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Attorney-Client Privilege

IRS Can't Go After Privileged Documents Before Defense Raised

BNA Snapshot

- Court won't interpret “AD Investment” to waive privilege at exam, initial pleading stage
- Tax Court, not IRS summons enforcement action, is proper venue to seek privileged documents

By Erin McManus

Two dermatologists didn't waive their attorney-client privilege by saying in a court document that they relied on the advice of counsel in claiming deductions for their captive insurance arrangements.

A federal judge in Kentucky declined to enforce an Internal Revenue Service summons for certain emails between the dermatologists’ agents and attorneys regarding their captive insurance after the dermatologists, their practice, and the captive insurance companies filed petitions with the U.S. Tax Court (*United States v. Owensboro Dermatology Assocs., P.S.C.* , 2017 BL 308975, W.D. Ky., No. 4:16-mc-00003, 9/1/17).

The 2014 Tax Court decision in AD Inv. 2000 Fund LLC v. Commissioner doesn't provide that a taxpayer waives attorney-client privilege merely by stating that it relied on advice of counsel during an audit or in a Tax Court petition. This court “would be encroaching upon the territory of the Tax Court to decide at what juncture disclosure should be compelled, if at all,” said Chief Judge Joseph H. McKinley Jr. of the U.S. District Court for the Western District of Kentucky.

The only proceeding where the IRS has reasonably put the attorney-client communications at issue is in the case before the Tax Court. Thus, those arguments “are best presented to that court, which possesses the power to compel disclosure if it determines that the privilege has been waived and disclosure is the necessary remedy,” McKinley said.

In AD Investment, the Tax Court ruled that if the taxpayer continued to persist in raising the defense that it reasonably relied on the advice of counsel that its tax treatment was proper, it would be unfair to the IRS to keep the tax opinions upon which the taxpayer was relying out of evidence.

Robert J. Kovacev, a partner at Steptoe & Johnson LLP in Washington, told Bloomberg BNA Sept. 5 that “when AD Investment came out there was concern that it would be leveraged to go after privileged material. This case shows that the IRS will not be able to intrude on privilege at the exam stage. If the taxpayer then goes to the Tax Court and presses that defense, the Tax Court could rule they waived the defense.”

Subterranean Aspect

David D. Aughtry, a partner at Chamberlain, Hrdlicka, White, Williams & Aughtry in Atlanta, told Bloomberg BNA Sept. 5 that a taxpayer's argument that it relied on advice of counsel “isn't an instantaneous waiver of privilege. This construction is a helpful distinction.”

Anson H. Asbury of the Asbury Law Firm in Decatur, Ga., told Bloomberg BNA in a Sept. 5 email that “the IRS has a track record of trying to use summons actions to skirt the Tax Court discovery rules and to a certain extent it looks like that's what they are trying to do here.”

“It's nice to see the District Court defending the sanctity of the attorney-client privilege and giving appropriate deference to the

Tax Court to manage its own proceedings. Taxpayers should not be forced into defending privilege issues on multiple fronts especially when the substantive issues are pending in a docketed case," Asbury added.

Aughtry said "there's a subterranean aspect to this case" involving tax code Section 831(b), which allows for captive insurance arrangements.

"The IRS has declared war on micro-captives. The agency is issuing massive information document requests that include as many as 117 subparts. It has decided it's going to disallow all deductions, treat premiums as fully taxable, and apply a 40 percent penalty," Aughtry said.

Even if the dermatologists—Michael J. Crowe and Artis P. Truett—don't prevail in defending the tax benefits they claimed from their captive insurance arrangements, privilege may not become an issue. The Tax Court recently ruled in Avrahami v. Commissioner that penalties for disallowed captive insurance deductions weren't appropriate, because there was no clear authority to guide the taxpayers, Aughtry said.

The IRS filed the petition to enforce its summons in the Kentucky court on Sept. 8, 2016. The dermatologists and their entities filed petitions with the Tax Court on Sept. 9, 2016.

Allison M. Helsinger of Moore Ingram Johnson & Steele LLP in Lexington, Ky., was lead attorney for Crowe, Truett, and their entities. Corinne E. Keel and Jessica R. Cusick Malloy of the U.S. Attorney Office in Louisville, Ky., were lead attorneys for the government.

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For More Information

Text of the decision is at http://src.bna.com/sf3.