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Seventh Circuit Affirms Narrow Application of Accountant-Client Privilege in Federal Tax Matters

In *Valero Energy Corp. v. United States*,[1] the Seventh Circuit Court of Appeals recently held that the statutory accountant-client privilege did not prevent the IRS from obtaining discovery of documents generated by two accounting firms in connection with a corporate restructuring transaction. The Court narrowly interpreted the scope of the accountant-client privilege in two respects. First, the Court held that the privilege does not apply to "accounting advice" as distinguished from legal advice. Second, the Court broadly applied the tax shelter exception to the privilege.

Under the *Valero* holding, a taxpayer who turns to its accountants for tax planning advice on transactions having significant tax benefits will not enjoy the same discovery protections as a taxpayer who turns to a lawyer. While this holding is arguably at odds with Congressional intent and other court decisions, taxpayers should expect that the IRS will rely on this case to seek broad discovery of non-lawyer tax planning communications and advice. Until the issue is resolved, taxpayers should consider obtaining sensitive tax planning advice from a lawyer rather than an accountant.

The Accountant-Client Privilege

Confidential communications with a lawyer for the purpose of obtaining legal advice, including legal advice related to federal taxes, are protected from discovery by the IRS under the common law attorney-client privilege. There is no accountant-client privilege under common law.[2] As a result, lawyers providing legal advice to clients on federal tax matters are eligible for a privilege that accountants do not enjoy under common law.

In 1988, Congress enacted Section 7525 of the Internal Revenue Code to extend the attorney-client privilege (subject to its attendant limitations and exceptions) to communications between a taxpayer and any "federally authorized tax practitioner" in non-criminal federal tax

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matters. (I refer to the statutory privilege as the "accountant-client privilege," although it applies to certain non-accountants, such as an enrolled agent or enrolled actuary.)

The accountant-client privilege does not apply to written communications between the accountant and any person "in connection with the promotion of the direct or indirect participation of the person in any tax shelter." For this purpose, a tax shelter is defined as any plan or arrangement having a significant purpose of tax avoidance or evasion.

The Valero Case

In December 2001, Valero acquired Ultramar Diamond Shamrock Corp., which had Canadian subsidiaries. Prior to closing the purchase, Valero consulted with Ernst & Young about tax planning in connection with restructuring the Canadian operations, and also engaged its long-time advisor Arthur Andersen to review Ernst & Young's tax plan. The plan was subsequently implemented, producing significant U.S. and Canadian tax savings.

The IRS audited Valero and issued it a summons seeking documents related to tax advice Valero received in connection with the transaction. The District Court ordered production of all documents reflecting communications with the accountants. It held that most of those documents were outside the scope of the accountant-client privilege because they involved Canadian or state tax advice, or business or accounting advice, or no advice at all, rather than legal advice as to federal tax matters. Other documents that were within the scope of the accountant-client privilege were ordered produced under the tax shelter exception.

On appeal Valero claimed that the District Court erred in concluding that certain documents – including worksheets containing financial data and tax calculations, and documents raising issues about Valero's inventory methods, compensation packages, or general structure and how those issues affect tax computations – constituted accounting advice rather than legal advice. The Circuit Court rejected this claim, stating that preparation of tax returns is an accounting, not a legal service and any information communicated to an accountant (or a lawyer) "so that it might be used on a tax return" is not covered by the privilege, whether or not the information is reported on the tax return. The Circuit Court found that many of the documents contained "the type of information generally gathered to facilitate the filing of a tax return," and that while other documents "contained some legal analysis, it

comes part and parcel with accounting advice."

Valero also challenged the District Court's broad application of the tax shelter exception. Valero argued that the tax shelter exception should be limited to communications associated with the marketing of prepackaged tax shelters, and not to tax advice given in connection with an individualized transaction. The District Court rejected this narrow reading of the tax shelter exception and held that even Arthur Andersen's advice was subject to the tax shelter exception because it was given "in connection with" Ernst & Young's promotion of the transaction to Valero. The Circuit Court appeared to adopt a more restrictive interpretation of the tax shelter exception, noting that "Promotion ... limits the exception to written communications encouraging participation in a tax shelter, rather than documents that merely ... assess such plans in a neutral fashion." Nevertheless, it did not disturb the District Court's holding that Arthur Andersen's otherwise privileged communications were not protected due to the tax shelter exception.

The Countryside Case

The Seventh Circuit's opinion in *Valero* does not discuss the decision in *Countryside Limited Partnership v. Commissioner*,[3] a Tax Court opinion issued nine days before the Seventh Circuit's decision. In *Countryside*, the Tax Court held that tax planning advice provided by a taxpayer's long-standing tax accountant on an hourly fee basis was protected from discovery under the accountant-client privilege. The Tax Court rejected the IRS's claim that the tax shelter exception applied, citing legislative history that advice given as part of a long-standing, ongoing, and routine relationship with the taxpayer does not constitute advice in connection with the "promotion" of a tax shelter.

Given that Arthur Andersen was Valero's long-time advisor, it appears that the Seventh Circuit's interpretation of the tax shelter exception is at odds with the Tax Court's *Countryside* opinion.

Implications of the Valero Case

The Uncertain Scope of Accounting Advice. The *Valero* case correctly notes that communications with a tax preparer (whether an accountant or a lawyer) for the purpose of facilitating preparation of a tax return are not privileged. However, the case expands this rule to communications and advice that were not related to preparation of a tax return, but were instead related to analyzing the tax consequences of a transaction as part of deciding whether to implement it. This seems to be clear

error. Until the law is clarified, taxpayers should consider seeking planning advice from advisors who do not regularly sign tax returns as a paid preparer for the taxpayer or otherwise.

The Tax Shelter Exception. The Seventh's Circuit broad application of the tax shelter exception to the statutory accountant-client privilege creates a significant risk that communications with accountants concerning proposed transactions having significant tax benefits will not be eligible for the accountant-client privilege. Because communications with lawyers are not subject to any such tax shelter exception, taxpayers seeking confidential advice on such transactions should consider whether the advice should be obtained from a lawyer rather than an accountant.

If you have questions relating to the issues addressed in this newsletter, please feel free to contact Jim Browne or Farley Katz, or any member of the Strasburger Taxes and Estates practice unit indicated in the side panel.

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[1] No. 08-3473 (7th Cir., filed June 17, 2009), *aff'g* 102 AFTR 2d 2008-6564 (N.D. Ill. 2008).

[2] *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

[3] 132 T.C. No. 17 (June 8, 2009).

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