IRS Insights | A closer look

In *Crandall v. Commissioner of Internal Revenue*[1], the Tax Court addressed a question about the scope and effect of a closing agreement signed between the taxpayers and the IRS

The case originated from the taxpayers' disclosure of unreported income through the Offshore Voluntary Disclosure Program ("OVDP"). During the tax years 2003 through 2011, the taxpayers were a husband and wife that resided in both the United States and Italy. One spouse was a dual citizen of the United States and Italy who worked for the Italian government and became eligible for a pension. During this period, the taxpayers received foreign source pension income, interest income, and ordinary dividends. However, for each of these years, the taxpayers did not report this foreign source income or pay the related US federal income tax.

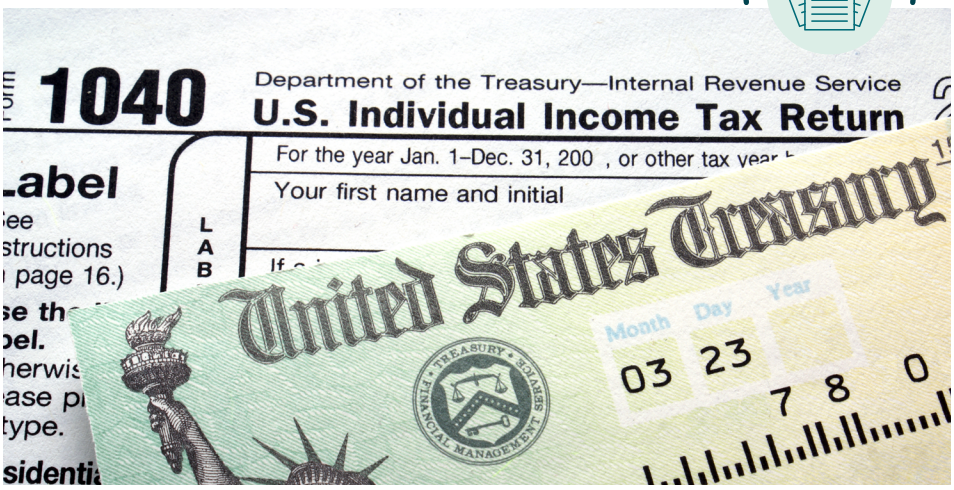
In 2012, the taxpayers entered the OVDP via a written submission, disclosing their underreporting of foreign source income. The taxpayers included amended Forms 1040, *U.S. Individual Income Tax Return*, for each year and made payments covering additional tax and interest for each year. On each of these returns, the taxpayers also claimed foreign tax credits ("FTCs"). An IRS revenue agent reviewed the taxpayers' OVDP submission. After an

In this edition

examination, the revenue agent issued a revenue agent report, proposing greater deficiencies than the amount reported on the amended returns for each of the tax years. The increased deficiencies resulted from the revenue agent allowing fewer FTCs than the taxpayers had claimed on their amended returns. However, the revenue agent inadvertently allowed the taxpayers an alternative minimum tax credit in 2011, which partially offset the downward adjustment of the 2011 FTCs.

In July 2015, the revenue agent sent the taxpayers a Form 906, *Closing Agreement on Final Determination Covering Specific Matters*. The terms of the closing agreement were laid out in 10 paragraphs, which summarized the adjustments for the 2003–2011 tax years. The agreement also included the accuracy-related penalties and additions to tax that applied to the underpayments resulting from the adjustments. The agreement provided that the IRS was not prevented from auditing the taxpayers for the tax years 2003–2011 and proposing adjustments unrelated to the offshore financial arrangement disclosed through OVDP. In addition, the closing agreement permitted the IRS to propose adjustments related to offshore financial arrangements not included in the OVDP. Critically, nowhere in the closing agreement did the parties specify the amount of FTCs the taxpayers were entitled to for 2011. The closing agreement further provided that the document was final and conclusive, except in the event of fraud, malfeasance, misrepresentation of material fact.

