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The Civil and Criminal Liability of Tax Advisors

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OF TAX ADVISORS

by
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If the past is prologue, tax advisors (lawyers and accountants) have good reason to be careful and scrupulous in the practice of their professions.

They have been and undoubtedly will continue to be civil and criminal targets of the IRS and of the Department of Justice with respect to their own tax liabilities and the liabilities of third persons. As summarized in a recent presentation to the Southern Federal Tax Conference, the tax practitioner is always a potential target. He is "the expert who knows the rules and calls the shots". Those involved in a disputed tax transaction may claim reliance upon him, when the chips are down and, indeed, accuse him of responsibility for any illegality involved. Moreover, nothing would appear to be more desirable to the IRS and the Department of Justice, from a deterrence point of view, than the successful prosecution of a tax advisor.

As to the civil tax liability of the tax advisor, it is significant that a leading weekly law journal published recently a feature article entitled "What the IRS Looks For In a Lawyer's Tax Return". Pointing out the apparently small percentage of audit probability (less than one percent for those filing individual returns, if wages are subject to withholding and the filer takes the standard deduction; partnership returns—probably less than 1½ percent; professional corporations—about 4 percent if corporate assets are under $100,000; Subchapter S corporations, infrequently used—about 2 percent)—the article warns nevertheless that the "IRS will predictably focus on certain items". In the "absolutely certain" category of such items are entertainment, promotional, automobile and travel expenses. In the "highly likely" category are bank deposits, expenses advanced for clients, insurance expense, pension and profit sharing plans and compliance with payroll tax requirements. In the "less likely" category are repairs, depreciation of leasehold improvements, equipment leases, and salvage value of automobiles. The percentage of audit probability may not seem foreboding; but the increased trend towards the investigation of "white collar" personnel should warn that the consequences of an audit should not be lightly regarded, even if it results only in a deficiency, including penalties.

This paper will not discuss the manifold civil tax cases in which lawyers and accountants are involved with respect to their own individual liabilities. These may result not only in a substantial deficiency

1 Bray, "Targeting Attorneys and Accountants for Prosecution and Civil Liability."
but also in the imposition of the burdensome 50% fraud penalty. The possibilities for such involvement are as broad as the provisions of the Internal Revenue Code. No useful purpose will be served by enumeration and discussion of those possibilities here. Parenthetically, it may be noted that where a taxpayer's deficiency and fraud penalty liability results in whole or in part from the tax advisor's inept or ill-considered advice, the advisor suffers no serious consequence (other than the possible loss of a client and professional discipline); the fraud penalty assessed against the taxpayer cannot be assessed against the advisor.

There are special civil penalties for tax return preparers which may be appropriately noted here. Sec. 6694(a) imposes a $100 penalty for the negligent or intentional disregard of rules and regulations. Sec. 6694(b) imposes a $500 penalty for the willful understatement of liability, reduced by the amount of the penalty paid by reason of the application of Sec. 6694(a). Sec. 6695 sets forth various penalties for the failure of return preparers to observe the rules with respect to the preparation of income tax returns for others, unless the failure is due to reasonable cause and not to willful neglect. Thus, Sec. 6695(a) imposes a $25 penalty for the failure to furnish taxpayer with a copy of his return or claim for refund. Sec. 6695(b) imposes a $25 penalty for the failure to sign a return. Sec. 6695(c) imposes a $25 penalty for failure to furnish an identifying number. Sec. 6695(d) imposes a penalty of $50 for failure to retain for three years after the close of the return period a copy of the return or claim or a list of names and identifying numbers of taxpayers for whom returns or claims were prepared. This section provides that the maximum penalty on any person for any return period shall be $25,000. Sec. 6695(e) imposes a $100 penalty for the failure to file a correct information return; a penalty of $5 for each failure to set forth an item as required; and it imposes a maximum penalty of $20,000 for any return period. Sec. 6695(f) imposes a penalty of $500 for the endorsement or negotiation of a check with regard to income taxes issued to a taxpayer.\(^3\)

The major threat to the tax advisor is of course his possible investigation and prosecution on criminal tax charges. If that occurs, he may be the object of aggressive action by law enforcement officials because he is a professional. As one writer has stated, "preliminary findings from a survey of defense lawyers nationwide show that more and more lawyers are being subjected to grand jury probes, wiretaps, search warrants and tax audits". A Justice Department assistant attorney general is quoted as saying: "We have to be sensitive to the attorney-client privilege, but we must also examine quite closely any indication that the attorney may be part of a criminal conspiracy."\(^4\) Moreover, the tax

\(^3\) Kelly, "Criminal and Civil Sanctions for Tax Practitioners."
advisor convicted on criminal tax charges may be the victim of an apparent trend of the courts to impose jail sentences in “white collar” crimes. One attorney who has defended many of his lawyer brethren recently observed: “The courts are treating attorneys harsher and harsher. It almost cuts against you to be an attorney when you’re sentenced. More and more lawyers are getting sent to jail. In the old days, it was given a great deal of consideration that the lawyer had suffered disgrace and dishonor.”

