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by Phyllis Epstein

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In this article, Epstein examines case law involving the reasonable cause and good-faith defense against penalties.

Our tax system depends on voluntary compliance. And yet anyone who fails to file a tax return on time or fails to pay the tax that is due on time can likely expect an invoice from the IRS for tax, interest, and penalties. According to the IRS: "Penalties exist to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue Code."[1]

The Supreme Court endorsed the imposition of penalties as necessary for effective tax administration:

> The government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward filing dates. Prompt payment of taxes is imperative to the government, which should not have to assume the burden of unnecessary ad hoc determinations.[2]

In other words, without the threat of penalty, the system of voluntary compliance would collapse. Indeed, compliant taxpayers can take some satisfaction in not being penalized and in knowing that fairness is achieved by penalizing tax offenders. And yet, fairness may also require a reprieve from onerous penalties.

Many penalties may be asserted to ensure taxpayer compliance. Some are related to tax deficiencies while others are imposed for behavioral infractions. Assessable deficiency penalties include additions to tax, accuracy-related penalties, fraud penalties, gross valuation misstatement penalties, trust fund recovery penalties, and penalties for failure to file, failure to pay, late filing, and late payment.[3] Penalties unrelated to a tax deficiency may cover conduct such as the failing to file information returns; failing to make disclosures; aiding and abetting the understatement of tax; promoting abusive tax shelters; and making frivolous tax submissions.[4]

While there may be no avoiding tax and interest, a taxpayer can challenge the assessment of penalties by arguing for a waiver under the IRS's first-time abatement policy or contending that there was reasonable cause for the violation.[5]

The first-time penalty waiver is administrative rather than statutory or judicial.[6] It is found in the Internal Revenue Manual and covers failure to file, failure to pay, and failure to deposit.[7] When considering first-time abatement, IRS examines the prior three years of tax returns to determine

[1] IRM 20.1.1.2(1) (Nov. 11, 2017).

[2] *United States v. Boyle*, 469 U.S. 241 (1985).

[3] Sections 6651-6665.

[4] Sections 6671-6725.

[5] Relief from penalty may be applied to correct an IRS error, by statutory and regulatory exception, or by administrative waiver. *See* IRM 20.1.1.3 (Oct. 19, 2020).

[6] *Laidlaw v. Commissioner*, T.C. Memo. 2017-167; and *Operating Engineers Local Union No. 3 v. United States*, 131 A.F.T.R.2d 2023-611 (N.D. Cal. 2023).

[7] IRM 20.1.1.3.3.2.1; and IRM 20.1.1.3.6.1. Sections 6651(a)(1), 6698(a)(1), and 6699(a)(1) (failure to file). Section 6651(a)(2) and (3) (failure to pay). Section 6656 (failure to deposit).

whether the taxpayer had been compliant in filing returns and paying tax and whether there were any forgiven penalties in those years.

In the absence of the first-time abatement, individuals may assert the statutory reasonable cause/good-faith exception.[8] What is considered reasonable cause or good faith is a matter of interpretation, circumstances, case law, and conjecture. It turns practitioners into authors of expository penalty abatement letters to the IRS with an emphasis on storytelling and persuasion. What we do know is that reasonable cause or good faith are a combination of taxpayer conduct, professional advice, and legal authority. What follows is an attempt to understand what makes for an effective reasonable cause argument.

I. What Is the Reasonable Cause Defense?

Reasonable cause is subjective. The Supreme Court reminds us that "whether the elements that constitute 'reasonable cause' are present in a given situation is a question of fact, but what elements must be present to constitute 'reasonable cause' is a question of law."[9] Penalty abatement for reasonable cause is determined after all relevant facts and circumstances are examined. The regulations confirm that a taxpayer acts with reasonable cause by "taking into account all pertinent facts and circumstances." The IRM has recommendations for IRS agents about what constitutes reasonable cause, and many courts have grappled with how to define it. Ultimately, the taxpayer bears the burden of proof.[10]

When a penalty is asserted for the failure to file a tax return or pay tax under section 6651, the taxpayer must establish reasonable cause as well as an absence of willful neglect.[11] In *Boyle* the Supreme Court wrote that "the term 'willful neglect' may be read as meaning a conscious, intentional failure or reckless indifference."[12]

