Fifty Shades of Grey: Informal Discovery in Tax Litigation

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Although formal discovery in tax litigation is sometimes available, it is only one avenue for advancing the taxpayer's case. Wood and Shapiro discuss the permissibility, advisability, and practical uses of informal discovery against the IRS in tax litigation.

Tax attorneys who find themselves trying a case in court can be an unhappy bunch. Many tax lawyers try to cope with an unfamiliar setting by focusing on what they *are* familiar with. For many tax lawyers the technical tax rules embodied in regulations, case law, and private letter rulings bring the comfort of old friends.

But like the lovers in *Fifty Shades of Grey* who revel in somewhat unconventional romantic practices, tax attorneys may discover new avenues of fulfillment. A less traditional aspect of litigation, informal discovery, can be particularly satisfying. More importantly, tax practitioners may find that informal discovery efforts can be essential to building a strong tax case, thus ameliorating any lack of familiarity they have with the courtroom.

Discovery of IRS Conduct

For obvious reasons, the IRS often tries to prevent taxpayers from attempting discovery of government conduct. This is especially true when it appears that the taxpayer is trying to suggest misconduct by the Service. However, the IRS is not without authority for its judicial stonewalling.

Tax cases are reviewed *de novo*. As a result, the administrative record and the actions or thoughts of IRS employees are generally irrelevant to the court's review.[1] In fact, it is not unusual for courts to issue protective orders precluding discovery of the Service, including depositions of IRS agents.[2] Courts do not want taxpayers rooting around for materials that may be sideshows to the tax dispute in question, and the government has a job to do in collecting taxes and administering the tax system.

However, there are important exceptions to the notion that the administrative process is irrelevant, and many involve cases in which the statute of limitations is at issue. For example, if IRS agents have unfairly pressured a taxpayer to consent to extend the statute of limitations, the consent may be invalid.[3]

That consent may also be invalid when there is a conflict of interest between a third-party signatory

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[1]*Texture Source Inc. v. United States*, 851 F. Supp.2d 1260, 1262 (D. Nev. 2012) ("Based on this *de novo* review standard, trial courts have prohibited or restricted discovery regarding the IRS's administrative determinations of the tax liability on the grounds that it is irrelevant"); *Xcel Energy Inc. v. United States*, 237 F.R.D. 416, 419 (D. Minn. 2006) (deliberative process privilege discussion and material deemed irrelevant); *R.E. Dietz Corp. v. United States*, 939 F.2d 1, 4 (2d Cir. 1991); *see also Ruth v. United States*, 823 F.2d 1091, 1094 (7th Cir. 1987) ("Courts will not look behind an assessment to evaluate the procedure and evidence used in making the assessment").

[2]*Flamingo Fishing Corp. v. United States*, 31 Fed. Cl. 655, 658 (1994); *see also Evergreen Trading LLC v. United States*, 75 Fed. Cl. 730 (2007).

[3]*Pictorial Printing Co. v. Commissioner*, 38 F.2d 563, 564 (7th Cir. 1930) (holding that "waiver or consent so procured [under duress is] wholly inoperative as to that year"); *Diescher v. Commissioner*, 18 B.T.A. 353, 357-359 (1929) (waiver of statute signed under the threat of fraud penalties) ("The waiver was signed under duress and is invalid"); *Hall v. Commissioner*, 105 T.C.M. 1563, 1565 (2013) (citing *Diescher* as the standard for determinations of duress).

and the taxpayer resulting from a criminal investigation.[4] Also, the Service's awareness of a defect in its notice, such as a wrong address or misidentified party, may be pivotal in determining whether the statute of limitations is still open.[5] In those cases, the taxpayer should be given access to government personnel and communications.

