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SCHOLARLY OPINION

Client Identity and the Attorney-Client Privilege: The Tax Attack Continues

CRAIG J. LANGSTRAAT*

The attorney-client privilege has been utilized by lawyers in tax proceedings as a shield to prevent disclosure of a client's identity. While this tactic has not always prevailed, it has been sufficiently successful to prompt action by the Internal Revenue Service (IRS) in an attempt to curtail its use.

This Opinion first will discuss the availability of an attorney-client privilege to protect a client's identity in tax controversies.¹ Second, recent tax-motivated governmental attempts to require all attorneys to report a client's involvement in substantial cash transactions will be analyzed.² Finally, strategies for dealing with I.R.C. § 6050I as it relates to a client's identity and the attorney-client privilege are presented.³

I. PURPOSES AND BACKGROUND OF THE PRIVILEGE

The attorney-client privilege has been a part of the common law longer than any other confidential communication privilege.⁴ According to the American Bar Association Model Code of Professional Responsibility, preserving confidences of the client is an ethical responsibility of every attorney:

A lawyer should be fully informed of all the facts of the matter he is handling in order for his client to obtain the full advantage of our legal system. It is for the lawyer in the exercise of his independent professional judgment to separate the relevant and important from the irrelevant and unimportant. The observance of the ethical obligation of a lawyer to hold inviolate the confidences and secrets of his client not only facilitates the full development of facts essential to proper representation of the client

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1. See *infra* text accompanying notes 4-40.
2. See *infra* text accompanying notes 41-56.
3. See *infra* text accompanying notes 58-64.
4. 8 J. WIGMORE, EVIDENCE § 2290 (McNaughton Rev. 1961).

but also encourages laymen to seek early legal assistance.⁵

The availability of the attorney-client privilege in federal litigation is embodied in Rule 501 of the Federal Rules of Evidence. In relevant part, that rule states:

Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law.⁶

The key concept in the Federal Rules of Evidence with regard to the privilege is the common law as interpreted by federal courts. Case analysis therefore is critical to understanding the scope of the attorney-client privilege.

The United States Supreme Court has been deciding cases involving the attorney-client privilege since 1888. In *Hunt v. Blackburn*, the Court stated that the privilege “is founded upon the necessity, in the interest and administration of justice, of the aid of persons having knowledge of the law and skilled in its practice, which assistance can only be safely and readily availed of when free from the consequences or the apprehension of disclosure.”⁷

In 1976, the Supreme Court in *Fisher v. United States*⁸ recognized that the purpose of the privilege is “to encourage clients to make full disclosure to their attorneys.”⁹ The Court commented further in *Trammel v. United States*¹⁰ that “[t]he lawyer-client privilege rests on the need for the advocate and counselor to know all that relates to the client’s reasons for seeking representation if the professional mission is to be carried out.”¹¹

The most recent Supreme Court discussion of the attorney-client privilege came in *Upjohn Co. v. United States*.¹² There, the Court stated:

Its purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader

5. MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 4-1 (1979).

6. FED. R. EVID. 501.

7. 128 U.S. 464, 470, (1888).

8. 425 U.S. 391 (1976).

9. *Id.* at 403.

10. 445 U.S. 40 (1980).

11. *Id.* at 51.

12. 449 U.S. 383 (1980).

public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client.¹³

II. A TAXPAYER'S IDENTITY AND THE ATTORNEY-CLIENT PRIVILEGE

While the United States Supreme Court has not specifically addressed the issue of nondisclosure of a taxpayer's identity under the attorney-client privilege, three U.S. Circuit Court of Appeals decisions have directly addressed the topic. The leading case in the area is *Baird v. Koerner*,¹⁴ decided by the Ninth Circuit in 1960.

