AICPA® Tax Section

Overview of the Federally Authorized Tax Practitioner — Client Privilege Under IRC Sec. 7525

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NOTICE TO READERS

This practice guide explains the federally authorized tax practitioner—client privilege pursuant to section 7525, *Confidentiality Privileges Related to Taxpayer Communications*. Tax practice guides are designed as educational and reference material for the members of the Tax Section and others interested in the subject. They do not establish standards or preferred practices.

Although thought and effort have gone into the development of this guide, it is subject to change. You need to consider the effect that any new developments might have on this practice guide. In addition, the law itself is subject to varying interpretations. Accordingly, you retain responsibility for the final use of its content.

Acknowledgements

This guide was developed and compiled by the members of the Tax Practice Responsibilities Committee (TPRC) of the AICPA Tax Division.

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Overview

The federally authorized tax practitioner—client privilege was created in 1998 with the enactment of Internal Revenue Restructuring and Reform Act of 1998 (IRSRRA). In passing what became IRC section[1] 7525, Congress believed that communications between a taxpayer and his or her advisor should be privileged in noncriminal proceedings before the Internal Revenue Service (IRS) and in noncriminal proceedings in federal courts where the IRS is a party, provided the practitioner is authorized to practice before the IRS.[2] This privilege belongs to the client, and as such the client will need to assert it to prevent CPA/client communications from being introduced as evidence in covered proceedings. As will be discussed later, the privilege does not extend to return preparation matters.

The privilege generally allows communications between taxpayers and their tax advisors, with respect to U.S. tax advice, made on or after July 22, 1998 (the date of enactment of the IRSRRA), to be protected from disclosure to the IRS in an administrative or civil proceeding. However, there are numerous exceptions and limitations to the privilege, and the protection is likely to apply to only a limited number of circumstances.

To date, no regulations have been promulgated, either in temporary or proposed format, to implement section 7525. There has not been significant administrative guidance in this area either. Accordingly, practitioners and their clients should recognize that the final determination of whether any particular communication and/or document is protected from disclosure by the federally authorized tax practitioner—client privilege may be a legal matter. As such, it may be necessary for both practitioners and their clients to consult with counsel in evaluating the scope and application of the privilege in a particular case. Therefore, members should avoid giving any assurances to their clients regarding the applicability of the privilege to any particular situation.

General Rule

The general rule for the federally authorized tax practitioner—client privilege under section 7525 draws on the attorney-client privilege (although the two privileges are separate and distinct in their application):

With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication

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[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

[2] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* (JCS-6-98), November 24, 1998, at 86-87.

between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.[3]

Thus, elements analogous to the elements necessary for the attorney-client privilege to apply must be present in order for the federally authorized tax practitioner—client privilege to apply. Similarly, the exceptions and limitations that apply to the attorney-client privilege also apply to the federally authorized tax practitioner—client privilege. The next sub-section discusses the necessary elements as well as notable exceptions and limitations.

Communication is between a federally authorized tax practitioner and a client.

A necessary element relates to the individual providing the tax advice. The statute provides that in order to be protected by the privilege, tax advice must be provided by a "Federally Authorized Tax Practitioner" ("FATP"). An FATP is defined as a tax professional authorized under Circular 230 to practice before the IRS.[4] FATPs include licensed attorneys, CPAs, enrolled agents, enrolled actuaries, and enrolled retirement plan agents.

In addition, the taxpayer with whom the FATP is communicating must be a client, or is in the process of becoming a client of the FATP. The privilege is unlikely to protect communication outside that professional relationship. Accordingly, communication between a CPA and a personal friend while at lunch is likely not privileged unless there is a formal advisor-client relationship between the two.

The communication is for the purpose of seeking, obtaining, or providing tax advice.

The tax practitioner privilege applies to communications, the substance of which is tax advice. The term "tax advice" is defined in section 7525(a)(3)(B) as advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice under Circular 230 and is subject to regulation under Circular 230.

Practice that is subject to regulation under Circular 230 includes, but is not limited to, preparing documents, filing documents, and rendering written advice.[5] Written advice likely includes email and text messages. Oral advice, in addition to written advice, would likely also be considered tax advice for purposes of the tax practitioner privilege. Although Circular 230 does not specifically

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[3] IRC section7525.

[4] 31 CFR § 10.01 *et. seq.*

[5] Circular 230 § 10.2(a)(4).

include oral advice in its definition of tax advice, the standards established in the regulations clearly also apply to oral advice. For example, the prohibition in section 10.34 (b) against advising a client to take a frivolous position on a return includes the prohibition of providing such advice verbally as well as in writing.[6] The attorney-client privilege has also been extended to the attorney's notes of a conversation with his/her client.[7] Thus, the tax practitioner privilege should extend to advice given verbally, including voice messages and file memos memorializing such conversations.