Discovery of the IRS is relevant in other contexts as well.[6] In a recent case, the U.S. District Court for the Northern District of California allowed a taxpayer to conduct discovery into whether the IRS had concluded, in prior audits of other taxpayers, that the transaction at issue was not an abusive tax shelter.[7] The court noted that:

> If the IRS concluded that the program was legitimate when it audited borrowers, that may tend to show that a reasonable person in defendant's position would believe that the program was not an abusive tax shelter.[8]

Without discovery and a court's enforcement of it as necessary, a taxpayer may end up conceding, settling, or losing an otherwise winnable case. However, if the IRS refuses discovery and the court agrees, what recourse does a tax attorney have?

Informal Discovery Is Always Allowed

A common mistake in litigation — especially among tax attorneys — is to think that if the court has closed discovery, no discovery can be taken. This is untrue. In fact, when formal discovery channels are cut off, informal discovery is encouraged**.**

Plainly, the courts see a legitimate purpose in informal discovery because it is less expensive and burdensome for the parties and the courts.[9] It can also help in promoting settlement and encouraging the amicable resolution of disputes.[10]

One reason tax attorneys in particular are often unaware of their right to conduct informal discovery is that the term "informal discovery" has a specific and limited meaning in the Tax Court. It is well known that the Tax Court has relaxed rules of evidence and, in many respects, is less formal than other courts. However, the Tax Court has surprisingly formal procedures for informal discovery, generally requiring parties to request information from each other before submitting formal discovery requests.[11]

Most such requests for discovery in the Tax Court come from the IRS, seeking information from the taxpayer. As a result, tax attorneys often think of discovery as a weapon only the Service can use. The Tax Court rules even make it difficult to take depositions of third parties, which are only available under very limited circumstances.[12] However, informal discovery is not limited to the Tax Court's procedures for requesting information from the other party.

In fact, it can include informal requests for documents and information directed to third parties; informal interviews of potential witnesses; and requests for government records through the Freedom of Information Act and other channels.

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[4]*See, e.g.*, *Transpac Drilling Venture 1983-63 v. United States*, 26 Cl. Ct. 1245, 1247 (1992).

[5]Robert W. Wood and Dashiell C. Shapiro, "For Whom the Statute Tolls," *Tax Notes*, Sept. 2, 2013, p. 1035.

[6]*Timken Roller Bearing Co. v. United States*, 38 F.R.D. 57 (N.D. Ohio 1964) (IRS documents were "reasonably calculated to lead to the discovery of admissible evidence" because they would clarify the government's defense); *Gaughen v. United States*, No. 1:09-cv-02488 (M.D. Pa. 2010) (finding that *de novo* review does not "render all IRS documents irrelevant"); *Pierson v. United States*, 428 F. Supp. 384, 390-391 (D. Del. 1977), *rev'd on other grounds* (holding that the commissioner's reasoning for his conclusion is irrelevant in a *de novo* proceeding, but that not all IRS documents are necessarily irrelevant); *Nevada Partners Fund LLC v. United States*, 714 F. Supp.2d 598; No. 3:06-cv-00379 (S.D. Miss. 2008) (holding that some IRS documents may be relevant and lead to discovery of admissible evidence).

[7]*United States v. Cathcart*, 104 AFTR 2d 2009-6625, 2009-2 USTC par. 50,658 (N.D. Cal. 2009).

[8]*Id.*

[9]*See, e.g.*, *Krell v. Prudential Ins. Co. of Am. (In re Prudential Ins. Co. Am.)*, 148 F.3d 283 (3d Cir. 1998) ("Finally, the court found

(Footnote continued in next column.)

class counsels' 'use of informal discovery was especially appropriate in this case because the Court stayed plaintiffs' right to formal discovery for many months, and because informal discovery could provide the information that plaintiffs needed'") (citing *In re The Prudential Ins. Co. of America Sales Practices Litigation*, 962 F. Supp. 450, 479, n.13 (D.N.J. 1997) ("Fairness Opinion")). *United States v. Four Hundred Sixty Three Thousand Four Hundred Ninety-Seven Dollars & Seventy Two Cents in U.S. Currency*, 604 F. Supp.2d 978 (E.D. Mich. 2009) ("The Court entered an order explaining that formal discovery would await adjudication on the motion to stay. Nevertheless, the Court encouraged the parties to engage in informal discovery in the meantime").