In *Baird*, the taxpayers' accountants consulted a tax attorney to discuss the best course of action to follow if the IRS subsequently instituted criminal proceedings against the taxpayers. The accountants had determined that certain of the taxpayers' returns erroneously underreported the tax due; however, no governmental investigation had commenced at the time of this consultation.¹⁵

Shortly thereafter, the taxpayers' general attorney visited the same tax attorney and discussed the specifics of the returns. Neither the accountants nor the general attorney disclosed the identity of the taxpayers to the tax attorney. As a result of this conference, the general attorney delivered a check to the tax attorney to cover the calculated deficiency, the accrued interest and the tax attorney's fees. The tax attorney then forwarded a cashier's check in the amount of the calculated deficiency plus the accrued interest, along with a cover letter to the IRS. The cover letter did not disclose the taxpayers' identities, the tax years involved, or the identities of the accountants and general attorney.¹⁶

An IRS special agent responded to the letter by issuing a departmental summons requiring identification of the taxpayers, attorneys and accountants involved in the case. When the tax attorney refused to disclose these identities, the IRS proceeded in the district court with a petition for enforcement of the summons and an order to show cause. The district court granted the petition. When the tax attorney again refused to disclose the identities, he was committed to custody until he was willing to provide the information. The district court granted a stay, however, until the

13. *Id.* at 389.

14. 279 F.2d 623 (9th Cir. 1960).

15. *Id.* at 626.

16. *Id.*

appeal could be heard by the Ninth Circuit.¹⁷

A preliminary issue in *Baird* was whether state or federal law applied to the application of the attorney-client privilege.¹⁸ To resolve this issue, the *Baird* court first concluded that "there is no federal body of law that *requires* the exclusion of the identity of the client from the extent of the attorney-client privilege."¹⁹ The court then determined that the law of the forum state, California, applied.²⁰ The *Baird* decision therefore must be evaluated in light of its state law background.

While recognizing California's general rule that the attorney-client privilege ordinarily does not include the identity of the client,²¹ the appellate court found that the following exception applied to the facts of this case:²²

"The name of the client will be considered privileged matter where the circumstances of the case are such that the name of the client is material only for the purpose of showing an acknowledgment of guilt on the part of such client of the very offenses on account of which the attorney was employed ***"²³

The facts of the *Baird* case brought the client's identity squarely within the exception to the general rule.²⁴ The court therefore released the attorney from any responsibility to disclose the client's identity, recognizing the applicability of the attorney-client privilege.²⁵ The court did note that there would be certain situations in which the privilege could not be invoked:

If the identification of the client conveys information which ordinarily would be conceded to be part of the usual privileged com-

17. *Id.* at 627.

18. *Id.* at 631. FED R. EVID. 501 has provided for a federal law analysis since its adoption in 1975. At the time of the *Baird* decision, however, choice of law was still an important issue since no such federal law existed.

19. *Baird*, 279 F.2d at 631.

20. *Id.* at 632.

21. *Id.* at 633.

22. *Id.* at 633; *see also Witnesses*, 81 AM. JUR. 2D § 213, at 244 (1976).

23. *Baird*, 279 F.2d at 633 (quoting 97 C.J.S. *Witnesses* § 283e (1957)). The trend seems to be for the individual states to recognize, or be poised to recognize, this exception or one based on "unusual circumstances," nevertheless maintaining the client's identity privileged. *See, e.g., Ex parte Enzor*, 270 Ala. 254, 117 So. 2d 361 (1960); *Sepler v. State*, 191 So. 2d 588 (Fla. Dist. Ct. App. 1966); *Colman v. Heidenreich*, 269 Ind. 419, 381 N.E.2d 866 (1978); *State v. Bean*, 239 N.W.2d 556 (Iowa 1976), *cert. denied*, 429 U.S. 824 (1976); *Morris v. State*, 4 Md. App. 252, 242 A.2d 559 (1968); *In re Kozlov*, 79 N.J. 232, 398 A.2d 882 (1979); *Matter of Jacqueline F.*, 94 Misc. 2d 96, 404 N.Y.S.2d 790 (1978); *Lemley v. Kaiser*, 6 Ohio St. 3d 258, 452 N.E.2d 1304 (1983); *Cole v. Johnson*, 103 Or. 319, 205 P.2d 282 (1922); *Brennan v. Brennan*, 422 A.2d 510 (Pa. Super. Ct. 1980); *McDonald v. Berry*, 243 S.C. 453, 134 S.E.2d 392 (1964). *See also Saltzburg, Communications Falling Within the Attorney-Client Privilege*, 66 IOWA L. REV. 811 (1981); Annotation, *Disclosure of Name, Identity, Address, Occupation or Business of Client as Violation of Attorney-Client Privilege*, 16 A.L.R. 3d 1047.

24. *Baird*, 279 F.2d at 633.

