This section addresses whether denying the client-identity privilege in tax planning situations is appropriate as a policy matter. After examining the position of the status-as-client approach on this issue and the distinct societal interests involved, this article concludes that limiting the scope of the attorney-client privilege in tax planning is highly desirable as a policy matter given the peculiar nature of the United States tax system.

1. Applying the Status-as-Client Approach in a TaxPlanning Context

The status-as-client approach would protect a client's identity in a tax planning context. When the Service seeks client identity information from tax practitioners in the context of discovering abusive transactions, it is clearly seeking to have the attorney link a client with specific legal advice given about a particular transaction. The Service is seeking to discover a client's status as a client (*i.e.*, as a receiver of particular legal advice). Consequently, this seems like a paradigm case for protecting client identity under the status-as-client approach.¹⁶² Nevertheless, this article maintains that the status-as-client approach reaches the wrong conclusion in these cases. To understand why, it is necessary to examine the rationale for the

¹⁶² Professor Goode would apparently apply the status-as-client test in this manner since he has stated that the *Liebman* result is "undoubtedly correct." Goode, *supra* note 15, at 332

status-as-client approach and then consider the implications of that rationale in the specific context of tax planning.

As discussed earlier, the purpose of the attorney-client privilege is to strengthen the efficient operation of the legal system and promote compliance with the law.¹⁶³ Efficiency is obtained because the free and frank communications promoted by the attorney-client privilege provide attorneys with the facts that they require to adequately prepare their case and anticipate defenses. This in turn facilitates the operation of our adversarial system of justice. The better prepared each side is to any dispute, the more likely the truth will emerge from the legal contest. Legal compliance is promoted because encouraging free and frank consultations provides an attorney the ability to educate clients about their responsibilities under the law, and thereby creates a more law abiding citizenry.

Achieving this desired societal result requires that clients be encouraged to seek out attorneys and freely communicate with them. The status-as-client approach to the client-identity privilege takes this underlying requirement as its starting point in developing an appropriate test for when the privilege should apply. It reasons that if client identity is being sought as a means of determining whether the client has obtained legal advice, then at least some clients needing legal advice would be dissuaded from seeking it due to the fear of identity disclosure.¹⁶⁴ Therefore, protecting client identity in such situations promotes the policies underlying the attorney-client privilege. Conversely, in circumstances where clients would not

¹⁶³ See *supra* text accompanying notes 14-23.

¹⁶⁴ Goode, *supra* note 15, at 336-37. Note that this conclusion implicitly relies on an assumption that clients would consider the mere fact that they sought legal advice to be somehow incriminating. That is, if no negative inference could be inferred from knowing that an attorney-client relationship existed, then there would be no reason a client would be dissuaded

be dissuaded from seeking legal advice by disclosure of their identity, identity should not be privileged. This would normally be the case where client identity is being sought for some reason apart from determining that a person requested legal advice. For instance, when a client seeks to use an attorney in a non-attorney capacity (*e.g.*, to secretly benefit a third party, or to transmit a payment anonymously) forcing the revelation of the client's identity does not dissuade others from seeking legal advice, it merely disabuses clients of the notion that they can employ attorneys to carry out their affairs in secret.

Normally, it is fair to conclude that some clients would be dissuaded from seeking legal advice if they knew the fact of their consultation could become known. Because the mere fact of consultation could be incriminating to them, they might eschew legal counsel. The status-as-client approach is based on this assumption. However, in the tax planning context, this baseline assumption does not hold true. Due to the peculiar nature of our tax system, clients will not be discouraged from consulting lawyers based on the risk that their identity could be revealed. The only potential clients who might decide to forgo legal advice about their activities would be those seeking to use attorneys to add a layer of secrecy to transactions premised on a lack of detection by the Service (*i.e.*, where the client's purpose is to play the "audit lottery"). To understand why this is so, it is necessary to examine the unique nature of the federal income tax system.

