



Successful Use of the Tax Practitioner Privilege Unlikely

The Seventh Circuit decision in *Valero* has restricted the tax practitioner privilege and broadened the tax shelter promotion exception.

By Tom R. Wechter

Originally published in the *AICPA Tax Insider Newsletter*.

July 16, 2009

One Atlantic Center, Suite 2300
1201 West Peachtree Street
Atlanta, Georgia 30309
t 404.437.7000 f 404.437.7100

225 Franklin Street, Suite 2600
Boston, MA 02110
t 617.848.5750 f 617.848.5784

233 South Wacker Drive
Suite 6600
Chicago, IL 60606-6473
t 312.258.5500 f 312.258.5600

One Westminster Place
Lake Forest, IL 60045-1885
t 847.295.9200 f 847.295.7810

900 Third Avenue
New York, NY 10022
t 212.753.5000 f 212.753.5044

One Market
Spear Street Tower
Thirty-Second Floor
San Francisco, CA 94105
t 415.901.8700 f 415.901.8701

1666 K Street NW, Suite 300
Washington, DC 20006
t 202.778.6400 f 202.778.6460

www.schiffhardin.com

The recent Seventh Circuit decision in *Valero Energy Corp. v. U.S.*, No. 08-3473, has dramatically changed the landscape with respect to the application of the tax practitioner privilege and the exception to the privilege with respect to the promotion of a tax shelter. The tax practitioner privilege provides that tax advice in the form of confidential communication between a client and a federal tax practitioner is privileged to the same extent that such communication would be privileged if made between a client and attorney. The privilege does not apply to written communication with respect to the promotion of the direct or indirect participation in any tax shelter as defined in Section 6662(d)(2)(C)(ii).

Valero Factual Background

At issue in Valero were several documents prepared by Arthur Andersen LLP (Andersen) with respect to tax and accounting advice on financial instrument transactions proposed by another accounting firm resulting in approximately \$46 million in U.S. tax savings when Valero completed a merger with a Canadian company. The Internal Revenue Service (IRS) served a summons on Andersen seeking all of the documents with respect to tax planning, research and analysis in connection with Valero's taxes for the years involved. Valero refused to hand over the documents asserting the tax practitioner-client privilege. The government sought enforcement of the summons, arguing that the privilege did not apply and if it did, the tax-shelter exception to the privilege applied. After an in camera review of the documents, the District Court held that certain documents did not reflect "practitioner-client communications" and therefore, had to be produced, while other documents that were communications between Andersen and Valero were subject to the exception for written communications regarding tax-shelter promotion and therefore, had to be produced. The District Court held that to find a tax shelter all that needed to be shown was a plan or arrangement, a significant purpose of which was the avoidance or evasion of federal income taxes. In addition, it held that "promotion" applies to a "person who organizes or assists in organizing a tax shelter."

Seventh Circuit Decision

Upon appeal, the Seventh Circuit, affirming the District Court's decision, took a narrow view of the privilege, noting that the intent of the statute was to merely extend the bounds of the attorney-client privilege to federally authorized tax practitioners and not to make accounting advice privileged communications. The Court upheld the District Court's decision that documents consisting of worksheets, financial data, estimates of tax liability and other documents containing information generally compiled to facilitate the filing of tax returns were not covered by the privilege since such information is generally accounting

advice and that memoranda and notes to the file by Andersen were not privileged because they were not communications between a client and a tax practitioner for the purpose of providing income tax advice.

Tax Shelter Defined

The Court saw the more interesting issue with respect to the other documents as to whether the tax shelter exception to the tax practitioner-client privilege applied. Valero argued that "promotion" meant the sale of merchandise through advertising or other publicity and that for these purposes merchandise meant prepackaged tax shelter products. Since Andersen provided individualized planning, it was argued that no tax shelter was involved. The Court first held that "nothing in the definition limits tax shelters to cookie-cutter products, peddled by shady practitioners or distinguishes tax shelters from individualized tax advice." To distinguish the definition of a tax shelter from legitimate attempts by a taxpayer to reduce its tax burden, the Court limited the definition to "only plans and arrangements with a significant — as opposed to an ancillary — goal of avoiding or evading taxes."