25. *Id.* at 635.

munication between attorney and client, then the privilege should extend to such identification in the absence of other factors. Such factors are (a) the commencing of litigation on behalf of the client where he voluntarily subjects himself to the jurisdiction of the court; (b) an identification relating to an employment by some third person, not the client nor his agent; (c) an employment of an attorney with respect to *future* criminal or fraudulent transactions; (d) the attorney himself being a defendant in a criminal matter.²⁶

The IRS did not capitulate after the *Baird* decision. The government encountered a virtually identical factual situation in *Tillotson v. Boughner*.²⁷ In fact, the court commented in its opinion that the defendant attorney in *Tillotson* had planned the litigated transaction in light of the *Baird* decision.²⁸

The *Tillotson* court did not have any trouble with the state versus federal law issue as the judges found that Illinois and federal law looked to the same body of common law in the attorney-client privilege area.²⁹ Without substantial comment, the court held that the defendant attorney need not disclose his client's identity based on the *Baird* decision and on a district court case which followed *Baird*.³⁰

The Court of Appeals for the Seventh Circuit also dealt with the client disclosure issue in *United States v. Tratner*.³¹ The attorney in this case deposited \$10,000 in cash into his client trust account. A few days later, he withdrew by check an identical amount. The bank reported the cash transaction to the IRS as required by statute.³²

An audit of the attorney's return was instigated by the IRS as a result of the bank's reporting. An IRS agent requested to see the cancelled \$10,000 check in question. Showing the check to the agent, the attorney covered up the name of the payee. The attorney refused to provide any additional information based on the attorney-client privilege.³³

In the district court action brought by the IRS to enforce its summons to produce the check and all information related to it, the attorney made the check and his client files available to the court for an *in camera* inspection. The district court's opinion or-

26. *Id.* at 632.

27. 350 F.2d 663 (7th Cir. 1965).

28. *Id.* at 665.

29. *Id.* at 666.

30. *N.L.R.B. v. Harvey*, 235 F. Supp. 580 (D.C. W. Va. 1964), *aff'd*, 349 F.2d 900 (4th Cir. 1965).

31. 511 F.2d 248 (7th Cir. 1975).

32. *Id.* at 250. The bank reported the cash transaction as required by 31 U.S.C. § 1081 which now is revised 31 U.S.C. § 5313 (1982).

33. *Tratner*, 511 F.2d at 250.

dered the attorney to produce the cancelled check, but did not require the production of the client files.³⁴ The summons for "all information" related to the check was found to be overbroad.³⁵ Both the attorney and the government appealed the district court's decision to the Seventh Circuit.³⁶

The issue of whether state or federal law controlled the attorney-client privilege was again sidestepped by the court of appeals; rather, the court based its opinion on its finding that Illinois law and federal law were both patterned after the same common law authorities.³⁷ The court reviewed both the general rule that a client's identity is not protected by the attorney-client privilege,³⁸ and the well-established exceptions to that rule in the tax area represented by the *Baird* and *Tillotson* decisions. The court noted that the *in camera* evidence was not part of the record and the district court had not delineated the specific applicability or non-applicability of the attorney-client privilege based on the *in camera* inspection. Therefore, the court remanded the case for such a determination related to the cancelled check.³⁹ The district court's holding that the "all information" portion of the summons was overbroad was upheld by the appeals court.⁴⁰

Unfortunately for precedential purposes, no reported opinion details the ultimate disposition of this case. The most positive inference from *Tratner* is that the Seventh Circuit seems to acknowledge the possibility that the attorney-client privilege could protect the client's identity in this type of situation.

III. THE NEWEST ATTACK

The newest form of governmental attack to force attorney disclosure of client identity in a tax context originated with the Tax Reform Act of 1984.⁴¹ In this Act, Congress added section 6050I to the Internal Revenue Code.⁴² This provision requires any per-

34. *Id.* at 251.

35. *Id.*

36. *Id.*

37. *Id.* (citing *Tillotson v. Boughner*, 350 F.2d 663 (7th Cir. 1965)).

38. *Tratner*, 511 F.2d at 252 (citing *United States v. Ponder*, 475 F.2d 37, 39 (5th Cir. 1973)), *Tillotson v. Boughner*, 350 F.2d 663, 666 (7th Cir. 1965) and *Colton v. United States*, 306 F.2d 633, 637 (2nd Cir. 1962), *cert. denied*, 371 U.S. 951, (1963)).