For the most part, federal income tax laws do not obligate taxpayers to undertake or avoid particular actions under fear of penalty or sanction. Aside from penalties for fraud and penalties imposed for failure to file returns or pay taxes owed, most of the Code is dedicated to

from seeking legal counsel merely due to the fact that the existence of their relationship might become known.

merely describing the tax treatment of a taxpayer's receipts, disbursements and transactions.¹⁶⁵ Absent the creation of fraudulent or sham transactions, there is generally no legal prohibition imposed by the tax law on a taxpayer *undertaking* any transaction, no matter how tax motivated. Rather, the Code merely attempts to define how such transactions impact on the calculation of a person's taxes. That is, does the transaction create items of income, gain, loss or deduction that are allowed to be accounted for in calculating one's tax liability. Overly aggressive reporting of a transaction may be illegal, but engaging in such a transaction itself is not illegal or prohibited by the Code.

As a direct consequence, it has long been acknowledged that taxpayers are free to structure their affairs in the manner that results in minimizing their tax liability.¹⁶⁶ Tax planning is not only accepted by the Code, Congress often counts on taxpayers engaging in such planning when it adopts provisions of the Code intended to encourage or discourage (but not prescribe or proscribe) certain taxpayer behaviors or transactions.¹⁶⁷ As a result, the mere knowledge that a taxpayer has engaged counsel to assist in her tax planning carries no stigma or inference of wrongdoing which would dissuade a taxpayer from pursuing legal advice even if her status as a client were to become known.¹⁶⁸

¹⁶⁵ See Kayle, *supra* note 145, at 551 ("Aside from a few relatively trivial items like return filing requirements, the tax law does not have many prescriptions or proscriptions. Tax law simply ascribes a tax consequence (taxable vs. nontaxable; deductible vs. nondeductible; benefit available vs. unavailable) to taxpayer conduct.").

¹⁶⁶ See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *Superior Oil Co. v. Mississippi*, 280 U.S. 390, 395–96 (1930); *Bullen v. Wisconsin*, 240 U.S. 625, 630–31 (1916); *Comm'r. v. Newman*, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting opinion).

¹⁶⁷ For instance, Congress grants an interest deduction for mortgages on individual residences to encourage home ownership.

¹⁶⁸ To the extent that a taxpayer is seeking advice regarding a committing a tax fraud or other criminal activity, she would be no more dissuaded from seeking counsel than under the

Additionally, the self-assessment nature of the United States tax system creates a very different regulatory paradigm than is the case with other codified bodies of law.¹⁶⁹

Taxpayers must undertake an evaluation of how the tax laws apply to their peculiar situation and must report their conclusions to the Service in an annual tax return.¹⁷⁰ Conversely, the Service may audit anyone randomly without any belief that they have reported their income incorrectly. Given the scope of economic activity in the United States that must be reported and taxed, it is clearly impossible for the Service to examine more than a small fraction of filed tax returns. Since placing the burden on the Service of ferreting out all the transactions impacting the tax liability of millions of taxpayers would be insurmountable, the entire tax system is based on disclosure and fair reporting by taxpayers.¹⁷¹ Taxpayers are obligated to review their records and transactions and apply the proper tax characterizations under the Code. The Service has been granted sweeping powers to gather information regarding tax matters in order to check that the self-assessment system is operating properly.¹⁷² The tax system functions because taxpayers

normal attorney-client privilege since the privilege would not protect such a client in any event due to the traditional crime-fraud exception.

¹⁶⁹ See Kayle, *supra* note 145, at 551-52.

¹⁷⁰ Treas. Reg. 1.461-1(a)(3) (“Each year’s return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return.”). See also, *Wiseley v. Comm’r*, 13 T.C. 253, 256 (1949) (taxpayer must file a correct return); *Valverde v. Comm’r*, 53 T.C.M. (CCH) 628, 629 (1987) (taxpayer has obligation to file a correct return); I.R.C. § 6065 (requiring returns to be signed under penalty of perjury).

