AD Investment 2000 Fund LLC v. Commissioner, 142 T. C. No. 13 (U. S. Tax Court 2014)

In a pivotal ruling on attorney-client privilege, the U. S. Tax Court decided that by asserting affirmative defenses to tax penalties, taxpayers implicitly waive their right to withhold attorney-client communications relevant to their legal understanding and beliefs. The court compelled production of opinion letters in a case involving tax shelters, highlighting the tension between privilege and fairness in litigation where a taxpayer's state of mind is at issue. This decision underscores the importance of transparency when taxpayers claim good faith and reasonable belief in defending against tax penalties.

Parties

AD Investment 2000 Fund LLC and AD Global 2000 Fund LLC, both electing to be taxed as partnerships, were the petitioners. Community Media, Inc. , and Warsaw Television Cable Corp. , partners in the respective LLCs, were identified as petitioners other than the tax matters partner. The respondent was the Commissioner of Internal Revenue.

Facts

The case involved two partnerships, AD Investment 2000 Fund LLC (ADI) and AD Global 2000 Fund LLC (ADG), which engaged in transactions described by the Commissioner as a Son-of-BOSS tax shelter. The Commissioner adjusted partnership items for the year 2000 and determined that accuracy-related penalties under section 6662 of the Internal Revenue Code should apply. The partnerships contested these adjustments and penalties. In defense, the partnerships claimed they had substantial authority for their tax treatment and acted with reasonable cause and in good faith. The Commissioner sought to compel the production of six opinion letters from the law firm Brown & Wood LLP, which opined on the likelihood of the transactions' tax benefits being upheld. The partnerships objected, asserting attorney-client privilege.

Procedural History

The Commissioner moved to compel production of the opinion letters and to sanction the partnerships for potential noncompliance. The partnerships objected on grounds of attorney-client privilege. The Tax Court, after reviewing the arguments, granted the motion to compel production but set the issue of sanctions for a hearing. The court's decision was influenced by the partnerships' affirmative defenses, which placed their legal knowledge and understanding into contention.

Issue(s)

Whether, by asserting affirmative defenses to accuracy-related penalties that rely on the partnerships' beliefs and state of mind, the partnerships impliedly waived the

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attorney-client privilege concerning the opinion letters from Brown & Wood LLP?

Rule(s) of Law

The court applied the common law doctrine of implied waiver of attorney-client privilege. According to this doctrine, a party may forfeit the privilege when it voluntarily injects into the suit the question of its state of mind. The court cited the Hearn test, which considers whether (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 deny the opposing party access to information vital to its defense.

Holding

The Tax Court held that the partnerships, by asserting affirmative defenses that relied on their good-faith and state-of-mind, impliedly waived the attorney-client privilege with respect to the opinion letters. The court ordered the production of these letters, stating that the partnerships' legal knowledge and understanding were put into contention, making the opinion letters relevant.

Reasoning

The court reasoned that the partnerships' defenses, which included claims of substantial authority and reasonable cause with good faith, directly involved the partnerships' legal knowledge, understanding, and beliefs. By asserting these defenses, the partnerships made their state of mind a pivotal issue in the case. The court referenced several precedents, including United States v. Bilzerian and Cox v. Adm'r U. S. Steel & Carnegie, which established that when a party's intent and knowledge of the law are at issue, attorney-client communications relevant to those issues may be subject to disclosure. The court dismissed the partnerships' argument that the opinions were not relied upon, stating that their relevance to the partnerships' legal understanding was sufficient to warrant production. The court also addressed the partnerships' reliance on Pritchard v. County of Erie, distinguishing it on the grounds that it did not involve a good-faith or state-of-mind defense. The court emphasized fairness, stating that it would be unjust to allow the partnerships to assert their defenses while withholding potentially contradictory evidence.

Disposition

The Tax Court granted the Commissioner's motion to compel the production of the opinion letters. The court set the issue of sanctions for a hearing, indicating that failure to comply with the order could result in the partnerships being prohibited from introducing evidence of their reasonable beliefs and state of mind in support of their affirmative defenses.

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Significance/Impact

This decision is significant for its clarification of the scope of implied waiver of attorney-client privilege in tax litigation. It establishes that when taxpayers assert defenses based on their good faith and state of mind, they risk waiving privilege over communications that may shed light on their legal understanding and beliefs. This ruling may impact how taxpayers approach defenses against tax penalties, as it underscores the importance of transparency in such cases. Subsequent courts have cited this case in discussions of privilege and waiver, indicating its doctrinal importance in tax law and litigation strategy.

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