

## When Is Tax Practice 'Legal'?

**BY CHRISTOPHER S. RIZEK**

**T**he recent report of the American Bar Association's Commission on Multidisciplinary Practice stresses the need to maintain client confidentiality. While lawyers may believe they need not be reminded of the sanctity of secrets, the commission understood that client confidences may be undermined when firms include lawyers and non-lawyer professionals working side by side. The problem is simply this: A client's communications to his or her accountant, auditor, or other nonlawyer professional ordinarily are not covered by the attorney-client privilege.

Tax practice, in which lawyers and non-lawyers frequently work together to advise and represent clients, presents perhaps the most visible example of the challenges of maintaining client confidences in a multidisciplinary setting. Last year, Congress addressed some of these challenges in the IRS Restructuring and Reform Act of 1998, enacting a new evidentiary privilege for certain communications between taxpayers and their advisers.

Issues relating to the scope of, and exceptions to, this new privilege are sure to be litigated in coming years, but commentary from the courts has already begun. In dicta in *United States v. Frederick*, 83 AFTR2d 99-1870 (7th Cir. 1999), Judge Richard Posner highlighted the conceptual issue at the heart of the new privilege: that it applies to accountants or other non-lawyers only when they are rendering legal advice—in other words, practicing law. This core problem is likely to focus attention on a broader issue in the tax field, namely the extent to which Congress has overridden the authority of states to regulate the practice of law.

### **COMMON LAW GAP**

Common law recognizes no privilege for communications made between individuals and their accountants. Since there is

no common law accountant-client privilege, federal courts do not recognize such a privilege under Rule 501 of the Federal Rules of Evidence. Likewise, the U.S. Tax Court does not recognize an accountant-client or tax adviser-client privilege, even though it allows accountants and others to represent taxpayers before it. IRC §§7452, 7453; Tax. Ct. Rule 200.

In the 1998 law, however, Congress created a federal statutory privilege analogous to the statutory accountant-client privilege in many states. New §7525 of the Internal Revenue Code provides:

With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

The statute defines a "federally authorized tax practitioner" (FATP) as an individual authorized to practice before the IRS pursuant to 31 U.S.C. §330. "Tax advice" is defined as "advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice."

The statute identifies various exceptions to the new privilege. It does not apply to criminal tax matters, nor can it be asserted in any proceeding other than a federal civil tax matter (e.g., in nontax litigation or an investigation by the Securities and Exchange Commission). Like the attorney-client privilege, the statutory privilege is waivable, so communications disclosed in nontax proceedings will presumably be nonprivileged in subsequent tax proceedings. Finally, the new privilege does not apply to certain communications related to corporate tax shelters.

In order for communications "with respect to tax advice" to be privileged under this provision, they must be the sort of communications that would be protected if made between a lawyer and a client. Of course, it is hornbook law that communications between a lawyer and a client are privileged only to the extent they are made in connection with *legal* advice.

Although defining the exact boundaries of “legal advice” has been the source of much controversy over the years, the general principle is well-established that communications with an attorney that are not for the purpose of obtaining legal advice (e.g., managerial consultations, investment or economic analysis, or preparation of a tax return) are not privileged. *A fortiori*, such communications with a nonlawyer FATP cannot be privileged under §7525. Indeed, the legislative history of the new privilege says exactly this. H. Conf. Rep. No. 105-599 at page 268.

Conversely, if a communication is privileged only to the extent the “tax advice” would be “legal advice” if given by a lawyer, then such tax advice must necessarily be a subset of legal advice. True, some kinds of tax advice may be outside the scope of legal advice. But a communication for the purpose of getting such tax advice would then be outside the scope of the attorney-client privilege even if made with a lawyer, and so it would remain nonprivileged under the new statute.

This analysis was apparently discerned by Judge Posner in *Frederick* and underlies his comment about the new privilege. Richard Frederick, who is an attorney and an accountant, rendered both legal and tax return preparation services to his clients. The court held that he was acting primarily as an accountant, not as a lawyer, and thus that the communications at issue were not privileged. The court correctly held that the new statutory privilege was inapplicable because the communications occurred before its effective date. But Judge Posner nevertheless observed that the new privilege can be invoked only if the subject matter of the communications is legal and, noting that the IRS allows nonlawyers to practice before it, said, “Nothing in the new statute. . . suggests that these non-lawyer practitioners are entitled to privilege *when they are doing other than lawyers’ work*.”

So the question is not whether privileged tax advice constitutes legal advice. It does—indeed it must, or there will be no privilege. The only question is whether an FATP can offer such advice without engaging in the unauthorized practice of law. This is a much trickier issue, particularly in view of the accounting profession’s long-standing claim that an accountant is not practicing law when he or she offers tax advice or other tax-related services.

## PRACTICE PUZZLER

The statutory provision cross-referenced in the definition of an FATP authorizes the secretary of the Treasury to “regulate the practice of representatives of persons” before Treasury, to impose certain requirements for admission to such practice, and to suspend or disbar such persons. 31 U.S.C. §330. The authority to admit and regulate practice is subject to 5 U.S.C. §500, which in turn provides, with certain limitations, that a member in good standing of the bar of a state may practice before any federal agency and that a duly qualified certified public accountant may represent a person before the IRS.

Pursuant to these provisions, Treasury regulations state that attorneys, CPAs, enrolled agents, and (in limited cases) enrolled actuaries may practice before the IRS. 31 C.F.R. §10.3 (Treasury Department Circular 230). Circular 230 states that “practice” before the IRS “comprehends all matters connected with a presentation” to the IRS “relating to a client’s rights, privileges, or

liabilities” under federal tax laws, including “preparing and filing necessary documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.” 31 C.F.R. §10.2(e).