¹⁷¹ *United States v. Arthur Young & Co.*, 465 U.S. 805, 815-16 (1984) (“Our complex and comprehensive system of federal taxation, relying as it does upon self-assessment and reporting, demands that all taxpayers be forthright in the disclosure of relevant information to the taxing authorities. Without such disclosure, and the concomitant power of the Government to compel disclosure, our national tax burden would not be fairly and equitably distributed. In order to encourage effective tax investigations, Congress has endowed the IRS with expansive information-gathering authority...”); *Couch v. United States*, 409 U.S. 322, 335 (1973) (describing the system as one where “obligations of disclosure exist [] under a system largely dependent upon honest self-reporting even to survive”).

¹⁷² See 1 Internal Revenue Manual: Audit (CCH) 4015.1 (June 29, 1984), at 7006 (“The mission of the service is to encourage and achieve the highest possible degree of voluntary

have faith in the basic fairness of the system.¹⁷³ When taxpayers believe that others are avoiding their fair share of the tax burden, they lose faith in the system and are more likely to cheat.¹⁷⁴ In short, the tax system is essentially self-enforced, but such self-enforcement only works if taxpayers believe that the reporting requirements of the system, coupled with the broad powers of the Service to check on the degree of voluntary compliance, ensure that everyone is applying the tax laws fairly.¹⁷⁵

Since taxpayers are obligated to disclose their transactions and their tax consequences to the Service, it is especially difficult to see why a taxpayer would be dissuaded from seeking tax advice regarding the structuring and reporting of those transactions by the fact that their attorney might also need to provide such information to the Service. Only those who are trying to evade the built-in disclosure requirements of the system and wish to force the

compliance with the tax laws and regulations and to conduct itself so as to warrant the highest degree of public confidence in its integrity and efficiency.”); I.R.S. Policy Statement P-1-1 (Dec. 18, 1993), 1 Internal Revenue Manual: Administration (CCH) at 1303-25 (“The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.”).

¹⁷³ See Robert J. Peroni, *A Policy Critique Of The Section 469 Passive Loss Rules*, 62 S. Cal. L. Rev. 1, 5-6 (1988) (“[T]ax shelters destroy the horizontal and vertical equity of the tax system and lead average taxpayers to feel that they are fools for paying their fair shares of the income tax burden, thereby undermining the foundation of the self-assessment system.”); Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 Fla. Tax Rev. 327, 351-52 (1995) (“Our self-assessment system of taxation relies on a willingness of the populace to report honestly to the government, and that willingness rests on a popular belief that the government’s system of taxation is fair.”); LILLIAN DORIS, *THE AMERICAN WAY IN TAXATION: INTERNAL REVENUE, 1862-1963* 1, 2 (1994) (noting that the self-assessment system is threatened if the public loses confidence that the tax laws are operating fairly).

¹⁷⁴ See *Treasury White Paper*, *supra* note 3, at ¶ 95; Joel Slemrod & Varsha Venkatesh, *Public Attitudes About Taxation and the 2000 Presidential Campaign*, 83 TAX NOTES 1799, 1799 (June 21, 1999).

¹⁷⁵ See Darrell, *The Tax Practitioner’s Duty to His Client and His Government*, 7 PRAC. LAW. 23, 38 (1961) (the U.S. tax system is “dependent for enforcement primarily upon voluntary compliance and not police state methods”).

Service into an active investigative policing posture would have reason to fear attorney disclosure of their identity. Consequently, it is not the provision of legal advice that would be dissuaded by denying the client-identity privilege, it is only the use of attorneys to defeat the intended transparency of the tax system that would be discouraged.

This reality should be contrasted with that of other bodies of regulatory law that dictate particular behaviors, impose sanctions for non-compliance, and are policed for breaches by an enforcement agency. In such situations, if clients consult an attorney regarding their obligations under the relevant law they may have legitimate concerns about maintaining the secrecy of their consultation. Since the enforcement agency is affirmatively charged with investigating suspected breaches of the law, it might seek leads from attorneys. So, for instance, the Securities and Exchange Commission (“SEC”) might seek client lists from attorneys known to specialize in insider trading cases or other securities defense work as a means of identifying clients likely to have violated the securities laws. If the SEC is successful in such attempts, this might well dissuade clients from seeking legal advice because it would subject them to scrutiny they would not have triggered without seeking legal advice and this scrutiny may in turn subject them to penalties for their behavior. In the tax world, however, taxpayers have an affirmative obligation to make their transactions and their tax treatments known to the Service. Thus, merely seeking legal advice would not generally create any increased scrutiny that they would fear.