[10]*See, e.g.*, *Castagna v. Madison Square Garden LP*, 06-cv-00589 (S.D.N.Y. 2011) ("In fact, informal discovery designed to develop a settlement's factual predicate is encouraged because it expedites the negotiation process and limits costs which could potentially reduce the value of the settlement"); *see also Jones v. Amalgamated Warbasse Houses Inc.*, 97 F.R.D. 355, 360 (S.D.N.Y. 1982) ("Although little formal discovery has occurred, the parties freely exchanged data during settlement talks. In view of the way this speeds the negotiation process, informal 'discovery' is to be encouraged").

[11]Tax Court Rule 70. *International Air Conditioning Corp. v. Commissioner*, 67 T.C. 89 (1976); *Branerton Corp. v. Commissioner*, 61 T.C. 691 (1974). *See* Alex E. Sadler and Daniel G. Kim, "Scope of Pretrial Discovery: A Key Difference in Litigating Tax Cases in the Tax Court and Refund Tribunals," *J. of Tax Prac. & Proc.* (Apr.-May 2009) (noting that *Branerton* letters "appear very similar to formal discovery requests").

[12]Tax Court rules 74 and 75(b) (noting that the taking of nonparty witness discovery is an extraordinary method).

Sometimes, if the IRS refuses to turn over information in formal discovery, those informal channels become key to developing and litigating important issues in a tax case.

Requesting IRS Transcripts and Case Records

The first informal source for information is the Service itself. In response to FOIA requests, the IRS will often produce case history records and ''transcripts'' of a taxpayer's account for a particular period and tax return. These documents contain valuable information that can help to unravel an otherwise strong government case.

Tax attorneys should routinely make FOIA requests when a case is on track toward litigation. Requests should ask for all files regarding the audit, including the IRS administrative file; e-mails; workpapers; case activity records; copies of all statements given by individuals in connection with the investigation; documents obtained from summonses or requests of third parties; and reports by independent consultants, such as economists, international examiners, and engineers. The more comprehensive the request, the better.

Transcripts should also be requested, which can often be done outside the FOIA process. Courts have routinely looked to IRS transaction records to establish and confirm evidentiary findings in tax disputes.[13] The Service often relies on transcripts as prima facie evidence of the correctness of the tax assessment.[14]

However, if something in the transcript appears to be incorrect, a taxpayer may be able to use it against the IRS. For example, in a recent memorandum opinion in *Rosenbloom v. Commissioner*, the Tax Court sided with the taxpayer after a careful review of an IRS transcript.[15] The taxpayer was able to prove that some extensions were invalid because no code on the transcript indicated that a prior installment agreement had ever been terminated.

Moreover, different types of transcripts can be requested. The IRS often relies on a certified transcript, known as Form 4340, in court. The Form 4340 transcript can be prima facie proof of the validity of an assessment. However, Forms 4340 often contain discrepancies or are missing data when compared with the master file for a taxpayer's account.

For example, the Form 4340 transcripts do not include accrual information. Given their importance, it is not surprising that the IRS has had trouble in court with Forms 4340. In *Clough v. Commissioner*,[16] the Tax Court noted that there was nothing in the Form 4340 transcript showing that a notice of deficiency was sent for that year.

As a result, taxpayers should routinely request additional transcripts directly from the IRS so that they have more information about their tax assessment and account activity. These transcripts include the account transcript, or record of account (formerly known as the ''MFTRA-X''), as well as the specific, or TXMOD, transcript. The TXMOD transcripts are mainly for internal IRS use and are often difficult for a layperson to understand.