For an opposing sentiment as to the probability of a jail sentence or a severe jail sentence for the convicted tax advisor, indicated more than ten years ago at a Pilot Institute on Sentencing Tax Violators, held at the University of Colorado on July 16 and 17, 1969, see the comments of United States District Court Judges O’Sullivan and Goodman. Judge O’Sullivan:

I think there is one thing we should always keep in mind. While we have the right to hold lawyers, doctors and successful businessmen to a higher standard of integrity and morality, we should nonetheless appreciate that they are still human beings with the same weaknesses that are possessed by persons who hold positions of less prestige in the community. Although it may be more popular to do so, I doubt whether we should be moved in all instances to impose a severe sentence upon a doctor or lawyer. I do not think we should have a different standard for a professional man than for others. I therefore do not believe that we ought to say, as a general rule, that every lawyer, doctor, C.P.A., industrialist, or other executive who violates the income tax law should go to jail.

Judge Goodman:

In sentencing the non-gangster type of income tax violator I have not seen a probation report on the basis of which I could not say that the defendant was a good probation risk. This is because of the nature of the offense. Every probation report involving income tax violations by doctors, lawyers, and big merchants show that they are suitable for probation. Sentencing the income tax violator presents a different sort of problem than that presented by other Federal offenses where there may be a difficult question as to whether the offender is a suitable risk for probation. Therefore, the basis for sending a person to prison for an income tax violation may be different than that present in other types of offenses where the criterion may be his unsuitability for probation.

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b Report on Role of Sanctions in Tax Compliance (IRS) (September 1968).
In a sense, the tax advisor implicated personally in a substantial civil tax case or in criminal tax litigation is always the loser. The consequences of such implication, especially in a criminal case, may be devastating. They are correctly summarized in the Garbis-Namorato article (fn.1): The lawyer or accountant suffers considerable cost in terms of lost time and professional fees. During the period of investigation by the Criminal Investigation Division of the IRS, knowledge of the investigation somehow seeps through to IRS personnel, to the local members of the Bar and of the accounting profession (and nationwide if prominent figures are involved), to clients and to the general public. The tax advisor may suffer intense anxiety and resulting serious health impairment. The cost of defending criminal charges may drain him financially. If convicted, there may be not only a heavy fine but also a jail sentence. Conviction may result in the loss of his professional license. And even if he is acquitted of the charges, the intense publicity attending indictment and trial is certain to adversely affect his reputation, and perhaps permanently.

What are the types of cases in which tax advisors have become criminally involved? And what are the criminal provisions to which they are subject? The writers on this subject have generally agreed that the criminal cases fall into well defined categories, constituting clear signposts of danger for the tax practitioner and affording ample warning of the types of transactions which may lead to their investigation and prosecution.

The Government's array of penal provisions is formidable. What follows is a listing of the chief provisions and the penalties involved:

18 U.S.C., Sec. 371—conspiring either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purposes.

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7 The writer recalls an extreme incident which occurred when he was chief of the Tax Division's Criminal Section. A young Wisconsin professional, prior to his entry on duty in World War II had arranged with a fellow professional to carry on his practice and to divert to his wife weekly amounts of $50, the receipt of which from earnings were not to be reported on his returns. During a final conference in the case, immediately prior to the anticipated return of an indictment, taxpayer's counsel, who had consistently warned that his client could not emotionally withstand indictment and trial, received a telephone message that the case had been "mooted". His client had committed suicide.

$10,000 fine or imprisonment for not more than five years, or both.⁹

18 U.S.C., Sec. 1001—knowingly and willfully falsifying, concealing or covering up by any trick, scheme, or device a material fact, in any matter within the jurisdiction of any department or agency of the United States, or making any false, fictitious or fraudulent statements or representations, or making or using any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry. (Sometimes referred to as the false statement statute.) $10,000 fine or imprisonment for not more than five years, or both.

26 U.S.C., Sec. 7201—willfully attempting in any manner to evade or defeat any tax or the payment thereof. (Sometimes referred to as the evasion statute.) $10,000 fine or imprisonment for not more than five years, or both.

26 U.S.C., Sec. 7206 (1)—willfully making and subscribing any return, statement, other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which the maker and subscriber does not believe to be true and correct as to every material matter. (Sometimes referred to as the false return statute.) $5,000 fine, or imprisonment for not more than three years, or both.

26 U.S.C., Sec. 7206 (2)—willfully aiding or assisting in, or procuring, counseling, or advising the preparation or presentation of a return or other document which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return or document. (This provision was chiefly designed to prosecute tax return preparers who, whether with the collusion of taxpayers or not, prepared false returns.) $5,000 fine, or imprisonment for not more than three years, or both.

Probably the most intriguing prosecutions of tax lawyers and accountants in recent years have been the evasion and conspiracy prosecutions of prominent tax shelter specialists. These arose out of IRS’ Project Haven, a lengthy IRS and Department of Justice probe of offshore tax shelters and secret Bahamian bank accounts. This is the probe that led to the notorious “brief case incident”. Using the services of a beguiling female, the Government surreptitiously obtained access to a tax-haven-bank officer’s brief case while the officer and the lady were out having dinner together. The brief case was opened and in it was a veritable gold mine of information concerning American de-

⁹ For a scholarly treatment of the arguments against use of the conspiracy to defraud statute, see Goldstein, “Conspiracy to Defraud the United States”, 68 Yale Law Journal 405 (Jan. 1959).
positors in the Bahamian bank, some 325 items, including the names of individuals and entities who were depositors. This incident led to the suppression of virtually all of the evidence and the acquittal of the taxpayer-defendant in United States v. Payner. The trial judge had actually determined that the defendant was guilty of violating 18 U.S.C., Sec. 1001 because he had given a false answer to a question on his 1972 return with respect to disclosure of foreign financial accounts, but was constrained to suppress the use of the tainted evidence. The Sixth Circuit affirmed.