When a tax return was filed and the accuracy-related penalty of section 6662 and fraud penalty of section 6663 are asserted, the taxpayer must have reasonable cause for his actions and demonstrate that he acted in good faith.[13] "Good faith" is a generally undefined term, but circumstances can shed light on its existence or absence. Good faith is a combination of actions and personal character in a given set of circumstances. According to the Tax Court, good faith may be "an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge, and education of the taxpayer."[14] Also, good faith may exist when the taxpayer had "an honest belief" and the "intent to perform all lawful obligations."[15]

A. Personal Character of the Taxpayer

The sophistication and business experience of the taxpayer as well as the taxpayer's education and profession are compelling factors.[16] As stated by the Third Circuit in *Neonatology*, "As highly educated professionals, the individual taxpayers should have recognized that it was not likely that by complex manipulation they could obtain large deductions for their corporations and tax free income for themselves."[17] That is what I often refer to as the too-good-to-be-true doctrine. The savvier and more sophisticated the taxpayer, the more likely the IRS or a court will determine that she failed to exercise the ordinary business care and prudence expected in the situation.

B. Individual Conduct of the Taxpayer

What actions did the taxpayer take leading to the tax violation? For there to be a reasonable cause defense to penalties, the focus is on what the taxpayer did or didn't do initially and how the

[8] Section 6664 and reg. section 1.6664-4.

[9] *Boyle*, 469 U.S. at 249 n.8.

[10] *Id.* at 245; "Each case must be individually judged based on the facts and circumstances at hand." IRM 20.1.1.3.2(5). The burden of proof may shift to the IRS to prove the absence of reasonable cause if the penalties are raised by new matter by the IRS. For more, see, *e.g.*, *Murfam Enterprises LLC v. Commissioner*, T.C. Memo. 2023-73 (sections 170, 6662).

[11] *Soni v. Commissioner*, 132 A.F.T.R.2d 2023-5365 (2d Cir. 2023); and *Operating Engineers*, 131 A.F.T.R.2d 2023-611.

[12] *Boyle*, 469 U.S. at 245.

[13] Section 6664(c)(1).

[14] *Higbee v. Commissioner*, 116 T.C. 438, 449 (2001).

[15] *Barnes v. Commissioner*, T.C. Memo. 2016-79 (taxpayers exhibited a sincere effort to document their charitable deductions).

[16] Reg. section 1.6664-4(c)(1).

[17] *Neonatology Associates PA v. Commissioner*, 115 T.C. 43 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

taxpayer conducted herself afterward. Because the taxpayer's first interaction is with a revenue agent, it is informative to see how agents are instructed to judge a taxpayer's conduct. IRM 20.1.1.3.2(5) urges agents to consider the following:

a. What happened and when did it happen?
b. During the time the taxpayer was noncompliant, what facts and circumstances prevented the taxpayer from filing a return, paying a tax, or otherwise complying with the law?
c. How did the facts and circumstances result in the taxpayer not complying?
d. How did the taxpayer handle the remainder of their affairs during this time?
e. Once the facts and circumstances changed, what attempt did the taxpayer make to comply?

Essentially, the inquiry concerns what happened to this taxpayer, what actions she took or failed to take that caused the penalty assessment, and the facts and circumstances that might give rise to abatement. Finally, the taxpayer should make every effort to pay the past-due tax, file all tax returns as they become due, and pay all new tax obligations as a condition of obtaining reasonable cause abatement.

C. Death, Serious Illness, or Unavoidable Absence

IRM 20.1.1.3.2.2.1 provides that "death or serious illness in the taxpayer's immediate family may establish reasonable cause for filing [or] paying . . . late (i.e., siblings, parents)." But the death of a family member, by itself, usually won't sustain a reasonable cause defense. In *Boyle* the Supreme Court noted that illness, death, incompetence, or infirmity can be significant factors if they prevented the taxpayer from exercising ordinary care and prudence. Quadriplegia was sufficient for abatement in one court.[18] Blindness, a condition from birth, was insufficient for another court.[19] What must be answered is whether the taxpayer's disability created the conditions that led to a late or unfiled return or the late payment of tax. A disability or a relative's death is a factor weighing in favor of abatement, but only if it is directly related to the otherwise inexcusable failure to file or pay tax.