39. *Tratner*, 511 F.2d at 253-55.

40. *Id.* at 255.

41. Pub. L. No. 98-369, §§ 146(a)(d), 98 Stat. 494, 685-87 (1984).

42. I.R.C. § 6050I (Supp. III 1985).

Returns Relating To Cash Received In Trade Or Business.

(a) Cash receipts of more than \$10,000. Any person—

(1) who is engaged in a trade or business, and

(2) who, in the course of such trade or business, receives more than \$10,000 in cash in 1 transaction (or 2 or more related transactions),

son receiving more than \$10,000 in cash in the course of that person's trade or business to file an informational return⁴³ with the IRS.⁴⁴ The return must disclose the payer's name, address and taxpayer identification number, as well as the amount of cash received and the date and nature of the transaction.⁴⁵

Transactions by most financial institutions are exempted from these requirements,⁴⁶ as are those occurring entirely outside the United States.⁴⁷ Any person actually filing a return under this statute also must notify the person who paid the cash that a return has been filed.⁴⁸ This notification must indicate the amount

shall make the return described in subsection (b) with respect to such transaction (or related transactions) at such time as the Secretary may by regulations prescribe.

- (b) Form and manner of returns. A return is described in this subsection if such return—
- (1) is in such form as the Secretary may prescribe,
 - (2) contains
 - (A) the name, address, and TIN of the person from whom the cash was received,
 - (B) the amount of cash received,
 - (C) the date and nature of the transaction, and
 - (D) such other information as the Secretary may prescribe.
- (c) Exceptions.—
- (1) *Cash received by financial institutions.* Subsection (a) shall not apply to—
 - (A) cash received in a transaction reported under title 31, United States Code, if the Secretary determines that reporting under this section would duplicate the reporting to the Treasury under title 31, United States Code, or
 - (B) cash received by any financial institution (as defined in subparagraphs (A), (B), (C), (D), (E), (F), (G), (J), (K), (R), and (S) of section 5312(a)(2) of title 31, United States Code.
 - (2) *Transactions occurring outside the United States.* Except to the extent provided in regulations prescribed by the Secretary, subsection (a) shall not apply to any transaction if the entire transaction occurs outside the United States.
- (d) Cash includes foreign currency. For purposes of this section, the term "cash" includes foreign currency.
- (e) Statements to be furnished to persons with respect to whom information is furnished. Every person making a return under subsection (a) shall furnish to each person whose name is set forth in such a return a written statement showing—
- (1) the name and address of the person making such return, and
 - (2) the aggregate amount of cash described in subsection (a) received by the person making such return.

The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

43. IRS Form 8300, due 15 days after the reportable cash payment is received.

44. I.R.C. § 6050I(a) (Supp. III 1985).

45. *Id.* § 6050I(b).

46. *See id.* § 6050I(c)(1)(B). Financial institutions have a parallel reporting requirement under title 31 of the United States Code.

47. I.R.C. § 6050I(c)(2) (Supp. III 1985).

48. *Id.* § 6050I(e).

of the cash payment reported and must be furnished on or before January 31 following the applicable reporting calendar year.⁴⁹

The purpose of this legislation is to force disclosure of the identity of those dealing in substantial cash transactions.⁵⁰ This information could, and probably would, be used by the IRS in subsequent income tax investigations. The Temporary Regulations issued in accordance with IRC section 6050I⁵¹ expressly indicated that attorneys were covered by the disclosure requirements both for payments received for services and for trust account transactions.⁵² The final regulations also adopted this position.⁵³ The American legal community quickly recognized that the disclosure required by I.R.C. section 6050I could violate an attorney's ethical duty of confidentiality to a client.⁵⁴ While the Treasury decision announcing the Temporary Regulations did indicate that the Treasury was willing to consider an exemption to section 6050I for attorneys,⁵⁵ statements from the Justice Department demonstrate strong governmental opposition to such an exception.⁵⁶ The Treasury Decision announcing the final regulations stated that an exception for attorneys was not adopted because neither the statute nor its legislative history provided for one.⁵⁷

IV. SUGGESTIONS AND STRATEGIES

An attorney who discloses the identity of a client dealing in cash pursuant to section 6050I is subjecting the client to probable IRS investigation and possible future civil or criminal penalties.⁵⁸ Such an action could subject the attorney to sanctions from the

49. *Id.*

50. "The [Senate] committee believes that reporting on the spending of large amounts of cash will enable the Internal Revenue Service to identify taxpayers with large cash incomes." S. Rep. No. 169, 98th Cong., 2d Sess. (1984).