After the parties executed the Form 906, the revenue agent who reviewed the taxpayers' OVDP submission issued an additional notice of deficiency determining a deficiency of $6,661, along with an accuracy-related penalty of $1,332 for 2011. The Revenue Agent Report showed that the deficiency resulted from reducing taxpayers' FTCs. The taxpayers petitioned the Tax Court for review. The taxpayers argued that the closing agreement precluded the IRS from adjusting their 2011 FTCs in the deficiency notice. The IRS argued that the absence of an FTC adjustment for 2011 in the closing agreement and therefore the closing agreement did not prohibit a subsequent adjustment to that item.



The Tax Court began its analysis by noting that the scope of a closing agreement is strictly construed to encompass only the issues enumerated in the agreement itself.[2] Closing agreements are contracts, subject to the federal common law rules of contract interpretation. The Tax Court observed that contracts are construed according to the parties' intent at the time of the agreement and that language of the contract is the ultimate determinant of the parties' intended agreement.[3]

Relying on these precedential guideposts, the Tax Court examined how the parties memorialized their agreement on the taxpayers' 2011 tax liability. The court noted that the closing agreement provided that the taxpayers were entitled to FTCs for 2011 for amounts paid in foreign taxes to Italy but did not specify the amount. The Tax Court also looked to other aspects of the closing agreement that provided the agreement "does not prevent" the IRS from proposing adjustments "unrelated to offshore financial arrangements" and adjustments "related to offshore financial arrangements not included… in the petitioners' voluntary disclosure."

When read together, the Tax Court found that these provisions reflected an intent to resolve the tax consequences related to the taxpayers' income they included in the voluntary disclosure. The Tax Court determined that the 2011 FTCs were covered by the taxpayers' voluntary disclosure. For these reasons, the Tax Court concluded that the 2011 FTC was included within the scope of the closing agreement and, therefore, the notice of deficiency was barred by the closing agreement.

In *CIC Services v. Internal Revenue Service*,[4] the Supreme Court held in a unanimous opinion, that a pre-enforcement challenge to enjoin an aspect of the IRS's reportable transaction information reporting regime was not precluded by the Anti-Injunction Act

The case rose to the Supreme Court after a series of lower court rulings on the validity of CIC Services' pre-enforcement action to enjoin Notice 2016-66 (the "Notice"), a notice requiring information reporting of micro-captive transactions by certain taxpayer and material advisors. CIC Services acted as a material advisor to taxpayers participating in transactions classified by the IRS in the Notice as micro-captive transactions. Generally, a micro-captive transaction is an insurance agreement between a parent company and a captive insurer that yields certain tax advantages for the parties involved.

In the Notice, the IRS identified micro-captive transactions as posing tax avoidance risk and classified them as a "transaction of interest" treated as a "reportable transaction." The Internal Revenue Code ("Code") provides the IRS with broad statutory authority to impose information reporting requirements.[5] The Code specifically delegates the IRS authority to identify particular transactions with a potential for tax avoidance or evasion.[6] The IRS has implemented this delegated authority by creating the reportable transaction information reporting regime, which requires taxpayers and material advisors to report certain information relating to identified transactions and certain categories of transactions. Failure to comply with these requirements can result in stiff penalties for taxpayers and/or material advisors. The statutory provision provides that a material advisor can be subject to a civil penalty of $50,000 for its failure to provide the IRS with the required information with respect to a reportable transaction.[7] An advisor can incur an additional $10,000 penalty for each day that it fails to provide the IRS with a list of the people that it advised with respect to a reportable transaction.[8] Critically, these penalties are deemed to be taxes for purposes of the Code and the Anti-Injunction Act.[9]