In United States v. Margolis, the San Francisco tax shelter advisers were charged with forming a complex tax shelter conspiracy, and of generating questionable loans and large interest deductions. The indictment contained many substantive counts of violations of 26 U.S.C., Sec. 7206 (2), and a conspiracy count. The latter was a so-called "Klein" conspiracy to defraud the United States in the exercise of its governmental functions by impeding, impairing, obstructing and defeating the lawful functions of the IRS in ascertaining, computing, assessing, managing and collecting the revenue. The long trial in the case ended in disaster for the Government. One of Margolis' co-defendants was acquitted at the conclusion of the Government's case. According to a report in U.S. Tax Week, August 1977, this defendant had once been a well-to-do tax attorney, but the litigation cost him $50,000 in legal fees and a loss of $200,000 in his practice. Margolis was acquitted at the conclusion of the case, much to the Government's disappointment.

In United States v. Baskes, two partners in a prominent Chicago law firm were indicted in connection with an alleged scheme falsely to allocate the proceeds of the sale of a property, which was subject to heavy recapture, to a wholly different and virtually valueless capital asset. Seven hundred thousand dollars of the purchase price of a particular property (an apartment and office building) was falsely allocated to an unpatented mining claim. Damaging to the defendants was evidence in the case that one of the defendant-attorneys had explained, in a meeting with the clients, that steps should be taken to separate in points of time the sale of the real estate and the sale of the mining claim so as to prevent the IRS from unravelling the true nature of the transactions.

Cases like Margolis and Baskes, standing on their own facts, perhaps have little value as precedent in trying to divine what reaction the IRS and the Department of Justice will have to any given set of proposed

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10 572 F.2d 144 (C.A. 6 1978).
11 Cr. No. 76-702 (N.D. Calif. 1975).
or anticipated tax shelter plans. But, as one writer has stated,\(^{14}\) these cases point to several troubling truths: lawyers and accountants stand to be indicted for tax advice deemed to be dishonest, even while their clients are not charged; prominent and respected members of the accounting and legal professions are by no means exempt from Margolis and Baskes type charges; and a charge of conspiracy to defraud the United States may be brought despite the complexity of the civil tax questions which may be involved, despite the intricacy of the transactions and the arguable propriety of each step in the alleged illegal scheme.

Tax lawyers and accountants should be aware of the fact that proper and technically accurate labels (from their viewpoint) which they apply to tax transactions may be regarded as criminal labels by the Government, particularly if the transactions are the brain children of the advisors, despite the possible sophistication of their taxpayer-clients in business matters. It must always be remembered that there is and has always been a thin line between legitimate avoidance and evasion. Moreover, there are indications of more aggressive activity in the tax shelter area. About two years ago, IRS announced an escalation of emphasis on the returns of partnerships, a much used vehicle for syndicating tax shelters. The coverage of partnership returns may be extended, particularly as to those partnerships with more than ten partners and with income in excess of $500,000. Also, there appears to be an increased effort at coordination among IRS district offices with respect to attacks on popular tax shelters: the control of real estate tax shelters from a central office in San Francisco; the control of oil and gas tax shelters from a central office in Dallas; and control of movie negative pickup shelters from a central office in St. Louis.

It must be anticipated that IRS attacks against tax shelters will be very consciously planned and that the risk of investigation and prosecution must be calculated. This is not to say that an agent's suspicions must always give rise to extreme action. Hopefully, the tax lawyer or accountant advising his client should be able to take questionable positions which have a rational and arguable basis in law or accounting without fear of being criminally struck down.

In addition to transactions involving foreign tax shelters, the following types of activities and transactions have involved taxpayers and their advisors in a substantial amount of civil and criminal litigation: the backdating of documents;\(^{15}\) sham transactions, e.g., the use of

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\(^{14}\) Bray, "Targeting Attorneys and Accountants for Prosecution and Civil Liability", supra.

multiple corporations, family partnerships, trusts with multiple beneficiaries, wash sales, transfers and transfers back, sales and leasebacks, sham loans, fictitious interest deductions, purchases of tax loss entities, assignments of income, step transactions, the misuse of tax exempt and tax loss entities, whipsaw cases. All these are compactly dealt with in Bray, "Targeting Attorneys and Accountants for Prosecution and Civil Liability".

The Bray article correctly points out that the transactions listed above historically have simply been considered inappropriate for criminal charges, resulting in the extreme in the imposition of the fraud penalty. However, there are factors which point to the possibility of criminal prosecution in situations previously subject only to civil penalty: the trend towards aggressive governmental action with respect to "white collar" crimes; the past history of criminal prosecution of tax advisors; the judicial diminution of privileges hitherto more or less safely relied upon by prospective defendants; the likelihood of continued economic

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16 Slappey Drive Ind. Park v. U.S., 561 F.2d 572 (C.A. 5 1977), affirming a holding that one of a group of corporations was formed primarily for tax avoidance. For the use of shell corporations in a non-tax context, see U.S. v. Benjamin, 328 F.2d 854 (C.A. 2 1964) (Attorneys convicted of setting up shell corporations and assisting in selling stock; accountants also convicted of compiling false financial statements for the shell corporations and the use of financial statements to sell stock); U.S. v. Crosby, 294 F.2d 928 (C.A. 2 1961) (Attorneys convicted of setting up shell corporations and selling unregistered securities.) The court said in Benjamin that "In our complex society *** the lawyer's opinion can be (an) instrument for inflicting pecuniary loss more potent than the chisel or the crowbar *** Congress equally could not have intended men holding themselves out as members of these ancient professions (attorney and accountant) should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess."