D. Ordinary Business Care and Prudence

A penalty for failing to file a tax return or pay tax (or being late) may be abated for reasonable cause if the taxpayer can demonstrate that she exercised ordinary business care and prudence. The Supreme Court has said that that standard for an ordinary individual requires being "physically and mentally capable of knowing, remembering, and complying with a filing deadline."[20] Like everything else, it is subjective. The regulations state: "If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause."[21]

A lavish lifestyle without regard to consequences may be evidence that the taxpayer failed to exercise ordinary business care and prudence. The regulations elaborate:

> A taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his assets and anticipated income will be insufficient to pay his tax, has not exercised ordinary business care and prudence in providing for the payment of his tax liability. Further, a taxpayer who invests funds in speculative or illiquid assets has not exercised ordinary business care and prudence in providing for the payment of his tax liability unless, at the time of the investment, the remainder of the taxpayer's assets and estimated income will be sufficient to pay his tax or it can be reasonably foreseen that the speculative or illiquid investment made by the taxpayer can be utilized (by sale or as security for a loan) to realize sufficient funds to satisfy

[18] *In re Erickson*, 172 B.R. 900 (Bankr. D. Minn. 1994).

[19] *United States v. Dracopoulos*, 131 A.F.T.R.2d 2023-2042 (N.D. Cal. 2023); sections 6651 and 7403.

[20] *Boyle*, 469 U.S. at 244; *Dracopoulos*, 131 A.F.T.R.2d 2023-2042 (sections 6651 and 7403); *see also Crimi v. Commissioner*, T.C. Memo. 2013-51 (in the context of a charitable appraisal, a sophisticated taxpayer acted reasonably when relying on his appraisers of many years).

[21] Reg. section 301.6651-1(c)(1).

> the tax liability. A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.[22]

E. The Disorganized Taxpayer

A disorganized and dilatory taxpayer who throws together a tax return at the last minute with several mistakes has not met the burden of reasonable conduct and good faith. "Carelessness, reckless indifference," or "intentional failure" might aptly describe the taxpayer's behavior in Example 4 of reg. section 1.6664-4(b)(2)[23]:

> H, an individual, did not enjoy preparing his tax returns and procrastinated in doing so until April 15th. On April 15th, H hurriedly gathered together his tax records and materials, prepared a return, and mailed it before midnight. The return contained numerous errors, some of which were in H's favor and some of which were not. The net result of all the adjustments, however, was an underpayment of tax by H. Under these circumstances, H is not considered to have reasonable cause for the underpayment or to have acted in good faith in attempting to file an accurate return.

F. Circumstances Beyond Control

Fire, casualty, natural disaster, or other disturbances may indicate reasonable cause. In *Boyle* the Supreme Court wrote that "the administrative regulations and practices exempt late filings from the penalty when the tardiness results from postal delays, illness, and other factors largely beyond the taxpayer's control." IRM 20.1.1.3.2.2.3 states that that "the inability to obtain the necessary records may constitute reasonable cause."[24] After a natural disaster, the IRS often extends some filing requirements to avoid penalty situations.

G. The 'I Didn't Think I Owed Tax' Defense

The Second Circuit, affirming the Tax Court, has held that it is not enough for a taxpayer to offer as an excuse for a late-filed return that he thought he didn't owe any tax.[25] The "no harm, no foul" defense is not a winning argument for abatement.

H. Mistake of Law or Fact

Recently a taxpayer was successful in having penalties abated because, the court found, the tax deductions claimed regarding an airplane came from "an honest misunderstanding" of the law. Citing reg. section 1.6664-4(b)(1), the court saw the reasonableness of the mistaken reliance as evidence of good faith regarding tax underpayments.[26]

But a mistaken reliance on the law, or the interpretation of the law, must also be actual — not just asserted in retrospect. The Eighth Circuit considered a case[27] in which the taxpayer claimed to have a reasonable legal basis for its tax return positions. The court concluded that the taxpayer must submit "evidence of actual reliance on the relevant authority." The taxpayer must have actually known about those authorities and relied on them, distinguishing it from a showing that the tax position was consistent with relevant authorities.

I. Reliance on IRS FAQs

A taxpayer's reliance on legal authority for taking a position on a tax return must be reasonable. The IRS had a long-standing position that the taxpayer's reliance on published FAQs in its bulletin and on its website was not reasonable. That changed in 2021 when the IRS announced that a taxpayer's reasonable reliance on a published IRS FAQ could be a factor in asking for penalty relief.[28] While FAQs are not the law,

[22] *Id.*

[23] *Spottiswood v. United States*, No. 3:17-cv-00209 (N.D. Calif. 2018).