Circular 230 does not, however, apply to state or local tax advice, and therefore the federally authorized tax practitioner—client privilege also does not apply to tax advice on state and local matters. It is unclear, for example, whether a document containing both state or local tax advice and federal tax advice would come within the federally authorized tax practitioner—client privilege. Some states do have rules analogous to the federally authorized tax practitioner—client privilege that may protect state and local tax advice with respect to that jurisdiction.[8]

Communication was intended to be, and in fact was, confidential.

Only communication that was intended to be, and in fact was, confidential will be protected by the tax practitioner privilege[9]. As discussed in greater detail in part IV below, an existing privilege can be "waived," or forfeited, if the confidential nature of the communication is destroyed. Where the confidentiality is destroyed by willfully disclosing the communication to a third-party, the privilege no longer protects the communication from further disclosure.

For example, a public company's legal department conducted an internal review of the company's business practices and produced a report that was shown to the company's accounting firm for purpose of its financial statement audit and counsel for its underwriter in connection with a public offering of the company's stock. When the government sought the same information, the company asserted that it was protected by the attorney-client privilege, but the court ruled that any privileged had been waived: "Once a corporate decision is made to disclose [an internal inquiry] for commercial purposes, no matter what the economic imperatives, the

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[6] See also SSTS No. 7.

[7] *Swidler & Berlin*, 524 US 399 (1998).

[8] Causey and Causey, *Duties and Liabilities of Public Accountants* (Accountant's Press, 5th ed., 1995), p. 116, as cited in Friedman and Mendelson, "The Need for CPA-Client Privilege in Federal Tax Matters," 27 *The Tax Adviser* 154 (March 1996), n. 17.

[9] *Westinghouse Elec. Corp. v. Kerr-McGee Corp.*, 580 F.2d 1311, 1317 (7th Cir. 1978).

privilege is lost."[10] Another court considered specifically whether the tax advice that was potentially protected by the tax practitioner privilege maintained its privileged nature if the taxpayer shared the advice with its financial auditor for purposes of the audit, and concluded that waiver had occurred.[11]

It is important to note that, while labeling a document as "privileged and confidential" or the like may show intent that advice be protected, such labels, or the absence thereof, are not conclusive in determining privilege.

Limitations and Exceptions to the Privilege

The federally authorized tax practitioner—client privilege was established to provide confidentiality protections similar to those afforded by the attorney-client privilege to communications between a taxpayer and a FATP. The federally authorized tax practitioner—client privilege has several limitations, however, that significantly impact its effectiveness when compared with other forms of privilege.

The federally authorized tax practitioner—client privilege may only be asserted against the IRS and only in non-criminal matters.

Unlike the attorney-client privilege, the federally authorized tax practitioner—client privilege may only be asserted in matters before the IRS or in federal courts in matters involving the IRS. As a result, successful assertion of the federally authorized tax practitioner-client privilege before the IRS would not be effective regarding a summons from another branch of the federal government (e.g., SEC, Federal Reserve Bank), or from a state, local or foreign taxing authority. Additionally, the federally authorized tax practitioner—client privilege may not be asserted with respect to non-tax or criminal matters.

Therefore, should a civil matter progress to a criminal matter, any previously established federally authorized tax practitioner—client privilege would be retroactively eliminated; potentially with unforeseen consequences (e.g., in the most extreme case, a FATP could be compelled to disclose information initially treated as confidential prior to a criminal referral, thereby effectively functioning as a witness against their client). Consequently, a taxpayer and their non-attorney FATPs should carefully consider what is in the best interest of the taxpayer in matters that could lead to a criminal referral.

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[10] In re. John Doe Corporation v. United States, 675 F.2d 482, 489 (2nd Cir. 1982).

[11] *United States v. Textron Inc.,* 507 F.Supp.2d 138, 151 (D.R.I. 2007) (overturned on other grounds).

The federally authorized tax practitioner—client privilege does not protect the confidentiality of tax return preparation.

