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Confidentiality, Conflict of Interest and Tax Professionals

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I. ORIGINS OF THE CONFIDENTIALITY AND CONFLICT OF INTEREST PRINCIPLES.

A. These Principles Are Relevant in All Professional Relationships.

1. Under the law of agency, it is fundamental that an agent must both maintain the confidences of the principal and serve as loyal representative of the principal. These requirements of confidentiality and loyalty lie at the heart of the relationship that exists between professional and client. In the professional context, the duty of loyalty to client is generally expressed as a requirement that the professional avoid other relationships that may result in conflict with the interests of the client, i.e., that the professional avoid "conflicts of interest."

2. While the confidentiality and conflict of interest principles are fundamental to all professional/client relationships, the standards for applying them have been most fully articulated by the legal profession. For that reason, we focus primarily on the rules governing lawyers, although our purpose is to discuss confidentiality and conflict rules with regard to all tax professionals.

B. Summary of the Confidentiality and Conflict of Interest Rules.

We summarize below the confidentiality and conflict of interest provisions of the ABA Model Rules, the AICPA Code of Professional Conduct, Circular 230, the

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1 Mr. Holden and Ms. Junghans will make the presentation of this subject. This outline has been prepared by Mr. Holden and does not necessarily reflect the views of Ms. Junghans, the United States Department of Justice, or any other government agency.
Rules of Practice of the United States Tax Court, and the ALI's draft Restatement of the Law Governing Lawyers. We also comment on the new extension of the attorney-client privilege to nonlawyer practitioners.

C. Problems for discussion.

At the end of this outline, we include various problems for discussion. It is expected that the oral presentation will consist primarily of a discussion of those problems.

II. THE ABA MODEL RULES OF PROFESSIONAL CONDUCT.

The ABA Model Rules contain a number of provisions that are designed to protect the confidences of the client and to assure loyalty from lawyer to client. The more important of these rules are summarized below.

A. ABA Model Rule 1.6 – Protecting Confidentiality of Information.

1. Rule 1.6(a) prohibits the disclosure of information relating to the representation of a client. Disclosure is permitted where disclosure is impliedly authorized in order to carry out the representation and where one of the exceptions of Rule 1.6(b) applies.

2. Rule 1.6(b) permits (but does not mandate) disclosure in very limited circumstances. Disclosure is permitted where the lawyer reasonably believes disclosure is necessary to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm. Note that, some states, the Rules have been modified to permit disclosure where necessary to prevent the client from perpetrating a fraud. Rule 1.6(b) also allows disclosure in the case of a controversy between the lawyer and client or where necessary to allow the lawyer to defend against a criminal or civil claim growing out of the representation.

3. It is important to recognize that the ethical obligation of confidentiality is quite different from the rule of evidence known as the attorney-client privilege. The ethical obligation of confidentiality is very broad, covering essentially anything that the client desires remain confidential, but it is not very durable in that the ethical obligation will not protect against disclosure sought in a court proceeding. In contrast, the attorney-client privilege is very narrow, applying only to communications that take place under specific terms of confidence, but it is very durable in that it will excuse the lawyer from making disclosure even such disclosure is sought in a court proceeding.
B. ABA Model Rule 1.7 – Existing Client Is Protected Against Conflicts.

1. **Rule 1.7(a)** forbids a lawyer from accepting a representation **directly adverse** to an existing client. The matter may be accepted where each client consents and the lawyer **reasonably** believes that the new representation will not adversely affect the relationship with the existing client.

2. **Rule 1.7(b)** may forbid a lawyer from accepting a representation even where there is no direct adversity to an existing client. This Rule applies where the contemplated representation may be **materially** limited by the lawyer’s responsibilities to another client or by the lawyer’s own interests unless the new client consents and the lawyer **reasonably** believes that the representation will not be adversely affected.

C. ABA Model Rule 1.8 – Dealings with a Client May be Deemed a Conflict.

1. **Rule 1.8** restricts business dealings with a client. Generally, under Rule 1.8(a), a lawyer may not enter into a business transaction with a client unless the terms are fair and reasonable to the client, these terms are communicated in writing, and the client is given the opportunity to seek independent counsel.

2. **Rule 1.8(b) through (j)** Other restricted relationships. These portions of Rule 1.8 list various specific relationships relating to a client that are considered to present conflict of interest issues. These include using information about the client to the client’s disadvantage, preparing an instrument giving the lawyer or the lawyer’s relative any substantial gift unless the client is related to the donee, obtaining literary or media rights based on a representation prior to its conclusion, providing financial assistance to a client in litigation other than advancing court costs and expenses (or paying them, if the client is indigent), accepting compensation from a person other than the client unless the client consents and there is no interference with the lawyer’s independence, agreeing to limit the lawyer’s liability for malpractice, and representing a client where a directly adverse client is represented by a close relative of the lawyer.

3. **Effect of client consent.** Some of these relationships may be permitted where the client consents or where the client receives independent legal advice concerning the relationship.
D. ABA Model Rule 1.9 – Former Client Is Protected Against Conflicts.

1. Rule 1.9(a) protects a former client against conflict of interest and loss of confidentiality. This Rule provides that a lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which the person’s interests are materially adverse to the interests of the former client unless the latter consents. The Rule effectively assures the former client that confidential information obtained in representing the former client is not used to that client’s detriment.