However, those transcripts contain much more information about a tax account. It is possible to decode them and occasionally find key data. Although IRS transcripts and administrative files are often used to support the agency's case, they sometimes end up foiling it. Don't be afraid to pursue FOIA requests regularly — they might just pay off.

Can You Speak to Former IRS Agents?

Informal discovery has boundaries. The rules of professional conduct generally allow informal interviews of witnesses, but not when a witness is represented. Generally speaking, a current IRS employee is considered represented and cannot be interviewed while litigation is pending.[17] Of course, normal contact with IRS employees who are handling aspects of a client's tax matter is allowed, despite any ongoing litigation.[18]

But is a former IRS agent considered represented by the IRS? This is a grey area in which the rules are

[13]*McLaine v. Commissioner*, 138 T.C. 228, 241 (2012) (''it is well established that a Form 4340 or a computer printout of a taxpayer's transcript of account, absent a showing of irregularity, provides sufficient verification of the taxpayer's outstanding liability'') (citing authorities); *Range v. United States*, 245 B.R. 266, 272 (S.D. Tex. 1999) (''Courts have recognized both types of records as admissible evidence in tax disputes. . . . A certified transcript of account is also admissible evidence of a taxpayer's failure to file timely returns''); *Sy v. United States*, 968 F. Supp. 345, 348 (E.D. Mich. 1997) (''the transcript of accounts indicates that the installments were indeed applied to the Sys' 1981 account, i.e., treated as payments by the IRS'').

[14]*See, e.g., United States v. Thurner*, 21 Fed. Appx. 477 (7th Cir. 2001) (''IRS records were prima facie evidence of the Thurners' liabilities, and that absent contrary evidence from the taxpayers, the transcripts of account should be deemed conclusive'').

[15]T.C. Memo. 2011-140.

[16]T.C. Memo. 2007-106.

[17]*See, e.g., Brown v. Oregon Department of Corrections*, 173 F.R.D. 265 (D. Ore. 1997) (holding that American Bar Association Model Rule 4.2 bars attorneys from conducting ex parte interviews of corrections employees). American Bar Association Committee on Ethics and Professional Responsibility, Formal Op. 97-408 (1997) (The no-contact rule applies to communications with employees of a represented governmental agency ''in the same way that it applies to a lawyer's communications with officials of a private organization, and no communication is therefore permitted except with the consent of counsel'').

[18]*See, e.g.*, District of Columbia Rules of Professional Conduct R. 4.2(d) (authorizing ''communications by a lawyer with government officials who have authority to redress the grievances of the lawyer's client'').

less clear. Section 4.2 of the American Bar Association Model Rules of Professional Conduct prohibits communication with persons represented by counsel.[19] Does this cover everyone who was at any time employed by the IRS?

The answer must be no, because the rules themselves are conditional. Interviews of former employees that are designed to elicit privileged or other protected information are prohibited. An ABA opinion from 1997 states that ''gaining from a former government employee information that the lawyer knows is legally protected from disclosure for use in litigation nevertheless may violate Model Rules 4.4, 8.4(c) and 8.4(d).''[20]

However, the ABA has also concluded that Rule 4.2 does not preclude contact with former employees of an opposing corporate party.[21] Either way, interviews that are not designed to elicit privileged information are generally permitted.

In one Delaware Court of Chancery case, the court held that an attorney may contact a former employee of an adverse party ex parte, even if that employee has knowledge of extensive privileged communications.[22] It held that as long as the attorney is not seeking privileged facts and informs the employee that communications with attorneys cannot be revealed, the informal contact is acceptable.[23]

Of course, not all courts agree, and different rules may apply in different states. One question that may arise is whether the former employee was high-level or was part of the litigation control group.[24] In those cases, any interview may be off-limits.