[24] *Boyle*, 469 U.S. at 249 n.6; *Operating Engineers*, 131 A.F.T.R.2d 2023-611.

[25] *See Soni*, 132 A.F.T.R.2d 2023-5365, *aff'g* T.C. Memo. 2021-137.

[26] *Conrad v. Commissioner*, T.C. Memo. 2023-100.

[27] *Wells Fargo & Co. v. United States*, 957 F.3d 840 (8th Cir. 2020).

[28] IR-2021-202 (Oct. 15, 2021).

taxpayers are justified in consulting and acting on them when preparing their returns. For that reason, the IRS will consider FAQs as "substantial authority" in a defense to penalties for accuracy and negligence.

J. Reliance on Forms and Amount Received

Reliance on information on a Form W-2 or 1099 usually indicates reasonable reliance and good faith if "the taxpayer did not know or have reason to know that the information was incorrect. Generally a taxpayer knows, or has reason to know, that the information on a return is incorrect if it is inconsistent with other information reported or otherwise furnished to the taxpayer or with the taxpayer's knowledge of the transaction. That includes, for example, the taxpayer's knowledge of the terms of his employment relationship or the rate of return on a payer's obligation."[29]

K. Professional Advice

Often a taxpayer claims that his accountant or return preparer or tax adviser is at fault for the wrongful reporting of income. The regulations and cases are clear about what should be considered when establishing reasonable cause and good-faith reliance:

- What is the sophistication or education of the taxpayer?
- Was the taxpayer acting reasonably when he relied on a specific professional? Did the taxpayer know "or reasonably should have known" that the adviser "lacked knowledge in the relevant aspects of Federal tax law?"[30]
- Did the taxpayer disclose all necessary and relevant information to the tax professional?
- Did the professional advice consider all "pertinent facts and circumstances and the law as it relates to those facts and circumstances"?
- None of the facts and circumstances or legal assumptions relied on can be unreasonable.
- Professional advice cannot be premised on assuming a regulation is invalid.
- Did the taxpayer actually rely on the professional advice offered or disregard that advice?[31]
- Did the adviser have a conflict of interest that could affect his advice?[32]
- Did the adviser consider all pertinent facts and circumstances? Did the taxpayer fail to disclose a fact that he knows or should know is relevant? If so, reliance will not be considered reasonable or in good faith.
- Was the advice based on unreasonable factual or legal assumptions?
- Did the taxpayer know, or should have known, that the adviser lacked knowledge in relevant aspects of federal tax law?[33]
- Reliance on forms 1099 or W-2 reporting may indicate good faith.
- Forged documents provided to an accountant are evidence of a lack of good faith.[34]
- Reliance on an insurance agent rather than an independent tax professional is not evidence of good faith.[35]

Ultimately, a taxpayer is primarily responsible for the information on her tax return and for filing that return on time. The penalties associated with underreporting or underpayment, late filing, or late payment are assessable against the taxpayer, not the agent. The excuse that "my accountant is at fault" is difficult to sustain. The general question is whether reliance on the tax professional was reasonable and in good faith. The answer to that depends on the answers to the questions above, but especially whether the adviser was competent and independent.

[29] Reg. section 1.6664-4(b)(1), Example (3).

[30] Reg. section 1.6664-4(c)(1).

[31] *See Alli v. Commissioner*, T.C. Memo. 2014-15; *see also Neonatology Associates*, 115 T.C. at 98-99, *aff'd*, 299 F.3d 221.

[32] *Mortensen v. Commissioner*, 440 F.3d 375, 387 (6th Cir. 2006), *aff'g* T.C. Memo. 2004-279; *see Gustashaw v. Commissioner*, 696 F.3d 1124, 1139 (11th Cir. 2012); and *Stobie Creek Investors LLC v. United States*, 608 F.3d 1366, 1382 (Fed. Cir. 2010) ("Advice hardly qualifies as disinterested or objective if it comes from parties who actively promote or implement the transactions in question.").

[33] *Thompson v. Commissioner*, 499 F.3d 129 at 135 (2d Cir. 2007) ("Reliance on an expert's opinion 'may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.'" (quoting reg. section 1.6664-4(c)(1))).

[34] *Soleimani v. Commissioner*, T.C. Memo. 2023-60.

[35] *Neonatology Associates*, 299 F.3d 221.