2. Rule 1.9(b) assures that the former client will not lose protection through the mobility of the client’s former counsel. It provides that the relocated lawyer may not represent a person in the same or a substantially related matter if that person’s interests are materially adverse to the former client and the relocated lawyer obtained confidential information at the former firm. The former client may, however, consent to such a representation.

3. Rule 1.9(c) protects against misuse of confidential information. This Rule provides that information relating to a former client may not be used to that client’s disadvantage except as permitted by Rule 1.6 (e.g., to defend a malpractice claim) or as required by Rule 3.3 (e.g., to prevent a fraud upon a tribunal).

E. ABA Model Rule 1.10 – Disqualification Is Imputed to Other Lawyers.

1. All firm members are disqualified. Under Rule 1.10(a), if any lawyer in a firm is precluded from accepting a representation by reason of Rules 1.7 (existing client), 1.8(c) (gift from client to lawyer), 1.9 (former client), or 2.2 (former intermediary), no other lawyer in that firm may accept the representation unless client consent is allowed under the rule and is obtained.

2. No imputation if both lawyer and client have left the firm and the new matter is unrelated. Rule 1.10(b) deals with the situation where a former member of the firm provided legal services to a former client of the firm. In this situation, the firm is allowed to represent a client adverse to the former client if (1) the new matter is not the same as or substantially related to the matter handled by the former member for the former client, and (2) the lawyers remaining in the firm do not have information material to the matter that is protected by Rule 1.6 (confidentiality).
3. "Screening" will not cure imputed disqualification. Note that Rule 1.10 does not give a firm the right to avoid imputed disqualification by "screening" the directly disqualified lawyer from the matter in question. However, where a conflict is cured by client consent, the arrangement with the consenting client often requires the otherwise disqualified firm to screen the directly disqualified lawyer from the matter in question.

4. Screening is effective in the case of former government officials. A firm does have the right under the Model Rules to employ screening procedures to avoid imputed disqualification in the case of a lawyer who was formerly in government service. See Rule 1.11. See also Circular 230, §10.26 for rules relating to former Treasury Department officials who enter private practice.

F. ABA Model Rule 2.2 – A Lawyer May Serve as Intermediary Among Clients.

1. Rule 2.2 sets out a special conflict of interest rule to guide the lawyer who undertakes the sensitive role of acting as intermediary between different clients of the lawyer. Rule 2.2(a) permits the lawyer to act in this role if (1) all clients consent after consultation by the lawyer concerning advantages and risks (including effect on the attorney client privilege), (2) the lawyer reasonably believes that the best interests of all clients can be served without material prejudice to the interests of any of them, and (3) the lawyer reasonably believes that the representation can be undertaken impartially.

2. Special requirements under Rule 2.2. The lawyer is required by Rule 2.2(b) to consult each client to assure that the client is adequately informed and by Rule 2.2(c) to withdraw from the representation of all clients upon the request of any of them or upon the failure of any of the above conditions.

G. ABA Model Rule 3.7 – A Lawyer May Not Serve As Both Advocate and Necessary Witness.

1. Rule 3.7(a) precludes a lawyer from acting as an advocate at a trial where the lawyer is likely to be a necessary witness. Exceptions apply except where (1) the lawyer's testimony would relate to an uncontested issue, (2) the testimony would relate to the nature or value of legal services, or (3) disqualification of the lawyer would work substantial hardship on the client.

2. Disqualification under Rule 3.7 is not imputed to other firm lawyers. Rule 3.7(b) allows a lawyer to act as advocate in a trial
even though a fellow lawyer from the same firm is likely to be called as a witness.

III. THE AICPA CODE OF PROFESSIONAL CONDUCT.

A. Confidentiality and Conflict of Interest Rules Are Provided. The AICPA Code of Professional Conduct contains rules requiring confidentiality and prohibiting conflicts of interest. These rules are less specific and detailed than the ABA Model Rules. However, the AICPA Code does clearly establish the principle that CPAs must, in their professional practice, maintain confidences and avoid conflicts of interest.

B. AICPA Rule 301 – Confidential Client Information. Rule 103 states that a member in public practice shall not disclose any confidential client information without the specific consent of the client.

C. AICPA Rule 102 – Integrity, Objectivity, and Avoidance of Conflicts. Rule 102 requires that, in the performance of any professional services, an AICPA member maintain objectivity and integrity, be “free of conflicts of interest,” and not knowingly misrepresent facts or subordinate the member’s judgment to others.

IV. THE TAX COURT RULES.

A. ABA Model Rules Adopted. The United States Tax Court has adopted the ABA Model Rules as expressing the applicable professional standards that are applicable in practice before the Court. See Tax Court Rule 201.

B. Tax Court Rule 24(f). The Tax Court, in addition to adopting the ABA Model Rules, including their conflict of interest provisions, has taken the further step of adopting Rule 24(f), which is a special Tax Court rule that specifically addresses certain conflict of interest issues. Tax Court Rule 24(f) requires a lawyer--

1. who was involved in planning or promoting a transaction or operating an entity connected to an issue in a case,

2. who represents more than one person with differing interests in a case,

3. or who may be a witness in a case

to do one of the following:

a. secure informed consent of the client (but only as to (1) and (2)),

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b. withdraw, or
c. take whatever other steps are necessary to obviate a conflict of interest or other violation of the ABA Model Rules.