CIC Services brought an action before paying the penalty, preemptively challenging the Notice for failing to comply with the notice-and-comment procedures of the Administrative Procedure Act. In response, the government moved to dismiss the action on the grounds that the Anti-Injunction Act barred CIC Services' requested relief because it would prevent the IRS from assessing a tax penalty. The government argued that this amounted to a restraint on the assessment of tax in violation of the Anti-Injunction Act, which provides that "no suit for the purposes of restraining the assessment or collection of any tax shall be maintained in any court by any person."[10] The Supreme Court has described the Anti-Injunction Act as barring litigation to enjoin or otherwise obstruct the collection of taxes.[11] The government persuaded the District Court that CIC Services' suit impermissibly interfered with its ability to assess a tax penalty and therefore was barred by the Anti-Injunction Act. In the government's view, the only lawful way to challenge the validity of the Notice is for CIC Services to pay the penalty and sue for a refund. CIC Services appealed the decision to the Sixth Circuit Court of Appeals, which affirmed the District Court's ruling in a divided decision. The dissenting opinion contended that a suit to enjoin the enforcement of a reporting requirement is not a restraint on tax collection barred by the Anti-Injunction Act.[12] The Supreme Court granted certiorari to resolve the question of whether the Anti-Injunction Act barred CIC Services' action challenging the validity of the Notice's reporting requirements.

In a unanimous opinion, written by Justice Kagan, the Court addressed the question of whether the Anti-Injunction Act barred CIC Services' pre-enforcement suit because an injunction against the Notice's reporting requirements would also restrain the assessment of the associated tax penalties. The Court began its analysis by considering the suit's purpose in order to determine if it was directed at enjoining the reporting

requirements or the associated tax penalties. The Court examined the face of the complaint to determine the substance of the suit. The government argued that an injunction against the Notice amounted to the same thing as an injunction against the tax penalty. In the government's view, the reporting requirements and the potential tax penalty were "two sides of the same coin." The Court disagreed, noting that three aspects of the regulatory scheme refute the view that CIC Services' suit was a tax action in disguise. The Court sided with CIC Services' interpretation of its complaint as a contest over the legality of the Notice, not an attempt to avoid the tax penalty consequences of its failure to comply with the Notice.

First, the Court noted that, while the Notice imposes reporting obligations, the associated tax penalty for violating this requirement is imposed separately, by statute. The court pointed out that the Notice imposes no tax obligation itself. Instead, the Notice compels taxpayers and their material advisor to collect and submit information about micro-captive transactions and their participants. The Court noted that complying with these requirements incurs its own costs apart from any associated penalty. The suit, according to the Court, is aimed at avoiding these costly burdens and that avoiding the tax penalty is simply a consequence of the action.

Second, the Court observed that the reporting requirement and the statutory tax penalty are several steps removed from each other. Several steps need to transpire in order for CIC Services' failure to report the required information to cause it to incur the discretionary tax penalty consequence. The Court cited the government's own concession at oral argument that a challenge to a duty is not a restraint on assessment of tax in instances where there is too attenuated a chain of connection between an upstream duty and the downstream tax. The Court concluded that, given the distance between the duty to comply with the Notice and the downstream tax penalty consequences, this principle applies here.

Third, the Court noted that a violation of the Notice is not only punishable by a civil tax penalty but also by separate criminal penalties in the case of a willful failure to comply. In the Court's view, the risk of these criminal penalties practically necessitates a pre-enforcement challenge. Additionally, the Court observed that only an injunction against the reporting requirement provides CIC Services with the relief from the reporting requirements that they seek.

The Court's opinion addressed the government's concern that a ruling in favor of CIC Services would undermine the Anti-Injunction Act. The Court recognized the government's concern that a wave of pre-enforcement actions could interfere with its ability to assess and collect revenue. The Court carefully distinguished this case from pre-enforcement challenges against regulatory rules that imposed a tax liability. The Court stated that CIC Services' pre-enforcement requested relief did "not run against a tax"; rather, it seeks relief from the information reporting requirements of the Notice. The Court reiterated that the Anti-Injunction Act applies whenever a suit calls for the enjoining of the IRS's assessment and collection of taxes. The Court is clear that pre-enforcement review challenging a tax rule, including so-called regulatory taxes, would be barred by the Anti-Injunction Act.