17 Michaels v. Comm'r, 15 T.C.M. 1344.
19 A common concept in securities cases as well as tax cases; proscribed by Sec. 9(a)(1) of the Securities Act of 1934, 15 U.S.C., Sec. 78i(a)(1).
22 Thompson v. Comm'r, 66 T.C. 1054 (1976), dealing with more than 100 taxpayers investing in the plans attacked in Project Haven.
23 Id.
26 Court Holding Co. v. Comm'r, 324 U.S. 331 (1945).
27 See Bray, "Targeting Attorneys and Accountants for Prosecution and Civil Liability", supra, p. 1250.
28 Id., p. 1251: "*** whipsaw cases should be added to the list of issues which, when ignited by a spark of concealment or misrepresentation, carry sufficient volatility to explode into a criminal charge."
29 Id.
adversity and the high rate of taxation. The Bray article (p. 1252) therefore gives the following advice to tax advisors “to assist in keeping them beyond the abyss of criminal enforcement:

(1) Do assure that the overall transaction is not riddled with borderline acts or techniques;
(2) Do assure that there is nothing about the transaction that rings of deception, misrepresentation or camouflage;
(3) Do assure that all mechanical steps that purport to have been taken were in fact done as represented by the documents;
(4) Do review all internal memoranda of the client and all working papers and memoranda of the accountants concerning comments about the transaction and the motivation for the transaction that might, during an investigation, cast a horrifying light on the transaction;
(5) Do transmit tax advice and directions for implementing the transaction in writing to the client;
(6) Don’t transmit any legal advice orally or in writing to anyone but the client;
(7) Don’t permit any fee to be expressly contingent or contingent as a practical matter upon achieving a substantial tax saving in any risky tax transaction;
(8) Don’t backdate any documents unless the document must speak “as of” a certain date and then use the words “as of” and correctly recite when signatures were actually appended to the document;
(9) Don’t omit any physical, mechanical, filing, fee, notarization, or other apparently trivial requirements necessary for consistency with the form you have selected for the transaction;
(10) Don’t do the transaction if its success would depend upon any side agreement or understanding which you would be unwilling to disclose to the Intelligence Division.”

Recent developments in cases involving the evocation of “privilege” indicate a probable diminution of protection in that area of the law for those under investigation for possible criminal tax prosecution. That development provides another reason, in addition to those already discussed, for tax advisors’ apprehension and circumspect practice of their professions. Among the cases to be considered here are Couch v. United States, Fisher v. United States, Bellis v. United States, United States v. Coopers & Lybrand, United States v. Upjohn Co.
Couch involved the issuance of an IRS summons to taxpayer's accountant, an independent contractor with many clients, for the production of taxpayer's business records (bank statements, payroll records, reports of sales and expenditures) which taxpayer had given the accountant for the preparation of her tax returns covering a number of years. Concededly, when taxpayer surrendered possession of the records to the accountant, she retained title in herself. The summons was issued after the accountant refused to let the special agent see, remove, or microfilm the records. When the special agent arrived at the accountant's office on the return day of the summons, he discovered that, at the taxpayer's request, the accountant had delivered the records to taxpayer's attorney. After institution of enforcement proceedings, taxpayer was permitted to intervene and she asserted that her ownership of the records warranted a Fifth Amendment privilege to bar their production. The Court rejected the assertion. It held, in line with its prior decisions in the area, that the Fifth Amendment privilege is a personal privilege; that in the case before it the ingredient of personal compulsion was lacking; that the summons and the District Court's order were directed against the accountant; that he, and not the taxpayer, was the only one compelled to do anything; that (p. 329) "no shadow of testimonial compulsion upon or enforced communication by the accused" was involved. The Court reiterated Mr. Justice Holmes' pithy conclusion that "A party is privileged from producing the evidence but not from its production."

Distinguishing the decision in Boyd v. United States from the facts in Couch, the Court noted that the person asserting the privilege in Boyd was in possession of the material in question. The Court rejected the hypothesized suggestion that it should read Boyd as marking ownership, not possession, as the bounds of the privilege, holding that, in its view, possession bears the closest relationship to the personal compulsion forbidden by the Fifth Amendment. To tie the privilege against self-incrimination to a concept of ownership (p. 331): would be to draw a meaningless line. It would hold here that the business records which petitioner actually owned would be protected in the hands of her accountant, while business information communicated to her accountant by letter and conversations in which the accountant took notes, in addition to the accountant's own workpapers and photocopies of petitioner's records, would not be subject to a claim of privilege since title rested in the accountant. Such a holding would

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35 26 U.S.C., Sec. 7602.
36 26 U.S.C. Sections 7402(b) and 7604(a).
37 Since October 17, 1976, taxpayers have an absolute right to intervene, under 26 U.S.C., Sec. 7609(b).
39 116 U.S. 616 (1886).
thus place unnecessary emphasis on the form of communication to an accountant and the accountant's own working methods, while diverting the inquiry from the basic purposes of the Fifth Amendment's protections.