C. Effect of Rule 24(f). Since the ABA Model Rules, adopted by the Court, impose essentially the same requirements as does Rule 24(f), the function of the Rule seems mainly to make the conflict rules more visible to lawyers who appear before the Tax Court.

V. CIRCULAR 230 IMPOSES A CONFLICT OF INTEREST STANDARD ON PRACTITIONER BEFORE THE IRS.

Circular 230, § 10.29, prohibits persons who practice before the Internal Revenue Service from representing conflicting interests. Circular 230 provides no guidance on such matters as the effect of client consent, the degree of protection afforded to former clients, or the imputation of disqualification to other lawyers.

VI. THE INTERNAL REVENUE CODE IMPOSES CONFIDENTIALITY REQUIREMENTS ON TAX RETURN PREPARERS.

Section 6713 imposes civil penalties on tax return preparers who make unauthorized disclosure of return preparation material or uses such material for unauthorized purposes. Section 7216 imposes criminal penalties for such conduct.

VII. THE CONFIDENTIALITY AND CONFLICT OF INTEREST RULES IN THE ALI RESTATMENT.

The American Law Institute has recently adopted a new Restatement of the Law entitled The Law Governing Lawyers (1998). This work was adopted by the Institute at its May 1998 meeting and is not yet available in its final published form. Paperback preliminary copies are, however, available in many law libraries. In the text following, citations are to “Restatement,” with the section number. This document contains extensive discussion of the rules relating to confidentiality and conflict of interest.

A. The Confidentiality Rules of the Restatement. The rules governing confidentiality are contained in Chapter 5 of the Restatement. These rules deal in detail with the attorney-client privilege, the work product doctrine, and the ethical obligation of confidentiality.

B. The Conflict of Interest Rules of the Restatement. These rules, contained in Chapter 8, largely parallel those of the ABA Model Rules, although they are more detailed and specific. They include a general prohibition against conflicts of interest, a rule that conflicts are imputed among lawyers in the same firm, and a recognition that informed client consent may remove the conflict prohibition.
C. Comments and Reporters' Notes. The draft Restatement contains comments and reporters' notes that furnish very helpful background information to those who are interested in researching this area of the law.

VIII. THE NEW TAX PRACTITIONER-CLIENT PRIVILEGE.

A. Introduction.

1. Section 7525, enacted as a part of the Internal Revenue Service Restructuring and Reform Act of 1998, extends the common law attorney-client privilege to tax advice communications between taxpayers and certain identified tax practitioners.

2. Specifically, section 7525 provides that tax advice communicated between a taxpayer and a "federally authorized tax practitioner" will enjoy the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.  

3. Section 7525 imposes various special terms and conditions on the application of the new privilege that are not found in the application of the attorney-client privilege. For this reason, the application of the new privilege requires an understanding of both the attorney-client privilege and the special terms and conditions that are contained in section 7525.

B. The Concept of a "Federally Authorized Tax Practitioner."

1. Definition. Tax advice communications are protected only where they occur between a "federally authorized tax practitioner" and a taxpayer. Thus, a threshold issue is the definition of this term.

   a. Section 7525(a)(3)(A) defines the term "federally authorized tax practitioner" as any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of Title 31, United States Code.

   b. 31 U.S.C. section 330 of Title 31 authorizes the Secretary of the Treasury to impose standards of conduct for those

2 Unless otherwise indicated, the term "attorney" as used in this outline refers to an attorney engaged in the practice of law, and the term "nonattorney" includes an individual who is an attorney but who is not engaged in the practice of law.
persons who practice before the Treasury Department and to discipline practitioners who fail to comply with those standards.

(i) Exercising this authority, the Secretary has issued regulations in Title 31, Part 10, Code of Federal Regulations, which govern practice before the Internal Revenue Service. These regulations are commonly referred to as "Circular 230."

(ii) Those who practice before the Internal Revenue Service are thus subject to regulation under Circular 230 in the conduct of that practice.

c. Identifying individuals who are authorized to practice before the Internal Revenue Service.

(i) Some individuals are authorized by statute to practice before the Internal Revenue Service; others are authorized to do so under the terms of Circular 230.

(ii) Section 500 of Title 5 provides that an attorney who is a member in good standing of the bar of the highest court of a state is authorized to practice before any Federal agencies without further action.

(iii) Insofar as practice before the Internal Revenue Service is concerned, 5 USC §500 extends the same automatic admission right to a CPA who is duly admitted to practice in a state.

(iv) Reflecting the terms of the statute, Circular 230 provides that all duly qualified attorneys and CPAs are, by virtue of their status as such, eligible to practice before the Internal Revenue Service. Circular 230, §10.3(a) and (b).

(v) Circular 230 provides for practice before the Internal Revenue Service by "enrolled agents," who are individuals that have successfully passed an examination administered by the Internal Revenue Service or have established their qualification by virtue of prior employment by the Internal Revenue Service. Circular 230, §10.3(c) and 10.4.

