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John Doe Summons Risk Underscores Need for Attorney-Client Privilege

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In this article, Wood and Smeltzer examine the implications of the recent district court decision in *Taylor Lohmeyer*, in which the government won enforcement of a John Doe summons issued to a law firm.

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In 2008 the world of Swiss banking was rocked when a federal judge allowed the IRS to issue a John Doe summons to UBS for secret data about U.S. taxpayers using Swiss bank accounts. The rest, quite literally, is history. Since that time, the IRS has collected more than $10 billion in taxes and penalties from those accounts and the parties involved. Some participants have even been sent to prison.

After that landmark disclosure, the Justice Department has continued to use John Doe summons powers on its own behalf, as well as for other countries under applicable tax information exchange treaties. A normal IRS summons seeks information about a specific taxpayer whose identity is known; a John Doe summons, as the name implies, involves taxpayers in a group that the IRS cannot identify by name — yet. With judicial approval, a John Doe summons allows the IRS to obtain the names of all taxpayers within that group.

The IRS may not need the extraordinary power of the John Doe summons if it can get the information from other sources. In fact, the Internal Revenue Manual specifically says examiners should only use a John Doe summons after trying other means. For example, if the IRS is investigating a tax shelter promoter, the identity of shelter investors may be relevant to that examination and obtainable by issuing a regular summons. However, this approach only works if the information is relevant to investigating the promoter and can serve a dual purpose.

First Banks, Now Law Firms

Many John Doe summonses are issued to banks or other financial institutions for information on customers. The Justice Department Tax Division received permission this year to serve a John Doe summons to Bank of America, Charles Schwab, and TD Bank for information about Finnish residents who have payment cards linked to bank accounts located

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outside Finland.[1] The Justice Department Tax Division has also sought information about U.S. taxpayers when it believes financial services companies are marketing products that allow taxpayers to hide assets offshore.[2]

However, it isn't just banks and financial institutions and some tax shelter promoters that can get caught in the IRS crosshairs. In *Taylor Lohmeyer*,[3] the Justice Department recently sought — and won — enforcement of a John Doe summons issued to a Texas law firm. What happened to attorney-client privilege? Read on.

The U.S. District Court for the Western District of Texas held that the government easily met its minimal burden and that the law firm's arguments of abuse of process and attorney-client privilege were insufficient to meet its heavy rebuttal burden. The court found that there is clearly an ascertainable group (firm clients between 1995 and 2017), and that information is not readily available elsewhere. The recipient of a John Doe summons is often between a rock and a hard place. The summoned party may want — or be required — to protect its customers, but it also will not want trouble with the IRS. Fighting in court can be expensive and unproductive.

The court acknowledged that the government's "slight" burden can be met by a "simple affidavit," and it relied on the details of the affidavit submitted by the IRS agent in deciding to enforce the summons. That affidavit described an audit of one of the law firm's clients (Taxpayer 1), who the IRS agent said concealed his connection to offshore structures in which he remained the beneficial owner and that were created under the advice of the firm. Taxpayer 1 also admitted, according to the affidavit, that he owned all the assets held by several offshore trusts and earned more than $5 million in unreported income between 1996 and 2000.

The IRS agent's affidavit also stated that he believed the law firm provided similar advice to other clients, based on statements from a now-deceased partner of the firm who claimed that he structured offshore entities for tax purposes for 20 to 30 clients between the 1990s and early 2000s. The firm argued first that the issuance of the John Doe summons was itself an abuse of process, attacking the affidavit as being "replete with misrepresentations and inaccuracies" that were "cooked up." The firm added that Taxpayer 1 failed to follow the lawful advice it provided and that its own review of the remaining client files had determined that all of them were distinguishable from Taxpayer 1. However, the court found that none of those arguments rebutted the government's showing of a legitimate purpose in investigating offshore tax evasion and the relevance of the records for meeting that objective.

