



# IRS Insights

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## **District Court Concludes that Attorney-Client/Tax Practitioner Privileges and Work Product Doctrine Did Not Protect Tax Memorandum from Disclosure in Summons Enforcement Case**

On May 28, 2014, the U.S. District Court for the Southern District of New York considered whether the attorney-client/tax practitioner privileges or the work product doctrine applied so as to protect from disclosure a memorandum prepared by Ernst & Young (“E&Y Tax Memo”), along with other related documents. The E&Y Tax Memo identified the potential U.S. tax consequences of restructuring and refinancing transactions, including an analysis of possible challenges that the Internal Revenue Service (“IRS”) could potentially raise to certain tax treatment, based on relevant provisions of the Internal Revenue Code, the Treasury Regulations, judicial opinions, and IRS rulings.

In *Schaeffler v. United States*, 1:13-cv-04864-GWG, the question before the Court was whether to quash an IRS administrative summons. Georg F.W. Schaeffler (“Petitioner”) petitioned the Court to quash the summons on the ground that the materials sought were privileged. As a result of an acquisition, Petitioner had to undertake substantial debt refinancing and corporate restructuring measures. Petitioner hired Ernst & Young (“E&Y”) to provide tax advice on the various tax implications of the Petitioner’s proposed refinancing and restructuring, and E&Y prepared the E&Y Tax Memo, which reflected E&Y’s conclusions regarding the tax consequences and potential IRS challenges to the tax positions taken by Petitioner.

After an *in camera* review of the documents requested in the summons, which was issued in conjunction with an IRS audit of the Petitioner’s 2009 and 2010 tax returns, the Court initially considered whether the attorney-client/tax practitioner applied. The Court did not reach the question of whether the E&Y Tax Memo was privileged, finding that the Petitioner had waived any privilege by sharing the document with the Bank Consortium, a third party. The Bank Consortium was responsible for funding the Schaeffler Group’s acquisition, and both E&Y and Petitioner worked closely with the Bank Consortium to effectuate the refinancing and restructuring. Petitioner argued that the “common interest rule” applied to its disclosure of the E&Y Tax Memo to the Bank Consortium and, as a result, a disclosure to a third party did not waive the attorney-client privilege when it was made by parties who were represented by separate counsel but were engaged in a common legal enterprise. The “common interest rule” serves to protect the confidentiality of communications between one party and the attorney for another party where a joint defense effort has been undertaken by the parties. The Court

concluded that the common interest rule was not applicable in this case; the Court found that, while the Bank Consortium had a shared economic interest with Petitioner, the two parties did not share a legal interest. Specifically, the Court found that the Bank Consortium did not have any legal stake in Petitioner's potential litigation with the IRS and that the Bank Consortium could not be named as a co-defendant in the anticipated dispute with the IRS.

Next, the Court considered whether the documents requested by the IRS summons were protected by the work product doctrine. The Court concluded that the work product protection had not been waived by Petitioner when it provided the E&Y Tax Memo to the Bank Consortium. The Court was persuaded that no waiver occurred because the Bank Consortium and Petitioner were not in an adversarial relationship, both had an incentive to withhold the details of the E&Y Tax Memo from the IRS, and the Bank Consortium entered into an agreement with Petitioner wherein the Consortium agreed to maintain the confidentiality of the E&Y Tax Memo.

However, the Court ultimately concluded that the work product doctrine did not protect the E&Y Tax Memo from disclosure because the E&Y Tax Memo would have been produced in the same form, irrespective of any concern about litigation. The Court noted that the E&Y Tax Memo did not specifically refer to litigation and focused more on planning; that the E&Y Tax Memo was prepared, in part, to ensure compliance with federal tax laws; and that Petitioner engaged E&Y to prepare the E&Y Tax Memo because of the complexity of the tax issues surrounding the relevant transactions, and not because Petitioner anticipated any particular litigation. Consequently, the Court denied Petitioner's petition to quash because the E&Y Tax Memo was not protected from disclosure under either the attorney-client/tax practitioner privilege or the work product doctrine.