(vi) Circular 230 also provides for practice before the Internal Revenue Service by "enrolled actuaries" in
certain specific statutory areas. An enrolled actuary must be enrolled as an actuary by the Joint Board for the Enrollment of Actuaries under 29 USC §1242.

2. Under the terms of section 7525(a)(3)(A), all attorneys, CPAs, enrolled agents, and enrolled actuaries constitute federally authorized tax practitioners. This classification is moot insofar as attorneys engaged in law practice are concerned because their tax advice communications with clients may be protected by privilege without regard to section 7525.

   a. It is unclear whether and to what extent the attorney-client privilege is available to protect tax advice communications with clients made by attorneys who are partners or employees of firms that do not hold themselves out as engaged in law practice. However, it is clear that tax advice communications by such individuals that meet the terms of section 7525 are protected by the new privilege.

   b. Although the stated purpose of section 7525 is to protect communications between nonattorney tax practitioners and their clients, the statute does not appear to require that a federally authorized tax practitioner be engaged primarily in the provision of tax services to clients. It thus appears an individual who is an attorney, a CPA, or an enrolled agent and who is employed by a bank or other commercial organization that is not engaged in traditional tax practice may communicate tax advice to clients or customers of that organization and that such advice is eligible for protection under section 7525.

C. The Concept of “Tax Advice.”

1. Section 7525 offers protection only to the communication of “tax advice.” Thus, it is important to explore the meaning of that term.

   a. Section 7525(a)(3)(B) defines “tax advice” as advice given by an individual with respect to a matter which is “within the scope of the individual’s authority to practice” before the Internal Revenue Service.

   b. It is thus necessary to determine what matters are within the scope of an individual’s “authority to practice” before the Internal Revenue Service. Since Circular 230 contains a definition of “practice” before the Internal Revenue
Service, that definition seems to be a logical starting point for the inquiry.

(i) Under Circular 230, practice before the Internal Revenue Service “comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a client’s rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include preparing and filing necessary documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.” Circular 230 §10.2(e).

(ii) The emphasis in this definition is on presentations to and communications with the Internal Revenue Service on behalf of a client, and the definition says nothing about providing tax advice to a client in a setting not before the Internal Revenue Service.

(iii) Despite this, Circular 230 does in fact expressly regulate some tax advice activities, thereby suggesting that those activities do constitute practice before the Internal Revenue Service. Thus, §10.33 regulates the content of “tax shelter opinions.” If the provision of tax advice in such form were not practice before the Internal Revenue Service, it could not be regulated in Circular 230.

(iv) Moreover, it would be inconsistent with the whole purpose of section 7525 to conclude that the giving of tax advice is not practice before the Internal Revenue Service and is thus not protected by that section.

(v) An argument that the giving of tax advice is not within the scope of an individual’s authority to practice before the Internal Revenue Service for purposes of section 7525 would likely be raised

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3 Various activities performed on behalf of clients before the Internal Revenue Service do not require qualification under Circular 230. See §10.7 (representing oneself or certain persons related by family or employment, preparing tax returns, appearing at rulemaking proceedings) and §10.8 (activities of customhouse brokers).
only by someone seeking to defeat the application of privilege, i.e., by the Internal Revenue Service. It seems quite unlikely that the Internal Revenue Service would raise such an argument, given the clear legislative history, even though the Treasury Department is not greatly enamoured of the privilege and did oppose its enactment.

2. Although it is likely that most tax advice communications protected under section 7525 will relate to Title 26 (Internal Revenue Code) matters, this is not a requirement of the statute. So long as the tax advice communicated relates to matters that are regulated by the Internal Revenue Service, it would appear to be within the concept of “practice” before the Internal Revenue Service and thus eligible for protection under section 7525.

3. The status of communications that combine tax advice with other subjects is unclear.

a. If a tax advice communication includes both tax advice and other matters, e.g., tax advice is included in a letter that describes the client’s public reporting responsibilities under the securities laws, it appears that only the tax advice content of the communication is protected.

b. In such circumstances, the Internal Revenue Service would presumably be entitled to a redacted version of the communication in which the tax advice portions were removed.

4. Tax advice communications related to tax return preparation may or may not be protected.

a. It is clear that a tax advice communication between a client and a return preparer who is not a federally authorized tax practitioner will not be protected under section 7525.

b. If the tax advice communication is between a client and a return preparer who is a federally authorized tax practitioner, whether or not it is protected is uncertain. The uncertainty in this instance derives from the interpretation of the attorney-client privilege rather than from the terms of section 7525.

(i) In construing the attorney-client privilege, some courts have regarded return preparation as not involving the practice of law, and thus have denied the application of that privilege for communications
related to such activities. The Restatement (§122, comment c., illustration 2) provides the following illustration:

“As Lawyer has done in past years, Lawyer prepares Client’s Federal tax returns, using records, receipts, and other information supplied by Client and without discussing any issues with Client. Client’s tax returns are not complex, nor do they require a knowledge of tax law beyond that possessed by non-lawyer preparers of tax returns. Client knows that Lawyer is admitted to practice law but has never discussed with Lawyer any legal questions concerning taxes or return preparation, nor has Lawyer offered such advice. Client pays Lawyer on a per-form basis and in an amount comparable to what non-lawyer tax preparers charge. The trier of fact may, but need not, infer that Client’s purpose was not that of obtaining legal assistance.”

