Johnston v. Commissioner, 119 T. C. 27 (U. S. Tax Ct. 2002)

In Johnston v. Commissioner, the U. S. Tax Court ruled on the applicability of the attorney-client privilege in tax disputes, emphasizing federal common law principles. The court granted a motion in limine, finding that the taxpayer's reliance on expert advice waived the privilege, allowing disclosure of attorney communications. However, the court denied a motion for partial summary judgment based on collateral estoppel from state court findings, highlighting the complexity of applying issue preclusion in tax litigation. This decision underscores the nuanced balance between protecting privileged communications and ensuring fair litigation in tax cases.

Parties

Thomas E. Johnston and Thomas E. Johnston, Successor in Interest to Shirley L. Johnston, Deceased, et al. , were the petitioners. The respondent was the Commissioner of Internal Revenue. The case was consolidated with docket numbers 26005-96, 2266-97, and 12736-97.

Facts

Thomas E. Johnston was involved in real estate development, conducting activities through Sea-Aire Properties, Inc. , his wholly owned corporation. He was a partner in Estrella Properties, Ltd. , a California limited partnership, which developed the Forster Ranch in San Clemente, California. In 1989, following dissatisfaction from Borg-Warner Equity Corp. , a major partner, the partners entered into a settlement agreement that led to the sale of the Forster Ranch property and distribution of other assets, including the Shorecliffs Golf Course. The Shorecliffs Golf Course was sold for between $5 and $6 million in June 1989. Johnston met with attorney Thomas J. O'Keefe to discuss the sale. Subsequent state court litigation by Leo A. Fitzsimon against Johnston and others alleged fraud and other misconduct related to the Shorecliffs sale and the S. C. Equestrian Lots, Ltd. partnership. The state court found Johnston liable for fraud and imposed damages. In the tax court, Johnston asserted reliance on expert advice to defend against IRS fraud penalty allegations, leading to disputes over attorney-client privilege and collateral estoppel.

Procedural History

The Commissioner of Internal Revenue determined deficiencies and penalties against Johnston for the tax years 1989, 1991, and 1992. Johnston filed petitions with the U. S. Tax Court. The Commissioner filed a motion in limine to deny Johnston's claim of attorney-client privilege and a motion for partial summary judgment, seeking to apply collateral estoppel based on state court findings. The Tax Court granted the motion in limine but denied the motion for partial summary judgment. The standard of review applied was de novo for the motion in limine and summary judgment standards for the motion for partial summary judgment.

© 2025 SCOTUSreports.com. All rights reserved.

Issue(s)

Whether the attorney-client privilege was waived by Johnston's assertion of reliance on expert advice in defending against IRS fraud penalty allegations?
Whether the doctrine of collateral estoppel should apply to the state court findings in the subsequent tax court proceedings?

Rule(s) of Law

The attorney-client privilege is governed by federal common law in federal tax proceedings. Under the federal common law, the privilege can be waived impliedly if a party affirmatively raises a claim or defense that relies on the privileged communications. The three-pronged test for implied waiver requires: (1) assertion of the privilege was a result of some affirmative act by the asserting party; (2) through this affirmative act, the asserting party put the protected information at issue by making it relevant to the case; and (3) application of the privilege would have denied the opposing party access to information vital to its defense. Collateral estoppel applies if: (1) the issue in the second suit is identical to the one decided in the first suit; (2) there is a final judgment rendered by a court of competent jurisdiction; (3) collateral estoppel may be invoked against parties and their privies to the prior judgment; (4) the parties actually litigated the issues and the resolution of these issues was essential to the prior decision; and (5) the controlling facts and applicable legal rules remain unchanged from those in the prior litigation.

Holding

The Tax Court held that Johnston waived the attorney-client privilege by asserting reliance on expert advice, which included communications with attorney Thomas O'Keefe, as an affirmative defense to the IRS's fraud penalty allegations. The court denied the Commissioner's motion for partial summary judgment, refusing to apply collateral estoppel to the state court findings due to the complexity and interrelated nature of the facts and issues involved.

Reasoning

The court's reasoning on the motion in limine centered on the federal common law doctrine of implied waiver. The court applied the three-pronged test from *Hearn v. Rhay*, finding that Johnston's affirmative defense of reliance on expert advice, which included legal advice from O'Keefe, met all three criteria. First, the defense was an affirmative act by Johnston. Second, it placed the tax advice received from O'Keefe at issue. Third, denying the Commissioner access to this information would prejudice the IRS's ability to rebut the defense, as the advice was vital to assessing the reasonableness or existence of the claimed reliance. The court rejected Johnston's attempt to limit the defense to accountant advice, citing inconsistencies in his pleadings and the broader context of the tax advice provided by O'Keefe.
Regarding the motion for partial summary judgment, the court declined to apply

© 2025 SCOTUSreports.com. All rights reserved.

collateral estoppel due to the interrelated nature of the facts concerning the Shorecliffs transaction and the S. C. Equestrian Lots partnership. The court noted that litigating related issues would inevitably involve evidence and arguments relevant to the transactions as a whole, diminishing the efficiency gains from issue preclusion. Additionally, the court expressed concerns about the fairness of applying collateral estoppel given the unconventional nature of the state court's disposition and the potential for compromising litigant fairness for efficiency.

Disposition

The Tax Court granted the Commissioner's motion in limine, allowing disclosure of attorney communications, and denied the Commissioner's motion for partial summary judgment, refusing to apply collateral estoppel.

Significance/Impact

Johnston v. Commissioner is significant for its application of federal common law to the attorney-client privilege in tax litigation, emphasizing the potential for implied waiver when taxpayers rely on expert advice as a defense. The decision clarifies that such reliance can extend to legal advice, even if not explicitly stated in pleadings. The court's refusal to apply collateral estoppel highlights the challenges of using issue preclusion in complex tax cases, particularly where state court findings are involved. This case underscores the delicate balance between protecting privileged communications and ensuring fair litigation, impacting how taxpayers and the IRS approach privilege and preclusion in tax disputes.

© 2025 SCOTUSreports.com. All rights reserved.