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### **Third Circuit Concludes that a Taxpayer May Be Able to Establish Reasonable Cause for Missing Tax Payment Deadline Due to Reliance on an Advisor**

In *Estate of John R.H. Thouron et al. v. United States*, 2014 U.S. App. LEXIS 8890 (3d Cir.), the Third Circuit Court of Appeals reviewed a Pennsylvania district court's decision denying the estate's refund claim for the amount of a late-payment penalty it was assessed and paid. The Third Circuit vacated the district court's decision, which granted summary judgment to the United States, and remanded the case, concluding that there was a genuine dispute of material fact as to whether the taxpayer reasonably relied on an advisor in good faith. Distinguishing the facts of *Estate of Thouron* from the situation presented in *United States v. Boyle*, 469 U.S. 241 (1985), the appellate court held that a taxpayer's reliance on the advice of a tax expert may be reasonable cause for a taxpayer's failure to pay by the deadline.

In the *Estate of Thouron* case, the executor of an estate ("Estate") retained an experienced tax attorney ("Attorney") to provide tax advice to the Estate. The original due date for Estate's estate tax return was November 6, 2007. On this date, Estate made a payment of estate tax in the amount of \$6.5 million, which amount represented less than one-third of its estate tax liability. Estate received an automatic six-month extension to file, to May 6, 2008, and Estate filed its return on or before May 6, 2008. Estate subsequently requested an extension of time to pay the balance of estate tax owed, which request was denied as untimely. Estate proffered that it did not pay the full liability or initially request an extension of time to pay because it received advice from Attorney that Estate could be eligible to defer the tax and pay its tax liability in installments over several years.

The Internal Revenue Service ("IRS") imposed a failure to pay penalty of approximately \$1 million. After losing an administrative appeal, Estate paid its outstanding estate tax liability and the \$1 million penalty. Estate filed a refund claim in the district court seeking a refund in the amount of the penalty, claiming that it had reasonable cause for Estate's failure to pay and that the failure was not due to willful neglect. The IRS moved for summary judgment and the district court granted the motion. The district court interpreted the Supreme Court's holding in *United States v. Boyle, supra*, very broadly to preclude any finding of reasonable cause based on reliance on an expert or agent in the context of failure to file. The district court adopted the Ninth Circuit's reasoning in *Baccei v. United States*, 632 F.3d 1140 (9th Cir. 2011), and determined that *Boyle's* holding also applied in the context of a taxpayer's failure to pay. Therefore, the district court concluded that Estate's reliance on Attorney for compliance with unambiguous deadlines did not constitute reasonable cause for late payment of tax. See *Estate of Thouron v. United States*, 2012 U.S. Dist. LEXIS 159400, \*21-\*22 (E.D. Pa. 2012).

On appeal, the Third Circuit distinguished the facts of *Boyle* from other situations where a taxpayer may have reasonable cause for failure to pay or file. The Court of Appeals discussed the three distinct categories of facts identified in the *Boyle*

case, as follows: (1) cases where a taxpayer relies on an agent for the ministerial task of filing or paying; (2) cases where a taxpayer files a return after the actual due date but within the time the advisor erroneously told the taxpayer was available; and (3) cases where an accountant or attorney *advises* a taxpayer on a matter of tax law. According to the Third Circuit, in *Boyle*, the Supreme Court concluded that a taxpayer who falls into category 1, above, is not entitled to reasonable cause relief; however, the Supreme Court did not address categories 2 and 3. The appellate court recognized the distinction drawn by the Supreme Court in *Boyle* between relying on an expert's clerical action, in category 1, and relying on an expert's advice, as in category 2 and category 3.

The Third Circuit concluded that Estate had not relied on Attorney for the ministerial task of filing or paying, in this case. Therefore, the appellate court found that Estate's reliance on the advice of an expert may be reasonable cause for failure to pay by the deadline if Estate also demonstrates either an inability to pay or undue hardship from paying at the deadline. Consistent with its holding that there was a genuine dispute of material fact as to whether Estate relied on Attorney, the Third Circuit vacated the district court's decision and remanded the case to the district court for further fact finding.