(ii) Other courts have recognized that return preparation may involve the practice of law in circumstances where the preparer engages in more substantive activity. The Restatement (§122, comment c., illustration 3) provides the following illustration:

“Client frequently has consulted Lawyer about legal matters relating to Client’s growing business. Lawyer drafts documents and provides other legal assistance relating to a complicated transaction having important tax implications that Client and Lawyer identify and discuss. Client later asks Lawyer to prepare Client’s Federal income tax return for the tax year in which the transaction occurs. The circumstances indicate that Lawyer is providing legal services in preparing the tax return.”

(iii) The better view seems to be that communications related to tax return preparation are protected by attorney-client privilege as long as they relate to substantive legal issues and contain material beyond that which is to be disclosed on the return. It seems likely that the section 7525 privilege will be available in similar circumstances, i.e., where the federally authorized tax practitioner provides legal
evaluations and risk assessments in conjunction with return preparation.

D. The Concept of "Communication."

1. Section 7525 offers protection only to a tax advice "communication" between a taxpayer and a federally authorized tax practitioner. It is thus necessary to evaluate the significance of this requirement. The principal issues concern the identity of the persons among whom protected communications may occur and whether tax advice must actually be communicated to a client taxpayer in order to be protected.

2. The identity of the group of "privileged persons."

a. In dealing with this question with regard to the attorney-client privilege, the Restatement uses the term "privileged persons" and defines that term to include "the client (including a prospective client), the client's lawyer, agents of either who facilitate communications between them, and agents of the lawyer who facilitate the representation." Restatement §120. Modifying this definition to fit the current context, we can identify the privileged persons under section 7525 as the actual or prospective client, the tax practitioner, agents of either of them who facilitate communications between them, and agents of the tax practitioner who facilitate the representation.

b. It thus seems clear that protected communications may be made to or by agents of the practitioner whose role it is to facilitate the provision of tax advice to the client.

(i) For example, secretaries and other staff assisting the practitioner who are not themselves federally authorized tax practitioners may be included in the communication loop.

(ii) In addition, the practitioner should be able to engage third-party professionals to assist the practitioner in the tax advice representation. This concept is analogous to the Kovel procedure under which attorneys have been able to retain accountants to assist in legal representation and to bring those accountants into the privileged group protected by the attorney-client privilege.
c. Similarly, agents of either the client or the tax practitioner whose role it is to facilitate communications between them, e.g., secretaries or administrative assistants, are within the protected group. Thus, communications made through such agents should be eligible for protection.

d. The group of privileged persons may be expanded in certain circumstances.

(i) If two or more clients are jointly represented by the same practitioner, tax advice communications relating to their common concerns should be privileged with respect to each of them, and the privilege may be asserted by any of them. See Restatement §125.

(ii) If two or more taxpayers with a common interest are represented by different tax practitioners, they may agree to an exchange of information among them, and any tax advice communications among them should be eligible for protection under section 7525. See Restatement §126.

3. Actual communication of tax advice should not be required.

a. Section 7525 on its face protects only tax advice that is communicated between a taxpayer and a federally authorized tax practitioner. This raises the question whether tax advice developed for a client but not actually delivered to the client will be protected. This might include, for example, tax analyses prepared in connection with a tax engagement and retained in the practitioner's files. It might also include workpapers and other backup materials.

b. As a general rule, the attorney-client privilege protects not only communications between attorney and client but also notes and documents relevant to those communications, disclosure of which would tend to reveal the nature of the actual communications. For example, if a taxpayer consults a practitioner for the purpose of obtaining tax advice, and the practitioner develops materials relevant to that taxpayer on the basis of information received from the taxpayer, those materials should be protected because their disclosure would in turn disclose the nature of the communication from the taxpayer. See Rice, §5.12.
c. If the section 7525 privilege is interpreted in a manner consistent with the attorney-client privilege (as seems likely), actual communication of tax advice should not be required in order to protect materials prepared as a result of communications made by the client in pursuit of tax advice.

E. Forums In Which the New Privilege Is Available.

1. Section 7525 specifies two kinds of proceedings in which the new privilege may be asserted: A "noncriminal tax matter before the Internal Revenue Service" and a "noncriminal tax proceeding in Federal court brought by or against the United States."

   a. These are the proceedings in which the privilege may be asserted to deny government access to the privileged communication. They do not define the setting in which the privileged communication must be made.

   b. In most circumstances, the privileged communication will have occurred at some prior point in time, and the issue will be whether the Internal Revenue Service or the Department of Justice may gain access to that communication in one of the above proceedings.

   c. By restricting the new privilege to the matters and proceedings described above, the statute denies its availability in all other settings, such as civil litigation, proceedings before other Federal agencies, and all state proceedings, including state tax matters. If the absence of privilege causes tax advice communications to be disclosed in such other proceedings, it is unclear whether that disclosure will operate as a waiver and void the section 7525 privilege in subsequent Internal Revenue Service matters and Federal tax litigation.