51. Treas. Reg. § 1.6050-I-1T (1985).

52. Treas. Reg. § 1.6050-I-IT, Q-5, A-5 (1985).

53. Treas. Reg. § 1.6050-I-1 (1986).

54. *See, e.g.*, "Should Attorneys Be Exempt from Cash Fees Reporting Requirement?" *A.B.A. Section of Taxation Newsletter*, 1 (1985); Wolf, *Ethical Dilemma*, 72 *A.B.A. J.*, 19 (Jan. 1986).

55.

Although these temporary regulations require attorneys to report with respect to the receipt of cash in excess of \$10,000, the [Internal Revenue] Service will entertain comments from the legal community concerning the possibility of developing an exception to the reporting requirement for information on transactions which might fall within the scope of the attorney-client privilege.

T.D. 8025, 1985-1 C.B. 348.

56. According to Deputy Attorney General D. Lowell Jensen, "the creation of an exception for lawyers from reporting under Section 6050I would be contrary to public policy and effective tax administration." *See* Wolf, *supra* note 54.

57. T.D. 8098, IRS Bulletin No. 1986-41 (Oct. 14, 1986).

58. *See supra* note 50.

state bar for ethical violations⁵⁹ and/or to liability to the client.

To avoid these problems, practicing attorneys have three basic alternatives. First, the attorney could refuse to accept cash in amounts generating a reporting requirement under section 6050I. However, this practice could cause clients to engage another attorney willing to accept the cash.

Second, the attorney could accept the cash, but not report the transaction as required by section 6050I. This would subject the attorney to a \$100 penalty per failure to file a return,⁶⁰ and possible criminal sanctions.⁶¹

A third alternative would be for the attorney to accept the cash and report the transaction without disclosing any information which could be used by the IRS to identify the client (i.e., name, address, taxpayer identification number). This refusal to identify the client would be based on an assertion of attorney-client privilege.

While this third alternative likely would result in a confrontation with the IRS, it has the dual advantages of upholding the attorney's ethical duty to the client while avoiding the penalties for failure to file the required documents. Also, any litigation instituted by the government to force disclosure of the client's identity would be subject to the precedents favoring the attorney discussed earlier in this Opinion.⁶² Presumably, a case-by-case analysis of the particular facts then would be undertaken by the court.⁶³ Since the purpose of reporting under § 6050I is to subject the payer to an income tax investigation,⁶⁴ a decision upholding the attorney-client privilege to protect the client's identity would be consistent with the reasoning of the *Baird*, *Tillotson*, and *Tratner* decisions.

CONCLUSION

Pending the creation of an exception to I.R.C. section 6050I for attorneys, practicing attorneys receiving substantial cash payments are faced with conflicting duties. Attorneys have an ethical duty to clients on the one hand and a governmental reporting duty on the other. In order to avoid liability to the client, possible disci-

59. See *supra* note 5 and accompanying text. This is applicable if the principle contained in EC 4-1 has been adopted by the subject state bar.

60. I.R.C. §§ 6652(a)(1)(B)(vi), 6652(a)(3)(A)(iii), and 6652(a)(3)(B) (Supp. III 1985); See also *id.* § 6678(a) which imposes a \$50 penalty for failure to furnish the annual statement to any payer under I.R.C. § 6050I(e).

61. Treas. Reg. § 1.6050-1-1(g)(3) (1986).

62. See *supra* notes 14-40 and accompanying text.

63. See *supra* note 19 and accompanying text.

64. See *supra* note 50.

plinary proceedings and/or governmental sanctions, the best course of action for the attorney at this time appears to be to report required cash transactions without identifying information under an assertion of attorney-client privilege. While this course of action may lead to litigation, recent precedent upholding protection of the client's identity under the attorney-client privilege in tax cases should lead the court to reach a result favorable to the attorney.