As stated by the court, the burden on the IRS is "slight," and the burden on those resisting the summons is "heavy." Thus, the law firm argued that the information sought by the summons was protected by the attorney-client privilege. Although the court recognized attorney-client privilege as a valid reason to rebut a John Doe summons, it noted that the burden is on the summoned party to establish that the privilege protects the information sought.

It may seem obvious that information regarding a client inquiry on a specific legal issue, such as offshore tax compliance, is privileged. However, what is covered by attorney-client privilege has been significantly eroded over the years, and the threshold for proving privilege has been significantly heightened.

Attorney-Client Privilege

The attorney-client privilege covers confidential communications made for the purpose of obtaining legal advice. The reason for protecting those communications is to encourage a full and frank dialogue between attorneys and their clients that would not likely occur without confidentiality. If taxpayers believed that everything they told their attorneys could end up in front of the IRS, they would be less likely to place their trust in tax lawyers.

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[1] *See* Justice Department press release, "Court Authorizes Service of John Doe Summonses Seeking Information About Finnish Residents Using Bank of America, Charles Schwab, and TD Bank Payment Cards Linked to Non-Finnish Bank Accounts" (May 1, 2019).

[2] *See, e.g.*, Justice Department press release, "Court Authorizes Service of John Doe Summons Seeking the Identities of U.S. Taxpayers Who Have Used Debit Cards in Furtherance of Tax Evasion" (Jan. 25, 2017).

[3] *See Taylor Lohmeyer Law Firm v. United States*, No. SA-18-cv-1161-XR (W.D. Tex. May 15, 2019).

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Aside from determining whether the purpose of a communication was to obtain legal advice, disputes abound over whether some items are properly classified as communications in the first place. The attorney-client privilege applies to situations in which counsel is sought on a legal matter. However, it may only protect disclosures that are necessary to obtain informed legal advice that would not have been made without the privilege. If a taxpayer finds himself on the wrong side of that line, highly confidential information could be ordered disclosed by the court.

Further complicating matters, courts sometimes construe the privilege narrowly by reasoning that privileges inhibit the search for the truth. Several courts have rejected general claims of privilege over undifferentiated groups of documents and required specific designations and descriptions, as well as precise reasons for confidentiality. Therefore, if the party asserting the privilege fails to provide sufficient detail and evidence of a valid privilege, it will not be granted.

Perhaps counterintuitive to clients, documents are not privileged merely because they were prepared by or sent to an attorney. If an attorney is found to be acting in another capacity for the client, such as an accountant, investigator, or business adviser, there may be no privilege.

In the tax context, matters can get even more nuanced. Taxpayers are legitimately concerned when handling tax issues. They may ask themselves how much they can reveal to their accountant or tax lawyer without worrying that it will be used against them later. If they choose to reveal potentially damaging information, will that information remain confidential?

Accountant communications are not protected by attorney-client privilege unless there is a *Kovel* letter in place, which will be discussed later. There is a statutory tax preparation privilege under section 7525, but it is quite narrow and completely inapplicable to criminal cases. That makes it of limited, if any, value.

Moreover, some courts have held that no privilege protects communications made for the preparation of a tax return even if they concern tax law issues or serve a dual purpose. For example, in a case involving KPMG, the court held that documents listed as concerning tax advice regarding U.S. federal income tax consequences were not privileged because they were prepared in conjunction with the preparation of a tax return.[4]

In *Taylor Lohmeyer*, the Texas law firm claimed attorney-client privilege but was unable to stave off court approval of the John Doe summons. The court noted that the party seeking to assert the privilege must allege its applicability with specificity regarding each document. Regarding the identities of the clients, the court indicated that they are not covered by the privilege unless they meet a limited and rarely available exception: when disclosure of the identity is the "last link in the chain" establishing incriminating evidence.

The government argued that its summons was tailored to avoid the attorney-client privilege, and that if the law firm asserts a privilege, it must produce a privilege log with specific objections. The firm, according to the court, did not do so, but instead submitted additional briefing with a declaration from an attorney at the firm and a sample of redacted documents. All of that simply wasn't enough.