2. Noncriminal tax matters before the Internal Revenue Service.

   a. There should be little difficulty in identifying tax matters before the Internal Revenue Service. However, identifying a "noncriminal" tax matter may be more problematic. If a firm indication of fraud arises in a civil examination, civil audit activity is suspended. IRM 4565.21(1). Upon first contact with a taxpayer, a special agent is required to identify himself/herself as such and to advise that one of the agent's responsibilities is to consider possible criminal violations. IRM 9384.2(2). At this point, a taxpayer who
has cooperated in the civil audit may elect not to cooperate as the criminal investigation goes forward.

b. When a taxpayer or practitioner is asked for information by the Internal Revenue Service in a civil examination, the taxpayer has the option to assert privilege. However, once the examination becomes a criminal investigation, the taxpayer will lose the opportunity to assert privilege with respect to prior communications with nonattorney advisors. There does not appear to be any limitation on this loss of privilege and the criminal labeling may permit the government to obtain tax advice communications that had been protected under section 7525 during the civil examination. Accordingly, if it is at all likely that a civil examination may turn into a criminal investigation, it is probably preferable to pursue the Kovel procedure and to cause an attorney to retain any nonattorney advisor.

3. Noncriminal tax proceedings in Federal court brought by or against the United States.

a. It should not be difficult to identify Federal court proceedings that are criminal in nature. In such a case, the section 7525 privilege may not be asserted, and all communications with nonattorney advisors will be subject to compelled disclosure.

b. The phrase “brought by or against the United States” does present some definitional difficulty. It clearly comprehends civil tax cases in Federal district courts, the Court of Federal Claims, and the United States Tax Court. Less clear is the status of other proceedings in Federal courts where Federal tax issues may be resolved but where the proceedings are not “brought by or against the United States.” Notable among such proceedings are those in the Federal bankruptcy courts. It would seem that the purpose of creating the privilege would be served by making it available in bankruptcy proceedings, but it is possible that the Internal Revenue Service will contest that result. Accordingly, care should be exercised to find other means to protect communications in these matters.

F. The New Privilege Is Restricted For “Corporate Tax Shelters.”

1. Section 7525(b) provides that the new privilege will not apply to any written communication between a federally authorized tax practitioner and a representative of a corporation in
connection with the promotion of the direct or indirect participation of such corporation in any tax shelter.

2. The scope of this restriction is difficult to measure.

a. Section 7525(b) refers to section 6662(d)(2)(C)(iii) for the definition of the term “tax shelter.” The latter defines the term as any entity, plan, or arrangement having “as a significant purpose” the avoidance or evasion of Federal income tax. This is a very broad definition that could reach almost any tax reducing proposal.

b. It is not clear what effect the phrase “in connection with the promotion . . . of the . . . participation” will have on the application of this restriction. It would appear reasonable to conclude that, if the practitioner’s role is to promote the shelter, the privilege would not apply, but that, if the practitioner’s role is to evaluate the tax validity of a shelter being promoted by another person, the privilege would apply. It would seem incongruous to deny privilege where the practitioner is engaging in a responsible exercise of his or her authority to practice before the Internal Revenue Service.

c. The conference report for section 7525 states that “The Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, the Conferees do not anticipate that the tax shelter limitation will adversely affect such routine relationships.” This language tends to confirm the interpretation offered above, i.e., that the restriction will apply only where the practitioner is engaged in a promotion effort, as distinguished from an evaluation assignment.

G. Duration and Waiver of the Privilege.

1. Privilege survives the representation. The privilege, once established, may be invoked at any time during or after the representation of the client or prospective client by the practitioner. Restatement §127. Thus, if a tax advice communication occurs between a practitioner and a client, the client may assert privilege with respect to that communication in future tax proceedings even if the client is no longer represented by that practitioner.
2. Waiver by agreement or failure to object. Restatement §128.

a. The privilege will be waived if the client, the practitioner, or another authorized agent to the client agrees to waive it.

b. It will also be waived if the client or the client’s authorized agent fails to object at a time when another person proposes to give testimony in a proceeding. Thus, if the practitioner’s testimony is sought and the client fails to object to that testimony, the privilege will be waived.

3. Waiver by disclosure.

a. The privilege will be waived if the client, the practitioner, or another authorized agent of the client voluntarily discloses the otherwise protected communication in a non-privileged communication. Restatement §129. For example, if the client or an agent of the client (including the practitioner) repeats the substance of a tax advice communication received from a practitioner in a letter to the client’s banker, the privilege will be waived.

b. Disclosure of the communication to agents of the practitioner does not ordinarily result in waiver. However, it is difficult to identify the outer edges of this statement. In the administration of the attorney-client privilege, it is generally considered that disclosures made within the attorney’s law firm do not inhibit the privilege if proper procedures are followed. This is on the theory that all client matters within the firm are confidential, and intra firm communication is thus not inconsistent with an intended confidentiality.

c. The degree to which this concept will operate in the case of the section 7525 privilege is uncertain because of several factors.

(i) Some professional service firms, such as accounting firms, have disclosure obligations that arise with regard to their public accounting function. It is thus unclear whether the presumption of confidentiality will operate to allow intra firm communication of privileged information.