Additionally, while an agency like the SEC might apply penalties or other sanctions in connection with any discovered violations of the underlying law, in the tax realm the impact of increased scrutiny is only that the *correct* tax treatment of an item will be determined. As a result the taxpayer may owe more or less tax, but no penalty will be imposed for its action

in undertaking the transaction. While the taxpayer's *reporting* of the transaction could potentially give rise to a penalty, under the self-assessment system taxpayers have an obligation to take supportable positions and penalties only become relevant when this obligation is not satisfied. In most instances where taxpayers are found to have underpaid their taxes no penalties apply because sufficient support existed for the taxpayer's position. Indeed, even if the taxpayer's position is found to lack the required level of support, no penalty will apply if the taxpayer can show the position was taken in good faith and that she had reasonable cause to believe her position was supportable.¹⁷⁶ The impact of these rules is that for any return position a taxpayer should believe that the position is supportable and should not fear incurring a penalty even if the position is ultimately proven incorrect. Consequently, while increased scrutiny by the Service might result in additional taxes being owed, the risk of creating such increased scrutiny would not cause a taxpayer to avoid seeking counsel. Further, seeking counsel is likely to ensure that the position taken is one that in fact reaches the correct tax result, so that even if increased scrutiny applies the taxpayer would generally expect no negative tax impact to result. Since the taxpayer must believe her position is supportable under the law and understands that the Service is always free to audit her position, she should have no fear of scrutiny by the Service. Indeed, if she fears scrutiny by the Service, this indicates she is taking her tax reporting position based not on a good faith belief in its merits but on a belief that the Service will not discover the transaction. This is counter to her duty as a taxpayer to fairly make her tax situation known to the Service under the self-assessment system.

The above discussion has demonstrated that the peculiar nature of the tax law is such that requiring tax advisors to reveal client identities should not dissuade taxpayers from

¹⁷⁶ I.R.C. § 6664.

seeking tax planning advice. Consequently, the status-as-client approach yields an incorrect result when applied to tax planning situations. In the tax context there are no negative inferences to be derived from the mere fact that a taxpayer consulted counsel regarding the proper tax treatment of her transactions. Additionally, the affirmative obligation placed on taxpayers to fairly self-report their tax situation to the Service creates an environment where no taxpayer should fear scrutiny unless they are affirmatively counting on non-detection of their transactions. If the latter is the case, then facilitating the ability of taxpayers to use the attorney-client privilege to defeat the intended transparency of the self-assessment tax system would cause serious harm to the tax system as a whole. As discussed below, this potential for harming the tax system provides an independent justification for limiting the client-identity privilege in tax planning situations.

2. Competing Societal Interests Warrant Limiting the Attorney Client Privilege

The previous section demonstrated that while the status-as-client approach reaches the wrong result in the context of tax planning, denying the client-identity privilege in tax situations still should not dissuade taxpayers from seeking legal advice. Thus, denying the privilege does not work against the goal of promoting compliance with the law. This section goes further and shows that granting an identity privilege in tax planning matters would cause significant harm to the tax system which would far outweigh any countervailing benefits from applying the privilege.

As discussed earlier, the very existence of the attorney-client privilege reflects a societal decision that the benefits of the privilege (promoting the adversary system of justice and

compliance with the law) outweigh the detriment (impeding the search for the truth).¹⁷⁷

Nevertheless, the societal considerations are sufficiently unique in the tax planning context to warrant a reappraisal of whether the attorney-client privilege should be applied in a more limited fashion.