Even when the employee did not have an important position, attorneys should be careful. For tax lawyers wondering how to proceed with informal interviews of former IRS employees, it is good to keep in mind basic rules of professional conduct for interacting with unrepresented parties. Lawyers who want to make ex parte contact with former IRS employees should:

1. never state or imply that the lawyer is disinterested;

2. make clear the lawyer's role, including the nature of the case, the identity of the lawyer's client, and that the IRS is an adverse party;

3. make reasonable efforts to correct any misunderstanding regarding the lawyer's role; and

4. never give the person advice other than that the person should obtain counsel.[25]

Some courts have held that there is no duty to warn an opposing party's former employees not to disclose confidential or privileged information.[26] A California appeals court held that the employer is responsible for seeking a protective order if it is concerned that former employees might disclose privileged information.[27] However, this is a treacherous area, and attorneys should be careful when stepping into uncharted territory.

In fact, when interviewing former IRS employees, taxpayer counsel should probably err on the

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[19]MRPC 4.2.

[20]''Communication With Government Agency Represented by Counsel,'' ABA Formal Op. 97-408, n.14 (1997). Rule 4.4 requires respect for the rights of third persons, and Rule 8.4(c) and (d) addresses misconduct involving dishonesty and conduct prejudicial to the administration of justice.

[21]ABA Formal Op. 91-359 (1991). However, see *Public Service Electric & Gas Co. v. Associated Electric & Gas Insurance Services Ltd.*, 745 F. Supp. 1037, 1042 (D.N.J. 1990) (concluding that both present and former employees of a corporation should be considered a party, and therefore, Rule 4.2 prohibited ex parte interviews of *all* current and former employees).

[22]*LaPoint v. AmerisourceBergen Corp.*, 2006 WL 2105862 (Del. Ch. 2006) (''one party's attorney may contact a former manager of an adverse party ex parte, even if the former employee was privy to extensive privileged communications, as long as the attorney is seeking only key non-privileged facts, and makes the former employee aware that she cannot divulge any communications she may have had with the adverse party's attorneys, or any other privileged information'').

[23]*Id.*

[24]*Michaels v. Woodland*, 988 F. Supp. 468, 471-472 (D.N.J. 1997) (''If it is a former employee that the lawyer wants to interview, and that person was within the litigation control group, the witness is presumptively represented by the organization''). *See also NAACP v. State of Florida*, 122 F. Supp.2d 1335, 1340, n.6 (M.D. Fla. 2000) (barring contact with former employees who ''may have been members of management or 'high-level' employees who had access to privileged or confidential communications/information, participated in decision-making activities, and/or worked with the attorneys'').

(Footnote continued in next column.)

[25]MRPC 4.3. *See also Orlowski v. Dominick's Finer Foods Inc.*, 937 F. Supp. 723, 728 (N.D. Ill. 1996) (former employees are not encompassed by Rule 4.2 and may freely talk with opposing counsel, but they are barred from discussing privileged information); *Clark v. Beverly Health and Rehabilitation Services*, 797 N.E.2d 905, 908 (Mass. 2003) (''While [Rule 4.2] prohibits lawyers from making ex parte contact with a former employee who counsel knows to be represented, it neither prohibits, nor purports to regulate, private contacts between an adverse party and the organization's former employees as such''). *See generally* Benjamin J. Vernia, Annotation, ''Right of Attorney to Conduct Ex Parte Interviews With Former Corporate Employees,'' 57 *A.L.R.* 5th 633 (1998).

[26]*See, e.g., Widger v. Owens-Corning Fiberglas Corp. (In re Complex Asbestos Litig.)*, 232 Cal. App. 3d 572, 588 (1991) (''We emphasize that our analysis does not mean that there is or should be any broad duty owed by an attorney to an opposing party to maintain that party's confidences in the absence of a prior attorney-client relationship'').