In *Couch*, taxpayer had contended that the confidential nature of the accountant-client relationship and her resulting expectation of privacy in delivering the records to her accountant protected her under the Fourth and Fifth Amendments from their production. The Court rejected that contention, noting that no confidential accountant-client privilege exists under federal law and that no state-created privilege has been recognized in federal cases. Moreover, it pointed out that there is no justification for a confidential accountant-client privilege (p. 335):

where records relevant to income tax returns are involved in a criminal investigation or prosecution. *** there can be little expectation of privacy where records are handed to an accountant, knowing that mandatory disclosure of much of the information therein is required in an income tax return. What information is not disclosed is largely in the accountant's discretion, not petitioner's. Indeed, the accountant himself risks criminal prosecution if he wilfully assists in the preparation of a false return. 26 U.S.C. Sec. 7206(2). His own need for self-protection would often require the right to disclose the information given him. Petitioner seeks extensions of constitutional protections against self-incrimination in the very situation where obligations of disclosure exist and under a system largely dependent upon honest self-reporting even to survive. Accordingly, petitioner here cannot reasonably claim, either for Fourth or Fifth Amendment purposes, an expectation of protected privacy or confidentiality.

It is important to note the caveat in *Couch*. The Court conceded that in a case where the taxpayer's relinquished possession of his own books and records to his accountant is "temporary and insignificant", where there is no more than a "mere fleeting divestment of possession", where the accountant works in the taxpayer's office or is taxpayer's employee— "constructive possession *** (may be) so clear *** as to leave the personal compulsions upon the accused substantially intact." (Pp. 333-334) In such circumstances the Fifth Amendment privilege could be successfully invoked.

The *Fisher* case and the companion case of *United States v. Kasmir* present the question whether a summons directing an attorney to produce

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41 No. 74-611.
documents delivered to him by his client in connection with the attorney-client relationship was enforceable over claims that the documents were constitutionally immune from summons in the hands of the client and retained that immunity in the hands of the attorney. The same basic factual situation was present in both cases. The taxpayers were under investigation for possible civil or criminal tax liability. They obtained from their accountants certain documents relating to the accountants' preparation of their tax returns and then transferred the documents to their attorneys (Fisher and Kasmir) so that the latter could assist them in connection with the investigations. Subsequently, the IRS served summonses on the attorneys directing the production of the documents. The attorneys refused to comply. Enforcement proceedings ensued and in each case the District Court ordered compliance with the summonses. In Fisher, the United States Court of Appeals for the Third Circuit affirmed, holding that the taxpayer had never acquired a possessory interest in the documents and that the documents were not immune from production in the attorney's hands. In the Kasmir case the Fifth Circuit reversed. It held that by virtue of the Fifth Amendment the documents would have been privileged from production pursuant to a summons directed to the taxpayer if he had retained possession, and that in light of the attorney-client relationship, the taxpayer retained such privilege after transfer of the documents to his attorney.

The Supreme Court held that the documents were not privileged either in the hands of the lawyers or their clients. As to the taxpayer-clients, it reasoned that their Fifth Amendment rights were not violated by enforcement of the summonses because (p. 397) "enforcement against a taxpayer's lawyer would not 'compel' the taxpayer to do anything—and certainly would not compel him to be a 'witness' against himself." As held in Couch, the Fifth Amendment is limited to prohibiting the use of physical or moral compulsion exerted on the person asserting the privilege. Requiring the lawyer to produce involves no compulsion on the taxpayer-client, and this is true (pp. 397-399):

whether or not the Amendment would have barred a subpoena directing the taxpayer to produce the documents while they were in his hands.

The fact that the attorneys are agents of the taxpayers does not change this result. Couch held as much, since the accountant there was also the taxpayer's agent, and in this respect reflected a longstanding view.

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Here, the taxpayers retained any privilege they ever had not to be compelled to testify against themselves and not to be compelled themselves to produce private papers in their possession. This personal privilege was in no way decreased by
the transfer. It is simply that by reason of the transfer of the
documents to the attorneys, those papers may be subpoenaed
without compulsion on the taxpayers. The protection of the
Fifth Amendment is therefore not available.

In the Kasmir case the Fifth Circuit had suggested that because
the lawyer legally and ethically was required to respect the con-
fidences of his client, the latter had a reasonable expectation of privacy
for the records in the attorney's possession and therefore did not forfeit
his Fifth Amendment privilege by transferring them in order to obtain
legal advice. The Supreme Court rejected this suggestion. It held that
the Framers had addressed the subject of personal privacy directly in
the Fourth Amendment, did not seek to achieve a general protection
of privacy in the Fifth Amendment but rather sought to deal in the
Fifth Amendment with the more specific issue of compelled self-
incrimination. Indeed, stated the Court (p. 399), it "has never on any
ground, personal privacy included, applied the Fifth Amendment to
prevent the otherwise proper acquisition or use of evidence which, in
the Court's view, did not involve compelled testimonial self-incrimina-
tion of some sort."