L. Delegating the Job of Filing and Paying

The ultimate responsibility for filing a return and paying tax is on the taxpayer.[36] In nearly all situations, this responsibility cannot be delegated, and the misconduct of the agent is not reasonable cause for abatement. The IRM considers delegation a factor that may be considered but it is not determinative. "If someone other than the taxpayer is authorized to meet the obligation, consider the reasons why that person did not meet the obligation," according to the IRM.[37] According to the Supreme Court in *Boyle*, the taxpayer's obligation to file and to pay is "fixed and clear" even though the hired agent was capable and expected to carry out compliance duties on the taxpayer's behalf.

In the corporate context, the Ninth Circuit held that a company was still liable for payroll tax penalties even though an employee engaged in acts of fraud that led to the nonpayment of tax: "Concealment involved intercepting and screening the mail for IRS penalty notices, altering check descriptions and quarterly reports, and undertaking the performance herself of all payroll functions."[38]

The Ninth Circuit, relying on *Boyle*, held that because corporations act through agents, they "cannot rely upon those agents or employees, acting within the scope of authority, to escape responsibility for the nonperformance of nondelegable tax duties." In a related case, a corporation had reasonable grounds for penalty abatement when the corporate officers and directors committed the fraudulent conduct. Because the misconduct was engaged in by those in control, an agency relationship was not involved, and no supervision was possible.

II. Applying the Facts to the Law

Dracopoulos,[39] an ongoing case from the U.S. District Court for the Northern District of California, is a good example of a taxpayer seeming to have a winning reasonable cause set of circumstances.

The IRS assessed tax, interest, and penalties against the taxpayer, Peter Dracopoulos, for failure to timely file and pay tax for 2002 through 2015. As a reasonable cause argument, the taxpayer asserted that he had been blind since birth and required an accountant to handle his finances, and his accountant had died. He also said that his business closed and that he started over in 2001. The taxpayer claimed that he could not retrieve his business records from his accountant's widow and was unable to find a new accountant nor afford to pay a new one. Also, his mother and four siblings died, and the bank tried to foreclose on his home. He has since become current with IRS filings and payments and has an arrangement with the bank and IRS to remain in his home. All in all, a sympathetic set of circumstances on the surface. What could go wrong?

The government argued that the taxpayer failed to associate each unfortunate event with the actual failure to file a tax return or pay tax. For example, the taxpayer was blind, but had been so since birth. The taxpayer's accountant died in the late 1990s, well before 2002, the first tax year at issue. Also, the death of the accountant is not a reasonable cause argument because the taxpayer cannot rely on an agent or accountant to shoulder the responsibility for filing a return and paying tax. (Recall *Boyle*.) The taxpayer's business did wind down and close from 1997-2001, but that also was before the first tax year assessment. The taxpayer's mother died around 1999-2000 — also before the first tax year, and a parent's death is not supportive of reasonable cause. The deaths of his siblings occurred at an undisclosed time. COVID-19 closed his business from 2020-2022 — after the most recent tax year of concern.

So the sad set of life circumstances that seemed to argue for reasonable cause occurred at times unrelated to the filing of tax returns and payment of tax at issue. Moreover, the IRS averred that the taxpayer may have been blind, but he was not incapable of comprehending and managing finances. He apparently had been a music producer and worked for a book publisher. He admitted that he was "very capable of doing things." Moreover, the court seemed to say that

[36] *Boyle*, 469 U.S. 241.

[37] IRM 20.1.1.3.2.2.1(2).

[38] *Conklin Brothers v. United States*, 986 F.2d 315 (9th Cir. 1993).

[39] *Dracopoulos*, 131 A.F.T.R.2d 2023-2042.

Dracopoulos's situation did not establish evidence of either advanced age or failing mental and physical abilities sufficient to support reasonable cause. Nor was he sufficiently disabled to prevent access to his own books and records as in *Erickson*, which involved a quadriplegic taxpayer.[40]

The court returned the case to Dracopoulos and directed him to organize the evidence of his disabilities and distress, and then tie in that evidence to each penalty event with specificity. The taxpayer could not ask the court to wade through the evidence and do the work on his behalf. The burden of proof was on the taxpayer to present an organized arrangement of the facts and circumstances tied to assessments. We don't know yet how this will turn out and wait for more out of the district court.

III. Attorney-Client Privilege Issues

As noted, one predicate for tax abatement is the good-faith reliance on professional tax advice or a good-faith independent understanding of the law that supports a position taken on a tax return.