The court ruled that the sample was insufficient to show that all 32,000 potentially responsive documents were privileged, and that the declaration provided generalities failing to show that the client identities fall within the narrow exception for privilege. The court did allow the law firm, following enforcement of the summons, to submit a privilege log, but it instead chose to file an appeal of the order enforcing the summons.

How to Protect Legal Advice

Taxpayers are not without avenues to protect the advice they receive from their accountants and tax lawyers. In sensitive civil or criminal tax matters, the conventional answer is the *Kovel* letter, named after the defendant in that case.[5] *Kovel* stands for the proposition that you can claim attorney-client privilege with your accountant by having your lawyer hire the accountant.

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[4] *See, e.g.*, *United States v. KMPG LLP*, 237 F. Supp. 2d 35 (D.D.C. 2002).

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

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In effect, the accountant is doing your tax accounting and return preparation but reporting as a subcontractor to your lawyer. Properly executed, it imports attorney-client privilege to the accountant's work and communications. The *Kovel* arrangement generally works well, but it can be less effective with client-accountant relationships that predate the *Kovel* letter. As with the attorney-client privilege, some IRS lawsuits have eroded parts of the privilege.

For example, in *Richey*,[6] the Ninth Circuit refused to protect an appraisal that a taxpayer, lawyer, and accountant were trying to keep from the IRS. In *Hatfield*,[7] the court forced disclosure of discussions between the lawyer and accountant. But this is rare; *Kovel* is still good law, and the practice remains widespread. For clients with complex or sensitive tax situations, adding a *Kovel* letter can provide a measure of additional comfort and control.

For tax advice from your tax lawyer, it is good practice to clearly document each communication and the legal reason for seeking the advice. If challenged, it is clear that the trend is to require more extensive privilege logs than a listing of titles and abbreviations of the privileges asserted. Spending a little more time producing a slightly more descriptive explanation with any details that will not inadvertently disclose the privileged information may be enough to defend against a challenge or buy favor with the deciding court.

Another good practice is to determine whether you can claim the work product doctrine along with the attorney-client privilege. The work product doctrine is broader than the attorney-client privilege. Further, unlike the attorney-client privilege, both the lawyer and the client hold work product immunity, and either may assert it to avoid disclosure. This doubling up of the privilege may help protect communications challenged as exceptions to attorney-client privilege.

Under the work product doctrine, documents, statements, correspondence, affidavits, attorney notes, models, exhibits, and similar materials prepared by an attorney, or by third parties acting under the direction of an attorney, may be protected from discovery if they were prepared "in anticipation of litigation."[8] Administrative proceedings before the IRS qualify as litigation.[9] Thus, materials prepared by the taxpayer or its representatives in anticipation of an audit may be protected under the work product doctrine.

However, to prevent practically everything generated in the course of tax planning and tax compliance from qualifying for the work product doctrine, the courts treat the phrase "in anticipation of" as creating a relatively demanding standard. Moreover, parties can sometimes overcome a work product challenge by showing a substantial need and an inability to obtain the document elsewhere without undue hardship.

Conclusion

Taxpayers must wait for the appellate court to decide if the government went too far in enforcing its John Doe summons for the client files of Taylor Lohmeyer. Perhaps the court will provide further guidance on how much specificity is required by the law firm to avoid turning over documents it believes are privileged. Regardless, taxpayers, accountants, and lawyers should reevaluate their interactions. Taxpayers should consider taking additional precautions when seeking advice on reducing their tax liabilities, evaluating amended return alternatives, and many other tax planning and compliance issues. Be careful in this brave new world. ■

[6] *United States v. Richey*, 632 F.3d 559 (9th Cir. 2011).

[7] *United States v. Hatfield*, 2010 WL 183522 (E.D.N.Y. 2010).

[8] *See Hickman v. Taylor*, 329 U.S. 495, 510-511 (1947); Federal Rules of Civil Procedure Rule 26(b)(3)(A).

[9] *See Hodges, Grant & Kaufman v. United States*, 768 F.2d 719, 722 (5th Cir. 1985).

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