The Fisher decision finally addressed the question whether applica-
tion of the attorney-client privilege barred production of the materials
in question. It agreed that if documents are transferred by a client to
an attorney for the purpose of obtaining legal advice, the attorney in
possession is not bound to produce (p. 404) "when the client himself
would be privileged from production of the documents ***." Accord-
ingly, the Court proceeded to the question whether the documents
involved in Fisher and Kasmir could have been obtained by summons
addressed to the taxpayers while the documents were in their posses-
sion. In responding in the negative, the Court asserted that the Fifth
Amendment would not be violated by the fact alone that the papers
in question might incriminate the taxpayers, since the privilege protects
a person only against being incriminated by his own compelled testi-
monial communications. Here, the Court said (p. 410), "In the light
of the records now before us, we are confident that however incriminat-
ing the contents of the accountant's work papers might be, the act of
producing them—the only thing which the taxpayer is compelled to do—
would not of itself involve testimonial self-incrimination." Moreover,
in light of the fact that it is not illegal for a taxpayer to seek accounting
help in connection with his tax returns or for the accountant to prepare
workpapers and deliver them to the taxpayer, the Court (p. 412) found
itself "At this juncture, quite unprepared to hold that either the fact of
existence of the papers or of their possession by the taxpayer poses
any realistic threat of incrimination to the taxpayer." 42

42 In connection with the Court's listing of the non-testimonial instances (p.
408) in which it has declined to extend the protection of the Fifth Amendment
The *Bellis* case, the last of a series of Supreme Court decisions dealing with the susceptibility of *entity* records to compelled production,43 established the proposition that the books and records of a dissolved three-man law partnership were subject to production upon issuance of a grand jury subpoena to a former partner in possession of the records. The Court held, in line with the rationale of its prior decisions, that the partnership involved was an independent entity apart from its individual members; that it was a well organized and structured group and not merely a loose, informal association of individuals or a temporary arrangement for the undertaking of a few projects of short-lived duration; that its records were partnership records and not individual records; and that Bellis held them in a representative capacity and not in a purely personal capacity. Therefore, Bellis could claim no Fifth Amendment privilege with respect to their production.

In arriving at this conclusion, the Court noted the partnership's formal institutional arrangement for the continuing conduct of a law practice; its actual existence for fifteen years prior to its dissolution; the fact that state partnership law imposed on the firm a certain organizational structure; the maintenance of a partnership bank account; the use of the firm name on stationery letter-heads; the filing of separate partnership returns for federal tax purposes; litigation conducted in the name of the partnership; the holding of title to property in the name of the partnership. The Court also held that Bellis had no direct ownership interest in the partnership records, that under state law they were the property of the partnership and that under state law he held them subject to the rights granted to the other partners. Nor did he have any right to use partnership property for other than partnership purposes.

Adverting to the *White* test for determining whether individual members of an entity possessed Fifth Amendment rights with respect to entity records—whether the organization involved (p. 100) "has a character so impersonal in the scope of its membership and activities that it cannot be said to embody or represent the purely private or personal interests of its constituents"—the Court in *Bellis* stated that it did not believe that the formulation in *White* could be reduced to a simple proposition based solely on the size of an organization. Nevertheless—

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less, the Court appeared to agree with the Solicitor General's statement on brief that it is difficult to know precisely what situations are covered by the White formulation, witness the Court's concession (p. 100) that the Bellis case embodied neither "purely *** personal interests" nor "group interests only", but rather some combination of the two. Perhaps the considerations underlying that concession account for the Court's final warning in Bellis (p. 101):

This might be a different case if it involved a small family partnership * * * or, as the Solicitor General suggests * * * if there were some other pre-existing relationship of any confidentiality among the partners.

In a recent article, a former Commissioner of Internal Revenue calls attention to the reignition of a longstanding dispute between IRS and accounting profession concerning the production of accountants' tax accrual files. These files are of particular interest to the IRS because they "pinpoint the precise issues the client thinks are vulnerable to IRS attack during an examination". However, in the view of the AICPA they reflect merely opinions, projections, judgments and have no relevance to the preparation of yearly returns. The dispute is reflected in two recent decisions: Coopers & Lybrand and United States v. Noall.

Coopers & Lybrand (C&L) was a victory for the taxpayer, the Johns-Manville corporation (J-M) and for the accounting profession. A summons was issued to C&L to produce voluminous workpapers and documents comprising its audit program or tax pool analysis file for its client, J-M. The audit program was a master plan specifically tailored for auditing J-M; the tax pool analysis file contained estimates of J-M's contingent liabilities for future income periods, utilized by J-M in preparing SEC-required financial statements and in verifying that the statements were prepared in accordance with generally accepted accounting principles. Neither was used in the preparation of the J-M returns for the years under investigation.

C&L refused to comply with the summons. The IRS agent testified at the enforcement hearing that the audit program would bear on J-M's intent and (p. 617) "would assist us in determining whether or not to pursue a particular area," and that the tax pool analysis file might be relevant as a source of possible inconsistent positions or improper figures. The Government's position was rejected. As the Tenth Circuit concluded, C&L was not responsible for the preparation or review of the returns for the years under investigation and did not prepare the audit program in conjunction with or in any manner in connection with the returns for the years under investigation.

\[44\] Caplin, "Should the Service be permitted to reach accountants' tax accrual workpapers?", The Journal of Taxation, October 1979, p. 194.

\[45\] 587 F.2d 123 (C.A. 2 1978).
with the preparation of those returns. Accordingly, the IRS had failed to show the requisite relevance of the audit program to the tax investigation. Further, the audit program was found to contain no factual data regarding any J-M transactions; rather, the audit program consisted solely of a listing of procedures to be followed by C&L personnel in examining J-M books and records, documentation of the extent to which such proceedings were followed and suggestions for modification of the proceedings. Actually, the audit program was prepared prior to C&L's audits of J-M for the years under investigation, and during those audits, the only information recorded in the audit program related to the compliance with or the inapplicability of the procedures and their modification.