Promotion Defined

With respect to the definition of "promotion," the Court rejected Valero's contention that "promotion" meant communications aimed at selling or marketing prepackaged tax-shelter products, as introducing a new definition of "tax shelter" not found in the statute. The government argued that "promotion" meant "furtherance" or "encouragement." The Seventh Circuit — in adopting the government definition — read the word "promotion" to mean "written communication encouraging participation in a tax shelter, rather than documents that merely inform [a taxpayer] about such schemes, assess such plans in a neutral fashion or evaluate the soft spots in tax shelters that [a taxpayer] has used in the past."

Textron Decision Distinguished

In support of its argument, Valero had cited *U.S. v. Textron*, 507 F. Supp. 2d 138 (Dist. Ct. R.I., 2007) for the proposition that "the tax shelter exception should merely apply to the peddling of prepackaged tax shelters" and since Andersen was only involved in reviewing Ernst & Young's work, it was not involved in peddling a tax shelter. The Court distinguished *Textron* on the basis that the tax accrual workpapers in that case involved the tax consequences of transaction that had already taken place and not future transactions that they were seeking to promote. The Seventh Circuit limited *Textron* to the "uncontroversial principle that you cannot promote participation in something once the deed is already done" while "Valero's documents concerned the structure of (what

was then) future transactions, not those that have already taken place."

Legislative History Dismissed

Valero had also cited the legislative history upon which the Textron court had relied. That legislative history consisted of a statement by Senator Connie Mack (R-FL) who was quoted as saying that "the exception was meant to target written promotional and solicitation materials used by peddlers of ... tax shelters." Further, Valero had pointed to the conference report in which it was stated that "the promotion of tax shelters [is not] part of the routine relationship between a tax practitioner and a client" and should not "adversely affect such routine relationships." Finding that the statute was unambiguous with what constitutes "promotion" the Court saw no need to consider the legislative history to interpret the meaning and dismissed the legislative history as unnecessary and unresponsive.

Countryside Limited Partnership Not Cited

Although in all likelihood the *Countryside Limited Partnership et. al. v. Commissioner*, 132 T.C. No. 17 (2009) case was cited to the Court, the opinion makes no mention of it. Tax Court Judge James Halpern found that the exception for tax shelter promotion was ambiguous as to the definition of "promotion" and therefore, relied upon the legislative history to define its intended meaning. As a result, it was held that the long-standing professional relationship and individualized advice rendered in the case did not constitute "promotion."

Conclusion

The decision in Valero presents a formidable barrier to enlisting the tax practitioner-client privilege. The narrowness of the tax practitioner-client privilege as found by the Seventh Circuit, the deference paid to the factual determinations of the lower court by the Seventh Circuit together with the burden of proof to sustain privilege claims makes the successful use of the privilege by a taxpayer very unlikely. In addition, the broad interpretation of both "promotion" and "tax shelter" in the exception to the tax practitioner-client privilege, gives the government powerful ammunition in the event a taxpayer is able to convince a court that the communications are subject to the tax practitioner-client privilege.

About the Author

Thomas R. Wechter concentrates his practice in tax planning for individuals, corporations, and venture capital and private equity firms. He focuses on complex transactions involving acquisitions, dispositions, spin-offs, and new venture investments.

About Schiff Hardin LLP

Schiff Hardin LLP is a general practice law firm representing clients across the United States and around the world. We have nearly 400 attorneys in offices located in Atlanta, Boston, Chicago, Lake Forest, New York, San Francisco and Washington

This publication has been prepared for the general information of clients and friends of the firm. It is not intended to provide legal advice with respect to any specific matter. Under rules applicable to the professional conduct of attorneys in various jurisdictions, it may be considered advertising material.

For more information visit our Web site at www.schiffhardin.com.

© 2009 Schiff Hardin LLP