[27]*Continental Ins. Co. v. Superior Court*, 32 Cal. App. 4th 94, 119 (1995) (''it is incumbent upon a party who knows that its former employees, including former control group employees, possess privileged information to seek a protective order'').

side of caution and provide a warning about disclosing confidential information. The Service might argue, for example, that section 6103 is the functional equivalent of a protective order and that the attorney was duty-bound to warn the former agent not to disclose any protected taxpayer information.[28]

Also, the IRS has taken the position that depositions of former employees need to await testimony authorizations from the IRS under the 'Touhy' regulations.[29] However, the IRS was recently rebuked by a district court for hiding behind those regulations, which noted that the IRS ''set out obstacles to block the request [for depositions] without even giving it serious consideration, and then nonchalantly gave spurious reasons for denying the request.''[30] The regulations likely do not cover informal interviews of former employees, but the IRS may argue otherwise.[31]

There are many shades of grey in these cases, so it is wise to carefully consult ethical rules (and rulings) in the relevant state. Lawyers should always proceed thoughtfully and respectfully. Whether dealing with current or former IRS employees, the government and its employees have rights. Of course, so do taxpayers, and the lawyer's duty is first and foremost to his client.

Admissibility

Finally, it is important to consider a potential Catch-22 of interviewing former IRS employees and informal discovery in general. Simply because information is discoverable does not mean it is admissible.

Although tax attorneys may be within their rights to interview a former IRS revenue officer or agent if he was employed at a sufficiently low level not to speak for the IRS as an entity, the former agent's statements may not be admissible because he arguably has no right to speak for the Service.[32]

On the other hand, the former employee's statements may be admissible if, for example, the agent was part of the litigation control group. In such a case, the interview itself may constitute a violation of Rule 4.2. The result could create a true double whammy: The statements could be excluded from evidence and also be the subject of sanctions.[33]

Of course, the sensitivity of this area and the potential repercussions of a misstep do not mean that tax attorneys should entirely avoid interviewing former IRS personnel. Assuming those interviews are conducted within ethical rules, they may provide crucial information about the case. They may also serve as the basis for a request for formal discovery, even if the former agent's statements themselves are not admissible in court.

Moreover, it is possible that information obtained through informal discovery may be admissible under an alternative exception to the hearsay requirement. In appropriate cases, it also could be used for impeachment.

Thinking Creatively

When you want information from the IRS, the courts are not the final word. Even when a judge says no to discovery, there may be simple steps you can take to extract files from the government. In short, informal discovery should not be overlooked in tax litigation.

E.L. James's best-selling novel brought unconventional romantic activities into mainstream supermarkets and homes. This resulted in a degree of shock, to be sure. It also brought financial success to the author and publisher, and perhaps romantic success to at least some readers. A similar, if not greater, degree of shock may confront the IRS if taxpayers begin to use the panoply of available informal discovery devices against the government in appropriate cases. Sometimes, however, a little shock is good for everyone.

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[28]*See generally* section 6103.

[29]*See, e.g., Philpott v. City of Mason City*, C09-3062-DEO (N.D. Iowa 2010). Reg. section 301.9000-1 through 301.9000-7.

[30]*Id.*

[31]The IRS may argue that an informal interview of a former employee is a ''request'' for information from an ''IRS officer.'' Reg. section 301.9000-1(b) (definition of IRS officer includes ''former officers and employees''); reg. section 301.9000-1(d) (definition of ''request'' includes any request for ''production of IRS records or information, oral or written, by any person, which is not a demand''). However, the requirement for testimony authorizations only applies to disclosure to a ''court, administrative agency, other authority, or to the Congress, or to a committee or subcommittee of the Congress.'' Reg. section 301.9000-3. It should not apply to an informal interview.

[32]*Young v. James Green Management Inc.*, 327 F.3d 616, 622-623 (7th Cir. 2003) (former employee's statement not admission of employer); *Hernandez Escalante v. Municipality of Cayey*, 967 F. Supp. 47, 51 (D. P.R. 1997).

[33]*Midwest Motor Sports Inc. v. Arctic Cat Sales Inc.*, 144 F. Supp.2d 1147, 1155-1156 (D.S.D. 2001) (excluding admissions obtained by Rule 4.2 violation).