As to the tax pool analysis file, the Tenth Circuit agreed that it and related papers did not reflect records of J-M transactions, and had nothing to do with the preparation of returns for J-M. Rather, the file was created for use in preparing certain financial statements and to verify that the statements were properly reported therein. The Tenth Circuit concluded that in seeking to obtain the file, IRS was seeking to discover the (p. 618) "private thoughts and theories of the taxpayer." In response to the Government assertion that issuance of the summons "might show substantial tax liability and *** the state of mind of employees at the time the returns were filed", the Tenth Circuit stated (pp. 619-621):

* * * the investigative powers of Sec. 7602 are not without limitation. Although the IRS need not establish probable cause prior to the issuance of a summons, it must establish that the investigation is pursuant to and relevant to a legitimate purpose ***.

* * * * * *** the government should not, for the mere sake of its convenience, impose unnecessary burdens on a taxpayer in conducting an audit or investigation for tax liability ***. The term "relevant" connotes and encompasses more than "convenience".

* * * * * The Government cannot go on a "fishing expedition through *** (taxpayer's) records. *** and where it appears that the purpose of the summons is a "rambling exploration" of a third party's files, it will not be enforced.

The Government had contended that the audit program was properly subject to the reach of the summons (p. 621) "as an index ***, as a key to understanding ***" and as "the guiding document which gives coherence, order, and logical sequence to the audit which generated the work papers." The Tenth Circuit's pithy rejection of that contention was
that "Mere convenience does not make an item producible under an IRS summons."

The Noall decision46 stands in sharp contrast to Coopers & Lybrand on the issue of relevance. In Noall the IRS summons was directed to the corporation itself, seeking production of its internal audit reports and related workpapers. The Second Circuit acknowledged that internal audit reports are not accounting records; that they are prepared by the corporation's own personnel to insure uniform bookkeeping practices, compliance with management directives and with internal control and operation procedures; that they may well include hearsay, rumors, opinions and other evidence gathered from the examination of certain bookkeeping practices; and that the internal audit reports were not used in preparing Noall's corporate tax returns. Despite this acknowledgement, the Second Circuit concluded that the internal audit reports and related workpapers of Noall were producible under the summons. It adopted a so-called "might-throw-light" test for relevancy, following the lead of at least two other circuits.47 It interpreted the term "relevant" broadly, pointing to the fact that Sec. 7602 provides that the Secretary or his delegate is authorized "To examine any books, papers, records, or other data which may be relevant or material ***." (Emphasis supplied.) In its view, Congress acted advisedly in using the verb "may be" rather than "is", since the Commissioner cannot be certain that the documents are relevant or material until he sees them, and (p. 126):

Clearly the purposes of the internal audit include the detection of overstated or understated revenues or expenses, and of identifying accounting procedures that would lead to these. If the internal auditors have ascertained an understatement of revenues or an overstatement of expenses, this plainly might throw light on the correctness of the return.

The Noall decision, in contrast with Coopers & Lybrand, found no significance in the fact that the internal audit reports were not used in preparing the tax returns of the corporation. The critical consideration was that the Commissioner's interest lay in whether the tax returns correctly reflected the corporation's actual income, not simply whether they were correctly prepared from the books of account and other records used.

The question for the future is to what extent the courts, absent a decisive Supreme Court decision in the area, will enforce summonses

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47 Caplin, "Should the Service be permitted to reach accountants' tax accrual workpapers?", supra, p. 199.
for tax accrual workpapers. That question, as the former Commissioner declares, "is far from settled." The IRS no doubt awaits an appropriate case with facts favorable to its position. In the meantime, there are indications that the IRS will not give up easily on this issue and that the accounting profession as well as defense lawyers will continue to press the IRS to exercise restraint in its request for tax accrual papers.

An important question in the "privilege" area concerns the attorney-client privilege with respect to corporate taxpayers. Several circuits have held that the privilege is limited to communications between corporate counsel and senior management, adopting a so-called "control group" approach. Other circuits, by contrast, have adopted a broader "subject matter" approach.

Illustrative of the "control group" approach is the Upjohn case. The IRS, during audit of the taxpayer-corporation's returns for earlier years, discovered that the company had made payments exceeding $4,000,000 to officials in many of the foreign countries in which it did business. The company conducted an in-house investigation involving top management personnel as well as lower level company employees. Some of the details of the payments-investigation were disclosed to the SEC and the reports were made available to the IRS. Additionally, the corporation gave the IRS information regarding $700,000 in payments which it conceded might affect its tax liability. The IRS issued a summons under Sec. 7602 for the production of the reports produced by the corporation's in-house investigation regarding the remaining $3,700,000. The corporation refused to comply, relying on the attorney-client privilege. Rejecting the so-called "subject matter" test of the Seventh and Eighth Circuits, under which information in the possession of any corporate agent acquired in the normal course of his duties is "privileged" when communicated confidentially to corporate counsel, the Sixth Circuit adopted the narrower "control group" approach, under which only communications between top corporate management and counsel are privileged. In support of this conclusion, it found that under the broader "subject matter" test, top management was encouraged to shield themselves from unpleasant facts about possibly illegal transactions and to order subordinates to communicate with counsel, with the result that discovery would have to be directed towards the various

48 Caplin, "Should the Service be permitted to reach accountants' tax accrual workpapers?", supra.
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subordinate agents who may be in foreign locations, thus creating too broad a zone of silence. Under the "control group" approach, the Court felt that the attorney-client objective was achieved because the corporate decision-makers still were allowed to communicate freely and confidentially with counsel.