A taxpayer asserting a reasonable cause argument may unwittingly find that she has waived the attorney-client privilege on documents that supported that argument. That was the result in the Tax Court case of *Eaton Corp.*[41] The court held that the taxpayer waived privilege by raising a section 6664 reasonable cause or good-faith defense to penalties. The court wrote:

> petitioner's reasonable cause/good faith defense puts into contention the subjective intent and state of mind of those who acted for petitioner and petitioner's good-faith efforts to comply with the tax law. Assuming as we do at this time that petitioner persists in this defense, it would be unfair to deprive respondent of knowledge of the legal and tax advice that petitioner received.

At the heart of the reasonable cause defense was whether the "petitioner provided its attorneys and tax practitioners with accurate information and all of the facts material to its APA (advance pricing agreements) request and the negotiations related thereto, and whether petitioner abided by the advice that it received from its attorneys and tax practitioners."

The Tax Court in *Eaton* reached back to its opinion in *Ad Investment*, in which it was presented with similar government motions for sanctions and to compel the production of documents.[42] The taxpayer raised reasonable cause and good-faith defenses to the accuracy-related penalties asserted by the government. The court in *Ad Investment* wrote: "By placing the partnerships' legal knowledge and understanding into issue in an attempt to establish the partnerships' reasonable legal beliefs in good faith arrived at (a good-faith and state-of-mind defense), petitioners forfeit the partnerships' privilege protecting attorney-client communications relevant to the content and the formation of their legal knowledge, understanding, and beliefs."[43] Thus, the taxpayers were compelled to turn over six relevant tax opinion letters from attorneys.

The result in *Eaton* and in *Ad Investment* would be the same regardless of whether the taxpayer relied on section B of reg. section 1.6662-4(g)(4)(i) by claiming reliance "in good faith on the opinion of a professional tax" adviser or on section A. Section A is asserted by a taxpayer who claims that his tax approach was arrived at from his own good-faith analysis of the law, and based on that analysis, he believed his tax position had a greater than 50 percent chance of surviving a challenge by the IRS. Both approaches would result in a waiver of the attorney-client privilege so the taxpayer's thought process could be considered, which became an issue when the reasonable cause and good-faith defenses to penalties were raised.

One additional lesson from *Eaton* is that anyone asserting the attorney-client privilege must produce a detailed document-by-document privilege log in compliance with Rule 26 of the Federal Rules of Procedure. The failure to produce such a log was critical to the court's

[40] *In re Erickson*, 172 B.R. 900.

[41] *See Eaton Corp. v. Commissioner*, Motion to Compel Production, Tax Court Dkt. No. 5576-12 (Apr. 6, 2015).

[42] *Ad Investment 2000 Fund LLC v. Commissioner*, 142 T.C. 248 (2014).

[43] *Id.* at 257.

determination against the taxpayer and in favor of full disclosure.

IV. Non-Attorney Privilege Issues

Section 7525 affords limited confidentiality to communications between a taxpayer and her non-attorney representatives. Section 7525 was added by the Internal Revenue Service Restructuring and Reform Act of 1998 and covers communications after July 22, 1998.

What remains murky (or "blurry" according to the Seventh Circuit or "messy" according to the Ninth Circuit[44]) is the nature of the information or communications that are sought to be shielded — a situation that more often arises when the privilege is raised for non-attorney communications. An accountant, for example, may offer a reflection about the law that is in the nature of a privileged communication but at the same time offer business, accounting, or return preparation advice.[45] That can lead to conflict with the government over whether the non-attorney communication is protected by section 7525. Ultimately, the burden of proof is on the taxpayer to establish the privilege.[46]

Overall, taxpayers have much more limited privilege protections with non-attorney communications. In addition to being limited to tax advice only, these non-attorney protections do not apply to criminal tax or tax shelter matters. Taxpayers cannot assert the privilege in nontax proceedings, in government regulatory proceedings, or in any matter in which the government is not a party. Several courts have held that the protections and privileges grounded in section 7525 do not preclude the disclosure of the identity of investors in an abusive tax shelter.[47]

Many communications between clients and attorneys or clients and non-attorneys have mixed purposes. That is, part of the advice might contain privileged material and part may not. Federal courts do not uniformly apply a single standard analysis for what might or might not be a privileged communications with non-attorney third parties. Some apply "the primary purpose" test, "a primary purpose" test, or a "significant purpose" test,[48] and others the "because of" test. One court used the "predominant purpose" test.[49] Courts struggle to determine whether communications are under the umbrella of privilege.