Most importantly, the harm the privilege causes to the search for the truth is considerably greater in the tax context than in other areas of the law. Permitting clients to use the attorney-client privilege to shield their identity and therefore their transactions from the Service severely harms the self-assessment tax system by allowing certain taxpayers to avoid the fair reporting and disclosure obligations essential to the system's proper functioning.¹⁷⁸ Allowing certain taxpayers to engage in aggressive tax planning that is hidden from Service scrutiny promotes the public's belief that tax cheating is widespread, which leads to the perception that the tax system is unfair. This in turn could seriously damage the operation of the self-assessment system. Given the limited resources of the Service and the many millions of tax returns filed each year, curtailing the Service's ability to identify potentially abusive transactions places too great a burden on the Service. Indeed, Congress's purpose in enacting the registration and listing requirements for potentially abusive transactions was to ensure that the Service would have the tools necessary to serve its role in maintaining the fairness of the self assessment system:

¹⁷⁷ See *supra* text accompanying notes 14-23.

¹⁷⁸ See Special Comm. on the Lawyer's Role in Tax Practice, The Ass'n of the Bar of the City of New York, *The Lawyer's Role in Tax Practice*, 36 TAX LAW. 865, 882 (1983) ("As a consequence of the aggressive positions taken by many taxpayers and the limited number of returns that can be effectively audited, the Government loses revenue it should receive, resulting in an inequitable sharing of the tax burden among taxpayers, and, most important, a growing disrespect for the fairness of the tax system.").

Congress was concerned that promoters of and investors in syndicated investments and tax shelters were profiting from the inability of the Internal Revenue Service to examine effectively every return. These promoters knew that even if a tax scheme they marketed was clearly faulty, some investors' incorrect returns would escape detection and many others would enjoy a substantial deferral of tax while the Internal Revenue Service searched for their returns and coordinated its handling of similar cases.

The new requirement that promoters keep lists of customers and investments will enable the Internal Revenue Service to identify quickly all of the participants in related tax-shelter investments. As a result, taxpayers claiming improper treatment will not escape detection and investors in similar schemes will receive more uniform treatment.¹⁷⁹

Additionally, allowing the attorney-client privilege to shelter client identity in the tax planning context essentially promotes *non*-compliance with the law since it encourages taxpayers to believe they can shield their aggressive positions from scrutiny. Normally the attorney-client privilege fosters compliance with the law since attorneys can educate clients on the law and act to dissuade improper actions before they are undertaken. However, applying the attorney-client privilege to protect client identity in tax planning matters encourages taxpayers to take riskier reporting positions relying on the low chance of detection. The baseline of the self-assessment system is that taxpayers should be taking positions based on a fair and accurate evaluation of how the law applies to their particular circumstances. Factoring the low risk of detection into such evaluations results in taxpayers taking a more aggressive view of the law than is optimal for the efficient functioning of the tax system.¹⁸⁰

¹⁷⁹ JOINT COMM. ON TAXATION, 98th Cong., 2d Sess., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 481 (Comm. Print 1984).

¹⁸⁰ For this reason, the Service requires tax practitioners to exclude the risk of detection as factor in determining whether a taxpayer has sufficient support to take a position on a tax return. 31 C.F.R. § 10.34(d)(1).

In light of the significant detriments that would arise if the attorney-client privilege is applied broadly to protect the identity of tax planning clients, the attorney-client privilege should be limited as it applies to client identity in this context. Given the preeminent importance of disclosure, equality, and fairness in the efficient functioning of the tax system, client identity should not be protected. Additionally, denying such protection should not negatively impact the normal benefits gained from applying the attorney-client privilege. Due to the nature of the tax system, clients would not be discouraged from seeking legal advice merely because their transactions would be discoverable through client lists. Further, denying the privilege here actually promotes compliance with the self-assessment system by indicating to taxpayers that they cannot rely on non-detection as a basis for taking aggressive tax positions. Consequently, as a policy matter, the attorney-client privilege should not shield the identity of clients engaged in tax planning, regardless of whether such planning relates to a tax shelter transaction.¹⁸¹