It is generally recognized that information presented on a tax return is intended to be disclosed to a taxing authority and, therefore, does not contain an expectation of confidentiality. It is unclear, however, exactly where the line between tax return preparation and tax advice is drawn. It may be clear that certain communications between a taxpayer and a FATP are not intended for disclosure to the IRS, such as the persuasiveness of contrary arguments or assessment of anticipated IRS responses to a proposed transaction. Other communications between a taxpayer and a FATP during the course of actually preparing the tax return is clearly intended to be disclosed to the IRS when the return is filed. There is likely a large category of tax advice where the implication of the tax return preparation rule is less clear. A member may provide to a client written advice in connection with a transaction that occurred mid-tax year. The client will consider the conclusions in the opinion when it reports the tax effects of the transaction on its federal tax return. There is no clear rule as to whether a court may regard the written advice as tax return preparation, and it likely depends in part on other uses for the advice. It is clear, however, that if a taxpayer voluntarily discloses the advice to the IRS, for example, in order to support the treatment of a position on a return, it is no longer protected by the privilege.

The federally authorized tax practitioner—client privilege does not protect the confidentiality of written advice in connection with the promotion of direct or indirect participation of the person in any tax shelter.

The federally authorized tax practitioner—client privilege does not protect written advice in connection with the promotion of a "tax shelter." While the definition of what constitutes a "tax shelter" is not clear, section 7525 does incorporate the definition of "tax shelter" as provided in IRC section 6662.[12] In defining a tax shelter, section 6662 focuses on whether a significant purpose of any plan or arrangement is the avoidance or evasion of federal income tax, without defining "significant purpose" therein or in the corresponding regulations.[13] Courts have interpreted significant purpose broadly to include merely "a" significant purpose of tax avoidance, as opposed to "the" significant purpose of tax avoidance, thereby including transactions with legitimate business purposes within the context of tax shelters in finding that the tax practitioner privilege did not apply.[14] Courts have also taken a broad view when defining "promotion," applying it to persons who organize or assist in organizing a tax shelter, instead of a more

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[12] IRC § 7525(b).

[13] IRC § 6662(d)(2)(C)(ii).

[14] *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009).

narrow interpretation focused on the marketing of pre-packaged transactions constituting tax shelters.[15]

Taxpayers and practitioners should carefully consider the aforementioned limitations, exclusions and various interpretations surrounding application of the federally authorized tax practitioner—client privilege.

Other Considerations

The federally authorized tax practitioner—client privilege is the property of the taxpayer and may only be invoked by the taxpayer, not their FATP. If, for example, the IRS requests access to a FATP's privileged files, the relevant client(s) should be notified as soon as is practicable so that such client(s) can take steps to assert the privilege if deemed appropriate. An advisor should confer with a client before providing confidential information to the IRS or government authority in order to give the client an opportunity to consider whether to claim privilege.

Common situations can result in waiver of the federally authorized tax practitioner—client privilege.

Regardless of whether a taxpayer's assertion of the federally authorized tax practitioner—client privilege is ultimately upheld, FATPs should take reasonable steps to ensure that their actions are not responsible for waiver of the privilege. Similar to the attorney-client privilege, disclosure of privileged communications to any third parties who did not participate in the rendering of the confidential advice may constitute a waiver of the privilege. There are many common situations in the course of an engagement that could result in such an inadvertent waiver, including the following examples:

- Sharing confidential advice even for training purposes with others within the FATP's firm who are outside of the privileged group (e.g., agents and/or employees of the practitioner) that rendered the confidential advice;
- Sharing confidential advice with other client advisors, e.g., tax advice disclosed to auditors in their audit of the client's financial statements; [16]
- Providing a confidential opinion to a financial institution to support a loan application; or
- Sharing a confidential opinion with third party advisors to a potential acquirer.

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[15] *United States v. Textron,* 507 F. Supp. 2d 138 (D.R.I. 2007).

[16] See e.g., *In re. John Doe Corporation v. United States,* 675 F.2d 482, 489 (2nd Cir. 1982); *United States v. Textron Inc.,* 507 F.Supp.2d 138, 151 (D.R.I. 2007) (overturned on other ground).

In addition to the above scenarios, FATPs should take affirmative steps internally to minimize the risk of inadvertent waiver of a client's privilege, such as stamping privileged documents with appropriate legends, segregating privileged files from other client files such as tax preparation files, restricting access to privileged files, and limiting communications regarding privileged advice to those individuals with a need to know.

How Does a Taxpayer Claim Privilege During a Tax Examination?

If, for example, during an examination by IRS, a request is made (such as through an Information Document Request) for documents or testimony, the taxpayer may claim that some or all of the sought information is protected from disclosure under the federally authorized tax practitioner—client privilege. Taxpayers generally cannot make a blanket claim of privilege but, rather, may be required to provide a privilege log (containing, e.g., the types of documents, authors, recipients, date created, type of privilege or protection claimed) and affidavits affirming to the fact that the documents were prepared in anticipation of litigation and that privilege has not been waived.