(ii) Some professional service firms are very large in size, extending both nationally and internationally. At those size levels, the sheer breadth of possible intra firm communication may suggest that
information so communicated will no longer be privileged.

(iii) Some organizations whose agents may qualify as federally authorized tax practitioners (e.g., banks, insurance companies, pension consultants, etc.) may have no system for preserving the confidentiality of intra firm communications.

(iv) It is likely that the courts will be called upon to establish limits on the permitted scope of intra firm dissemination of confidential client information.

d. Where there is voluntary disclosure of a portion of otherwise protected communications, as where one privileged communication is disclosed and other privileged communications on the same subject matter are not disclosed, there is risk that the partial disclosure will result in compelled disclosure of all the related communications. Where the disclosure of the one communication is voluntary and knowing, most courts apply the subject matter waiver doctrine and hold that the disclosure waives privilege for all communications on the same subject matter. Restatement §129, comment f. and reporters note.

4. Waiver by putting tax advice communication in issue.

a. The privilege will be waived if, in a proceeding, the client relies on the communication as justification for the client’s actions. Restatement §130. For example, if the client defends against imposition of the accuracy-related penalty under section 6662 on the grounds that the client acted on the basis of tax advice received from a practitioner, all otherwise privileged communications relating to that advice will become available to the government.

b. If the Internal Revenue Service asserts a penalty against a practitioner with regard to advice or assistance provided by the practitioner to a client, the practitioner may wish to disclose the substance of the relevant tax advice communicated to the client. In this circumstance, the operation of the privilege is not clear. The attorney-client privilege does not apply to a communication that is reasonably necessary to defend the attorney against an allegation that the attorney acted wrongfully during the course of representing the client. Restatement §133. It would be reasonable to presume that this rule will be
imported into the construction of the section 7525 privilege, thereby allowing the practitioner to defend himself or herself by disclosing otherwise privileged communications. However, where the client regards that disclosure to be adverse to the client's interests, it would also be reasonable to expect the client (presumably now a former client) to seek to prevent the disclosure.

5. The crime fraud exception.
   a. The attorney-client privilege does not apply to a communication if the client consults an attorney for the purpose of obtaining assistance to engage in a crime or fraud or of aiding another person to do so. It also does not apply if the client, regardless of original purpose, uses the attorney's advice to engage in or assist a crime or fraud. Restatement §132.
   b. The possible area of operation of this exception in the case of the section 7525 privilege appears to be quite limited. If a client consulted a practitioner for assistance with regard to a tax-based crime, there would be no privilege in later criminal proceedings since the section 7525 privilege is not available in criminal proceedings.

DISCUSSION PROBLEMS RELATING TO CONFIDENTIALITY AND CONFLICT OF INTEREST.

Problem No. 1.

Husband and Wife file joint income tax returns for the years 1992-1996, which report Husband's self-employment income of $35,000 per year from the operation of a convenience store. During this period, Wife knows that Husband has a legal, but compulsive, gambling habit. In 1997, Wife learns for the first time that Husband has been involved for several years in an illegal check-kiting scheme to generate funds both to operate his business and to fund his gambling habit. The bank which has been victimized by the check kiting requests that both Husband and Wife sign a promissory note to repay $150,000; the debt is to be secured by a mortgage on their jointly-owned residence. The parties accede to the bank's request without consulting with counsel.

In 1998, the IRS begins an audit of the 1992-1996 returns. It determines that husband realized $150,000 in additional income from the check kiting scheme and issues a notice of deficiency to both spouses. Both spouses seek your advice as to how to
respond. Can you advise both spouses? If not, why not? If you determine that you can advise both and the couple later separates, what are your obligations?

**Problem No. 2.**

You are an accountant. In January, 1999, a new client is referred to you. The new client asks that you prepare his 1998 income tax return, and you agree to do so. In the course of preparing the return, you learn that the client has filed inaccurate – and perhaps fraudulent – returns for the years 1994 through 1997. The client is adamant that the information he is providing you for 1998 is complete and accurate, and so you complete the preparation of the 1998 return.

The 1996-1998 returns are later selected for examination. At the same time, the client’s marriage breaks up, and bitter divorce litigation ensues. The client asks you to handle the audit for him. Can you? Should you? How should you respond if the agent asks you for your workpapers? How should you respond if your testimony or workpapers are subpoenaed in the divorce case?

**Problem No. 3.**

Prospective Client is planning a hostile takeover of Target Corporation and seeks legal representation in the corporate and securities area. To this end, Prospective Client interviews Law Firm, advises Law Firm of various strategies that it plans to use in the takeover effort, and seeks a description of Law Firm’s capabilities in this kind of matter. Law Firm meets with Prospective Client and favorably describes its capabilities. Law Firm is not selected by Prospective Client for this assignment. Later, Prospective Client publicly moves to acquire Target Corporation, and Target Corporation resists the takeover. Target Corporation contacts Law Firm, advising that it wishes to pursue various tax strategies in opposing the acquisition, and inquires whether Law Firm would be available to represent Target Corporation in tax matters related to the acquisition. Can Law Firm accept the representation of Target Corporation? See Restatement §27, Comment c., pp. 22-25.