In this case, CIC Services' suit was aimed at the stand-alone reporting requirement. The suit was not aimed at restraining the assessment or collection of tax and, therefore, the Court held that it was not barred by the Anti-Injunction Act.

In *IQL v Kingsbridge Technology*, a District Court had to decide whether the doctrines of attorney-client privilege and work product doctrine protections apply to certain emails and tax preparation documents

In *IQL v. Kingsbridge Technology*, the District Court for the Northern District of Illinois Eastern Division had to decide whether the doctrines of attorney-client privilege and work product doctrine protections apply to certain emails and tax preparation documents. The case in *IQL v. Kingsbridge Technology* arose out of a dispute between IQL-RIGGIG, LLC "IQL" and Kingsbridge over the majority ownership interest of a third party, Got Docs, LLC ("Got Docs"). Kingsbridge contested IQL's ownership interest in Got Docs, based on IQL's 2017 tax returns, as well as other documents and communications. Kingsbridge filed a motion for summary judgment on July 29, 2020. In response, IQL hired an accounting firm to prepare and file a second amended return for IQL for 2017. Relying on the amended tax returns, IQL filed its opposition to the summary judgment motion.

Kingsbridge served a subpoena on IQL's accounting firm seeking all material concerning IQL and Got Docs. In response to the subpoena, IQL's accounting firm produced the amended tax returns and related emails, but partially or wholly redacted most of the emails it produced, asserting attorney-client privilege and work product doctrine protections for the emails between IQL, its attorneys, and the accounting firm, as well as the tax preparation materials. In response, Kingsbridge moved to compel the accounting firm to produce unredacted versions of the emails produced in response to the subpoena, arguing that the protections of the attorney-client privilege and work product doctrine were inapplicable. The District Court reviewed each of IQL's accounting firm's assertions in turn.

Kingsbridge argued that IQL's accounting firm improperly withheld responsive information under the attorney-client privilege. The attorney-client privilege protects a communication: 1) between a client and attorney; 2) made in confidence; 3) for the purpose of obtaining legal advice.[13] The court noted that the Seventh Circuit does not recognize an accountant-client privilege, but it has explained that material an attorney sends to or receives from an accountant may qualify for protection under the attorney-client privilege if the accountant acts as the attorney's agent in rendering legal advice.[14] For the attorney-client privilege to attach to communications between an attorney and an accounting service, the purpose of the communication must be to seek legal advice and not accounting services. The court noted that an accountant's preparation of tax returns qualifies as an accounting service and not as legal advice.[15] Following the position of the Seventh Circuit, the court identified the engagement letter as the most important piece of evidence for determining whether communications between a law firm and an accounting service are privileged.[16] The court examined the engagement letter between IQL's law firm and accounting firm, which stated that the accounting firm was retained for tax preparation related to IQL's 2017 amended tax returns. Based on the engagement letter and the substance of some of the communications, the court concluded the communications related to accounting services and were, thus, not protected by the attorney-client privilege. Similarly, the court concluded that the emails between attorneys and the accountants were not protected by attorney-client privilege, because the privilege only attaches to communications between a client and an attorney or the attorney's agent. Here, neither the accounting firm nor the law firm could demonstrate that the emails related to privileged communications to or from the client. The court, however, did find that the emails between IQL's partners and their attorney and the accounting firm were protected by attorney-client privilege, determining that the subject of the communication was legal advice from the attorneys.