On the other hand, Circular 230 expressly states that “nothing in the regulations in this part shall be construed as authorizing persons not members of the bar to practice law.”

Although the boundaries of the practice of law are notoriously difficult to delineate, the ABA Commission on Multidisciplinary Practice has proposed to define them by presumptively including in legal practice “preparing any legal document,” “preparing or expressing any legal opinion,” and “preparing any claims, demands or pleadings of any kind, or any written documents containing legal argument or interpretation of law, for filing in any court, administrative agency or other tribunal.” The MDP Commission also suggests defining “legal services” as “services which, if provided by a lawyer engaged in the practice of law, would be regarded as part of such practice of law” for purposes of the disciplinary rules.

Arguably, therefore, Circular 230 is self-contradictory. At the same time it disclaims that it authorizes nonlawyers to engage in the practice of law, it identifies as part of “practice before the IRS” many activities that would undoubtedly constitute the practice of law if performed by a lawyer. Acts that would constitute the practice of law if done by a lawyer in a legal setting cannot logically cease to be the practice of law simply because they are done by nonlawyers in different settings.

In a similar situation, the Supreme Court found that federal authorization to practice before the Patent Office permitted activities by nonlawyer patent agents that certainly constituted the practice of law in Florida. *Sperry v. Florida*, 373 U.S. 379 (1963). Among the specific activities the Court found to be permitted were “rendering legal opinions,” “preparing, drafting, and construing legal documents,” and “otherwise engaging in the practice of law.” At the same time, the Court somewhat confusingly found that registration with the Patent Office did not authorize “the general practice of patent law,” but only those services that were reasonably necessary and incident to preparing and prosecuting patent applications.

## POSSIBLE SOLUTIONS

Should the disclaimer regarding the practice of law in Circular 230 be given effect? If so, it could be argued that the new statutory privilege applies to no communications whatsoever, for it would then apply only to a nonlawyer’s communications related to legal advice, i.e., advice rendered in the practice of law, which Circular 230 does not authorize. This might be what Judge Posner was hinting at in *Frederick*. Of course, this interpretation would leave Congress’ effort to create a tax adviser privilege an empty set, devoid of legal effect. Given Congress’ penchant for symbolic acts, that may well be accurate, but it is not an interpretation likely to be favored by the courts.

It seems more likely that controversies over the scope of the new statutory privilege will force the conclusion that tax advisory services by FATPs do constitute the practice of law if they would otherwise be the practice of law when performed by a lawyer. This may even be the better interpretation.

Notwithstanding Circular 230's disclaimer, it and the statutory provisions it interprets clearly authorize some activities by FATPs that would constitute "legal services" or the practice of law under the MDP Commission's proposed definition. At the very least, they authorize activities such as appearing before the IRS to seek a private letter ruling for a client, responding to an IRS summons or examination request, and appealing a proposed adjustment.

Under the *Sperry* analysis, legal opinions and advice concerning tax issues, research and preparation for such items, and perhaps even the structuring of transactions, may be considered to be parts of the practice of law that are now federally authorized for nonlawyers. Communications may therefore be privileged to the extent they relate to such matters.

As long as its own disclaimer is ignored, Circular 230 can be read to support this interpretation. For instance, even though one need not be an authorized "practitioner" to prepare tax returns, Circular 230 establishes ethical standards governing the positions that authorized practitioners can take on a return or advise a client to take. Likewise, Circular 230 provides standards for opinions on certain kinds of tax shelter transactions. From these facts, it may be argued that FATPs are authorized to offer legal advice as to return positions and opinions on transactions; otherwise, how could Treasury regulate such activities?

Taking the position even further, one might even argue that "tax advice" is broader than advice directly related to an actual presentation to the IRS, on the grounds that "tax advice" is defined as "advice given by an individual *with respect to a matter* which is within the scope of the individual's authority to practice." Thus, if a matter eventually ends up before the IRS, any communications relating to the matter may arguably be considered within the scope of privileged tax advice.

Courts are likely to come out somewhere between these extremes. Circular 230 can probably best be harmonized with the prohibition against unauthorized practice of law simply by adopting a narrow interpretation of the scope of the federal authority to practice before the IRS. A restrictive interpretation of such authorized tax practice in the privilege context would also be consistent with the habit of courts to construe privileges narrowly, since they are impediments to the determination of the truth. One ironic consequence, however, may be that, in an effort to keep the playing field between lawyers and accountants level, the courts will begin adopting a narrow view of what constitutes *legal services* provided to taxpayers by lawyers. The end result may be a loss of taxpayer confidentiality, not a gain.

Multidisciplinary practices in the tax area have so far dodged accusations that they are engaged in the practice of law. The new privilege provision may focus this controversy and force such practitioners to acknowledge that they are practicing law, albeit with federal authority. Otherwise, the definitional problem highlighted by Judge Posner in *Frederick* could lead to the conclusion that tax practitioners do not enjoy any privilege.

It may come as a surprise to some state bar associations to learn that nonlawyers claim federal authority to perform broad categories of work that are squarely within the traditional definition of legal services, and that Congress has implicitly endorsed these practices. At least in the practice of taxation, that day appears to be upon us. ■

*Christopher S. Rizek is a partner at D.C.'s Caplin & Drysdale. From 1995 to 1998, Rizek served as attorney-adviser and then associate tax legislative counsel in the Treasury Department's Office of Tax Legislative Counsel. While at Treasury, he was the department's main negotiator on the taxpayer rights provisions of the IRS Restructuring and Reform Act of 1998.*