**Problem No. 4.**

Buyer approaches Seller seeking to buy real estate that Seller owns and that has significant potential for future development. Lawyer has represented Buyer in various commercial transactions over the years, and Lawyer has also represented Seller in other transactions. Buyer retains Lawyer to represent Buyer in the real estate transaction. A few days later, Seller asks Lawyer to represent Seller. Lawyer advises Seller that Lawyer is not available, having already agreed to represent Buyer. Seller persists in seeking Lawyer’s services, and ultimately Lawyer agrees to represent both, being careful to provide Seller with a conflict letter in which Lawyer explicitly discloses to Seller that Lawyer also represents Buyer. A contract is signed. The contract is contingent on successful rezoning of the property, and the parties agree to cooperate to achieve rezoning. If the rezoning is not accomplished by a deadline date, the contract expires.
After the contract is signed, but before the rezoning is accomplished, Lawyer learns that Buyer has in hand a contract to resell the property at a substantially higher price than Buyer is to pay Seller. What are Lawyer's responsibilities upon learning this information? The rezoning effort drags on, and it becomes necessary for Buyer to obtain an extension of the contract to avoid its lapse. How does Lawyer handle this situation? See Baldasarre v. Butler, N.J. Super. 502, 604 A.2d 112 (1992). See also, Schlesinger v. Mitchell, 672 So.2d 701 (La. App. 1996).

Problem No. 5.

Husband and Wife consult Lawyer to obtain estate planning assistance. In the initial interview with both spouses, Lawyer perceives no conflict in their objectives. Lawyer accepts the representation, and work proceeds on the estate plans for both spouses. Later, Husband contacts Lawyer and advises that Husband desires to set aside substantial assets for the care and support of a former paramour of Husband. Husband stresses that Wife is not to know of this arrangement. There is both a confidentiality issue and a conflict issue. How does Lawyer handle these issues? Is it material whether or not the assets to be used to satisfy Husband's objectives will reduce property passing to Wife and/or children of Husband and Wife? See, Restatement, §112, comment 1.

Problem No. 6.

Lawyer represented Old Corporation for many years. Shareholder owned all of the stock of Old Corporation. Shareholder disposed of his stock of Old Corporation in a transaction in which Old Corporation merged into New Corporation, which then adopted the name of Old Corporation. A dispute arose concerning the representations made by Old Corporation and Shareholder in the acquisition agreement concerning Old Corporation's Federal income tax liabilities. New Corporation (now named Old Corporation) brought arbitration proceedings against Shareholder, and Shareholder retained Lawyer to represent Shareholder in the arbitration. New Corporation moved to disqualify Lawyer from the arbitration proceeding and to restrain Lawyer from disclosing any information concerning Old Corporation to Shareholder, asserting that New Corporation had succeeded to ownership of the attorney client privilege formerly held by Old Corporation. Is New Corporation entitled to assert the privilege and to disqualify Lawyer? If Lawyer was instead a "federally authorized tax practitioner" within the meaning of Section 7525, would the result be different? For a similar factual situation, see Techni-Plex v. Meyner & Landis, 89 N.Y. 123 (1996).

Problem No. 7. I am a CPA and member of an accounting firm. Among my other professional services, I provide personal financial planning services to various clients. In order to have a variety of investment opportunities available to my clients, I carefully watch business developments in my State. When I see ones that I consider sound and reasonably safe, I purchase either an interest in the venture or an option to purchase an interest. Typically, I keep a portion of these investments for my personal portfolio and make the balance available to my financial planning clients. I went to a seminar recently
where it was suggested that this procedure could be regarded as involving a conflict of
interest with my clients. May I continue to handle matters as I have in the past?

Problem No. 8.

Lawyer represents Company, a small startup that is struggling to become successful. Lawyer has done tax and corporate work for Company over the few years of its existence. Company badly needs additional financing to survive, but it has been unable to find a source. Lawyer approaches his brother-in-law, who has financial industry contacts. Through this avenue, a willing lender is located, and Company obtains the funds needed to survive. Company’s board of directors is highly pleased with Lawyer’s assistance, and the board votes to award Lawyer 3% of the outstanding stock, which currently has little, if any, value. Nothing more is done to memorialize the stock award. Company becomes quite successful and, several years later, the 3% stock interest has a value of $33 million. Lawyer asks that Company deliver on its agreement. Company refuses. Lawyer sues to obtain compliance. What is the result? See Passante v. McWilliam, 53 Cal. App.4th 1240, 62 Cal. Rptr.2d 298 (1997).

Problem No. 9.

Dilbert Oil Company is a minority shareholder of Supreme Oil Company. Supreme is in the process of reorganizing its operations and proposes to make a substantial distribution to its shareholders. My firm, which operates on a national basis, has been retained by Dilbert to obtain a private letter ruling from the Internal Revenue Service to the effect that the distribution from Supreme will be taxed to Dilbert as a dividend eligible for the dividends received deduction. My office, located in Omaha, has filed the request for rulings, and the matter is now being processed. Today our New York office received a request from one of its important clients, Chris Ramer, who is a substantial individual investor. Ramer asks that our New York office seek on his behalf an IRS private letter ruling that the distribution will be taxed as a redemption eligible for capital gain treatment. The tax professionals in our New York office operate independently from those in our Omaha office. Can we accept this representation?