The rationale of those courts upholding the "subject matter" test in this area is, as explained in *Diversified Industries, Inc.* (pp. 608-609) that:

In a corporation, it may be necessary to glean information relevant to a legal problem from middle management and non-management personnel as well as from top executives. The attorney dealing with a complex legal problem "is thus faced with a 'Hobson's choice'. If he interviews employees not having 'the very highest authority', their communications to him will not be privileged. If, on the other hand, he interviews only those with 'the very highest authority', he may find it extremely difficult, if not impossible, to determine what happened." * * * Thus, the control group tests inhibits the free flow of information to a legal advisor and defeats the purpose of the attorney-client privilege. * * *

* * * (The subject matter) test provides a more reasoned approach to the problem by focusing upon why an attorney was consulted, rather than with whom the attorney communicated. * * * In contrast to the control group test, it encourages the free flow of information to the corporation's counsel in those situations where it is most needed.

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* * * the limitations suggested by Judge Weinstein (2 Weinstein's Evidence, par. 503 (b)[04] have merit and * * * the attorney-client privilege is applicable to an employee's communication if (1) the communication was made for the purpose of securing legal advice; (2) the employee making the communication did so at the direction of his corporate superior; (3) the superior made the request so that the corporation could secure legal advice; (4) the subject matter of the communication is within the scope of the employee's corporate duties; and (5) the communication is not disseminated beyond those persons who, because of the corporate structure, need to know its contents.

In conclusion, and reflecting another block to resistance against a summons allegedly issued in bad faith by IRS, the decision in *United States v. La Salle National Bank*\(^1\) merits comment. IRS summonses were issued to the bank for the production of files of certain land trusts created for the benefit of the taxpayer. The bank refused to comply. In the subsequent proceedings for enforcement, the trial court denied enforcement on the ground that the summonses were not issued in good

\(^1\) 437 U.S. 298 (1978).
faith because they were issued solely for the purpose of unearthing evidence of criminal conduct. The Seventh Circuit affirmed. At the enforcement hearing, there was testimony that the special agent had conceded that the investigation of the taxpayer (p. 303) "was strictly related to criminal violations of the Internal Revenue Code". The District Court, which seemed to recognize that in any criminal investigation "there's always a probability of civil tax liability", nevertheless focused its attention on the special agent's purpose in conducting the investigation:

I'll say now that I heard nothing in Agent Olivero's testimony to suggest that the thought of a civil investigation ever crossed his mind.

*   *   *

Now, unless I find something in the in camera inspection (of the IRS case file) that gives more support to the Government position than the Agent's testimony did, it would be my conclusion that he was at all times involved in a criminal investigation, at least in his own mind.

The District Court relied on the dictum in Reisman v. Caplin in holding that it was an improper use of a summons to serve it solely for the purpose of obtaining evidence for use in a criminal prosecution. The Seventh Circuit regarded that finding of purpose as a factual, rather than a legal conclusion, and applied the clearly erroneous standard despite its noting that the special agent had testified about the existence of a civil purpose for the investigation. (It concluded that the district court simply did not believe the special agent in that regard!)

The Supreme Court reversed and remanded the case. Adverting to its prior decision in Donaldson v. United States, the Court concluded that to enforce a summons under Sec. 7602, the primary requirement is that it be issued before the IRS has recommended to the Department of Justice the initiation of a criminal prosecution relating to the subject matter of the summons. Donaldson also required that the summons be issued in good faith. The Court held that the finding with respect to the special agent's motivation in the case did not necessarily lead to the conclusion that the summonses were not issued in good-faith pursuit of the congressionally authorized purposes of Sec. 7602. Congress did not categorize tax fraud investigations into civil and criminal components. It created a tax enforcement system in which criminal and civil elements are inherently intertwined, and any limitation on the good-faith use of an IRS summons must reflect this statutory premise. The establishment of the transmission of a recommendation to the Department of Justice is, in a sense, an arbitrary cut-off point for the issuance of a summons but nevertheless constitutes a prophylactic restraint on the use of the

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summons. Prior to a recommendation for prosecution to the Department of Justice, the IRS must use its summons authority in good faith. There was no departure from good faith here at the time of the issuance of the summonses, the IRS had an institutional responsibility to calculate and to collect civil fraud penalties and fraudulently reported or unreported taxes. That responsibility was not overturned by the motivation of a single agent who attempts to build a criminal case. If it could be so overturned, it would necessarily (p. 316) “frustrate the enforcement of the tax laws by restricting the use of the summons according to the motivation of a single agent without regard to the enforcement policy of the Service as an institution.” (Emphasis added.) In other words, there must be a showing of institutional bad faith. There are circumstances which could spell out such institutional bad faith. As the Court observed (pp. 316-317):

Because criminal and civil fraud liabilities are coterminous, the Service rarely will be found to have acted in bad faith by pursuing the former. On the other hand, we cannot abandon this aspect of the good-faith inquiry altogether. We shall not countenance delay in submitting a recommendation to the Justice Department when there is an institutional commitment to make the referral and the Service merely would like to gather additional evidence for the prosecution. Such a delay would be tantamount to the use of the summons authority after the recommendation and would permit the Government to expand its criminal discovery rights. Similarly, the good-faith standard will not permit the IRS to become an information-gathering agency for other departments, including the Department of Justice, regardless of the status of criminal cases.