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## **Supreme Court Requires Taxpayers to Offer Specific Facts Plausibly Raising an Inference of Bad Faith to Conduct an Examination of IRS Motives for Issuing Summons**

In *United States v. Clarke*, 573 U.S. \_\_\_\_ (2014), the U.S. Supreme Court held that a taxpayer has the right to conduct an examination of Internal Revenue Service ("IRS") officials regarding their reasons for issuing a summons when the taxpayer points to specific facts or circumstances plausibly raising an inference of bad faith.

The IRS conducted an examination of the 2005 through 2007 tax returns filed by Dynamo Holdings, L.P. ("Dynamo"). During the course of the examination, Dynamo twice agreed to year-long extensions of the assessment statute of limitations. Ultimately, the IRS requested a third extension of the assessment statute, and Dynamo refused to grant the extension request.

Shortly after Dynamo refused to extend the assessment statute, the IRS issued summonses to individuals associated with Dynamo, requesting information and records relevant to the tax obligations of Dynamo. The IRS subsequently issued a Final Partnership Administrative Adjustment ("FPAA") to Dynamo proposing an increase in Dynamo's tax liability, and Dynamo petitioned the Tax Court. When the individuals failed to comply with the summonses, the IRS brought suit in the District Court to enforce the summonses. In the District Court, the individuals challenged the summonses on the ground that the IRS issued the summonses for improper purposes. According to the individuals, the IRS's motives in requesting information by summons were to circumvent the limited discovery rules of the Tax Court and to retaliate for Dynamo's refusal to agree to a third one-year extension of the limitations period for assessment.

The District Court denied the individuals' challenges, and ordered the summonses enforced. The District Court characterized the individuals' arguments as conjecture and incorrect as a matter of law. On Appeal to the Eleventh Circuit, the Court of Appeals reversed the District Court's decision, holding that the improper motive allegation entitled the individuals to an evidentiary hearing, and concluding that the District Court's refusal to allow the individuals to examine the IRS agents involved constituted an abuse of discretion.

In a unanimous opinion, the Supreme Court vacated the judgment of the Eleventh Circuit, and remanded the case to the Court of Appeals to consider whether the District Court had, in fact, abused its discretion in light of the new standard announced by the Supreme Court. The Supreme Court announced: "As part of the adversarial process concerning a summons's validity, the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith." The Supreme Court clarified that naked allegations of improper purpose were insufficient, and that the taxpayer must offer some credible evidence supporting the taxpayer's charge. Circumstantial evidence may suffice to meet the taxpayer's burden of proof.

The Supreme Court found that the Eleventh Circuit did not apply the correct standard; the appellate court failed to evaluate whether the individuals were able to bring any evidence of improper motive and, instead, applied a categorical rule, requiring that the IRS agents be examined even when the individuals made "only conclusory allegations."

On remand, the Supreme Court advised that the appellate court may also consider two additional de novo questions of law, which the Supreme Court declined to consider: whether the validity of a summons is judged at the time that the summons is initially issued; and whether issuing a summons because a taxpayer refused to consent to an extension of the statute of limitations would not be an improper purpose.

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## **IRS Adopts Taxpayer Bill of Rights**

On June 10, 2014, the Internal Revenue Service (“IRS”) formally adopted a Taxpayer Bill of Rights, as advanced by the National Taxpayer Advocate. The Taxpayer Bill of Rights captures numerous existing rights that exist throughout the Internal Revenue Code, and condenses these rights into ten fundamental rights. According to the IRS, the goal of adopting the Taxpayer Bill of Rights was to make the existing rights more clear, more understandable, and more quickly available to taxpayers. The Rights are as follows:

1. The Right to Be Informed;
2. The Right to Quality Service;
3. The Right to Pay No More than the Correct Amount of Tax;
4. The Right to Challenge the IRS’s Position and Be Heard;
5. The Right to Appeal an IRS Decision in an Independent Forum;
6. The Right to Finality;
7. The Right to Privacy;
8. The Right to Confidentiality;
9. The Right to Retain Representation; and
10. The Right to a Fair and Just Tax System.

### **Have a question?**

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