Next, the court turned to IQL's accounting firm's assertion that the withheld and redacted documents were protected under the work product doctrine. At the outset of its analysis, the court surveyed the Seventh Circuit's precedent on the purpose and scope of the work product doctrine. The work product doctrine protects documents prepared by an attorney or an attorney's agent to analyze and prepare the client's case.[17] The work product doctrine protects the party, and not just the attorney's preparation.[18] The doctrine shields two types of work from disclosure: 1) an attorney's thought processes and mental impressions; and 2) attorney's fact-finding investigation.[19] Like attorney-client privilege, the party asserting the work product doctrine bears the burden of showing that the disputed documents were protected by the work product doctrine.[20] As the Seventh Circuit had not previously ruled on the applicability of the work product doctrine in the realm of tax communications, the court drew on precedent from other Circuit courts to guide its analysis. Both the Second and Sixth Circuit Courts of Appeals have held that tax memoranda that provide legal analysis of tax law, identify possible IRS challenges, and discuss potential theories or counterarguments are potentially protected by the work product doctrine.[21]

Kingsbridge argued that the work product protection could not apply to emails exchanged between IQL's accounting firm and law firm because the accounting firm's emails could not reflect an attorney's work product. The court, however, observed that work product doctrine does not require an attorney to author the communications; it also applies to potentially protect communications prepared by an attorney's agent. Since the emails were exchanged in anticipation of litigation and reflected the opinion work product of counsel, the court found that these emails were analogous to the tax memoranda held by the Second and Sixth Circuits to be protected under the work product doctrine.

Kingsbridge argued further that even if work product doctrine attached to the emails exchanged between IQL and its law firm, the law firm waived the privilege when it forwarded the documents to IQL's accounting firm, relying on a Seventh Circuit decision, which found that information forwarded to a tax preparer for use on a tax return destroys any expectation of confidentiality.[22] After an *in camera* review of the relevant documents, the court found that none of the emails forwarded were for tax preparation purposes and therefore all were emails that were protected by the work product doctrine.

Lastly, the court found that while the emails between IQL's principal owners and IQL's attorneys were not covered by work product protection because they were not authored by IQL's attorneys nor their agent, they were protected by the attorney-client privilege protection and, thus, were not required to be disclosed in response to the subpoena.

Endnotes

1 *Crandall v. Commissioner*, T.C. Memo 2021–39 (Mar. 29, 2021).

2 *Analog Devices, Inc. v. Commissioner,* 147 T.C. 429, 445-446 (2016).

3 See *Baldwin v. Univ. of Pittsburgh Med. Ctr.*, 636 F.3d 69, 76 (3d Cir. 2011).

4 593 U.S. ___, *1 (2021).

5 See §6011(a).

6 See §6707A(c)(1).

7 See §6707(b).

8 See §§6708(a), 6112(a).

9 See §6671(a).

10 §7421(a).

11 *National Federation of Independent Business v. Sebelius*, 567 U. S. 519, 543 (2012).

12 *CIC Services, LLC v. Internal Revenue Service*, 925 F. 3d 247, 259-260 (2019).

13 *Judson Atkinson Candies, Inc. v. Latini-Hohberger Dhimantec*, 529 F.3d 371, 388 (7th Cir. 2008).

14 See *Judson Atkinson Candies, Inc. v. Latini-Hohberger Dhimantec*, 529 F.3d 371, 388 (7th Cir. 2008); *Valero v. United States*, 569 F.3d 626, 630 (7th Cir. 2009).

15 Id.

16 See *Sandra T.E. v. S. Berwyn Sch. Dist. 100*, 600 F.3d 612, 619 (7th Cir. 2010).

17 *United States v. Smith*, 502 F.3d 680, 689 (7th Cir. 2007).

18 *Caremark, Inc. v. Affiliated Computer Servs*., Inc., 195 F.R.D. 610, 616 (N.D. Ill. 2000).

19 *Sandra T.E*., 600 F.3d at 622.

20 *Binks Mfg. Co. v. Nat'l Presto Indus. Inc*., 709 F.2d 1109, 1120 (7th Cir. 1983).

21 See *Schaeffler v. United States*, 806 F.3d 34, 37 (2d Cir. 2015); see also *United States v. Roxworthy*, 457 F.3d 590, 594 (6th Cir. 2006).

22 See *United States v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999)