One court applied the primary purpose test with this explanation:

> Trying to find *the* one primary purpose for a communication motivated by two sometimes overlapping purposes (one legal and one business, for example) can be an inherently impossible task. . . . Was obtaining or providing legal advice *a* primary purpose of the communication, meaning one of the significant purposes of the communication?[50] [Emphasis in original.]

On the other hand, communications related to an attorney's preparation of tax returns are not covered by attorney-client privilege.[51] But legal advice about how to handle a matter on a tax return may be privileged.[52] The different analysis may lead to different results but as a rule of thumb, accounting work or tax preparation by an attorney or accountant is not privileged, but legal advice remains privileged unless waived by raising a reasonable defense argument to penalties.

One way to work around the lack of privilege is to have the taxpayer's attorney engage the accountant, thereby bringing the accountant's work and communications under the wing of the

[44] *United States v. Frederick*, 182 F.3d 496, 502 (7th Cir. 1999); and *In re Grand Jury*, 23 F.4th 1088 (2021), *cert. dismissed* Jan. 23, 2023.

[45] *United States v. KPMG LLP*, 316 F. Supp. 2d 30 (D.D.C. 2004); and *Frederick*, 182 F.3d at 502.

[46] *See United States v. Microsoft Corp.*, 125 A.F.T.R.2d 2020-547 (W.D. Wash. 2020); and *Valero Energy Corp. v. United States*, 569 F.3d 626, 630 (7th Cir. 2009) ("Admittedly, the line between a lawyer's work and that of an accountant can be blurry, especially when it involves a large corporation like Valero seeking advice from a broad-based accounting firm like Arthur Anderson.").

[47] *Doe v. Wachovia Corp.*, 268 F. Supp. 2d 627 (W.D.N.C. 2003).

[48] *In re Grand Jury*, 23 F.4th 1088.

[49] *In re County of Erie*, 473 F.3d 413 (2d Cir. 2007).

[50] *In re Kellogg Brown & Root Inc.*, 756 F.3d 754 (D.C. Cir. 2014).

[51] *Olender v. United States*, 210 F.2d 795 (9th Cir. 1954); *Frederick*, 182 F.3d 496.

[52] *In re Grand Jury*, 23 F.4th 1088, citing *United States v. Abrahams*, 905 F.2d 1276 (9th Cir. 1990), overruled on other grounds by *United States v. Jose*, 131 F.3d 1325 (9th Cir 1997).

attorney's privilege. This was the arrangement sanctioned by the Second Circuit in *Kovel*,[53] if the accountant communications were made for the purpose of aiding the lawyer to give legal advice.

Without reviewing the subject in too much detail — *Kovel* decisions are worthy of their own exploration — it is safe to say that shielding an accountant's communications using *Kovel* arguments is not a sure thing. For example, the First Circuit pondered whether the accountant's services were necessary or highly useful to the attorney in rendering legal advice.[54] The Ninth Circuit looked at whether the accountant's presence in lawyer-client conferences was merely convenient.[55]

It would be advantageous for attorneys and non-attorney representatives to clarify in writing — perhaps under separate fee agreements and in separate billing accounts — which of those services are clearly privileged and those that might not be. Establishing the parameters of privileged materials and conversations before the matter goes to litigation would carry greater weight.

V. The Magnitude of the Penalty Problem

For fiscal 2022, the IRS reported the imposition of civil penalties totaling about $73.6 billion, of which $50.8 billion was abated, and $36.7 billion of that was attributable to individual and estate and trust tax returns. Some portion of those abatements may have resulted from successful reasonable cause arguments, but the breakdown is unknown. Abatement may also have occurred because of such other circumstances as bankruptcy, IRS error, an administrative decision not to pursue collection or partial payment, or offers in compromise.[56]

While there is no breakdown of how much was abated from well-drafted reasonable cause arguments, it is not something to overlook. Given the dollars at stake, a taxpayer should seek the assistance of a tax professional to aid in the abatement of penalties by raising thoughtful reasonable cause arguments. ■

[53] *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

[54] *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002), *aff'g* 153 F. Supp. 2d 52 (D. Mass. 2001).

[55] *Himmelfarb v. United States*, 175 F.2d 924 (9th Cir. 1949), *cert. denied* 338 U.S. 860 (1949).

[56] IRS Data Book, 2022 (Apr. 14, 2023).