V. Conclusion

The promotion of aggressive tax shelter transactions has created a difficult problem for the United States tax system. In order to preserve the integrity of the self-assessment tax system the Service needs to identify such transactions and, when appropriate, challenge them. However, such transactions are often explicitly designed to be difficult for the Service to detect. To confront this trend the Service has promulgated regulations requiring attorneys and other promoters to maintain lists of investors in certain types of tax motivated

¹⁸¹ Note, however, that the same policy considerations are not implicated in criminal tax matters or in situations where tax advice is sought after the filing of a return. In these situations a client's state of mind may be highly relevant and negative inferences that might be drawn from such a client seeking counsel could warrant invoking the attorney-client privilege. The analysis here is limited to pre-filing tax planning advice.

transactions. The Service has also aggressively contested the application of the attorney-client privilege to shield the identities of clients engaged in such transactions. In effect, the Service is forcing tax attorneys to divulge their “naughty” clients to the Service. While requiring attorneys to maintain such client lists may appear contrary to the attorney-client privilege, this article has demonstrated that denying a client-identity privilege in the tax planning context is appropriate both under current law and from a broader policy perspective.

Under current law a client’s identity is generally only privileged if revealing her identity would be tantamount to revealing a confidential client communication. While revealing a client’s motive in seeking legal advice is usually sufficient to invoke the confidential communication exception, this article maintains this exception applies only if the confidential motive requirement is explicitly satisfied. That is, it must be proven that any motive revealed, in fact, also reveals some confidential communication. In the context of tax shelter transactions, merely revealing that a client wished to engage in transactions intended to decrease her tax burden would not qualify as a confidential motive. Such a generalized motive conveys no confidential client-specific information and is not relevant to any legal issue the tax advisor might be called upon to address. All taxpayers have a motive of structuring their affairs to pay the least tax legally owed. Nothing confidential is revealed if this is the *only* motive that is revealed by identifying a client. Consequently, this article maintains that cases like *Liebman* and *Arthur Anderson* were wrongly decided since they ignored the confidential motive requirement when they applied the confidential communication exception.

Similarly, the policy underlying the attorney-client privilege indicates that the privilege should not be applied to clients’ identities in tax planning situations. The primary purpose of the attorney-client privilege is to promote compliance with the law. The existence of

the privilege reflects a longstanding societal decision that the benefits from the privilege outweigh its costs. Nevertheless, the peculiar nature of the tax system creates a situation where applying the privilege to protect clients' identities *frustrates*, rather than furthers, these societal goals. Allowing a client-identity privilege in tax planning matters allows taxpayers to avoid their obligation to take fair reporting positions and make those positions known to the Service. Consequently, the harm to the search for the truth is greater in the tax context than in other areas of the law where the privilege would normally apply. Further, extending the privilege to shield transactions from view encourages taxpayers to take aggressive tax positions based on an audit lottery mentality. Thus, in the peculiar context of the self-assessment tax system, the client-identity privilege actually promotes *non-compliance* with the law. Additionally, society's goal of encouraging clients to seek legal advice is not impaired by denying the privilege to tax planning situations. Here again, the peculiar nature of the tax system indicates that taxpayers should not be dissuaded from seeking legal advice regarding their tax situation even if they know their advisors may need to reveal their identities. Consequently, as a policy matter, it is appropriate to limit the application of the attorney-client privilege in the context of tax planning, irrespective of how aggressive such planning is.

While the attorney-client privilege serves a valuable role in the legal system of the United States, there should be room to tailor the privilege to best serve its function in particular areas of the law. In the tax realm, limiting the scope of the privilege as it relates to client identity is a small price to pay for the large benefit of promoting the efficient operation of the self-assessment system. The actions of the Service in requiring attorneys to maintain client lists for tax motivated transactions and in challenging attorney assertions of client-identity privilege are necessary steps in protecting the fairness of the self-assessment system. Given the peculiar

nature of the tax system, the Service's actions appropriately reflect how the attorney-client privilege should be interpreted in the context of tax planning.