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## Quick Peek Discovery

### *Salem Financial, Inc. v. United States, No. 10-192T (Claims Court Jan. 18, 2012)*

A U.S. Court of Federal Claims judge has rejected some privilege claims and directed the taxpayer to allow the government lawyers a “quick peek” at other documents the taxpayer does not want to turn over in discovery. In the course of this opinion, most of the possible issues that can arise in tax litigation discovery were addressed.

#### *Facts*

The taxpayer engaged in a transaction called “STARS,” which had been suggested to it by accounting firm X (Firm X). As a result of the transaction, the taxpayer claimed foreign tax credits and various deductions, which the IRS disallowed. The taxpayer paid the tax and sued for refund in the claims court. Discovery commenced and the taxpayer objected to discovery requests.

#### *Tax Reserve Information*

The opinion did not decide the issue whether tax reserve documentation is privileged, but it decided that on the facts of the case, the taxpayer had waived any privilege. The privilege at issue was the work product doctrine.

The waiver was in the taxpayer’s reliance on the opinion of its regular financial accountant (Firm Y), which was evidently used in setting the reserve and was given to the IRS in the course of the audit dispute on the taxpayer’s liability for penalties. Firm Y’s opinion evidently was based in some part on its review of the tax reserve documentation. The court ruled that by making affirmative, albeit indirect, use of the tax reserve documentation, the taxpayer had waived any privilege based on work product as to the tax reserve documentation.

The court ruled that the waiver extended to all non-opinion work product on the same subject matter. When Firm Y relied on opinions from Firm X and from a law firm as to the reasonableness of the legal position on the tax reporting position, and the taxpayer relied on Firm Y’s views for penalty protection, the taxpayer waived the work product protection for Firm X’s opinion and the law firm’s opinion, insofar as the reserve was concerned. The taxpayer’s effort to link Firm Y’s activities to a technical analysis that did not inform the overall reserve setting was rejected.

#### *Tax Practitioner Privilege*

Alternately, the taxpayer claimed the tax practitioner privilege in Section 7525 as to an opinion obtained from Firm X after the implementation of the transaction, which concerned a change of law and unwinding the transaction. The government argued that Firm X had been a promoter of a tax shelter, and for that reason, the documents were not privileged. The court disagreed, stating that promotion was completed when the taxpayer implemented the transaction.

However, it also ruled that as to the post-implementation advice, the taxpayer waived the privilege by relying on the advice in its penalty defense.

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## *Attorney-Client Privilege*

The government interposed three arguments to the privilege claim: the advice was not legal advice; it was pure legal advice; or it was advice provided by a lawyer who was not giving legal advice. The court rejected the third argument and directed a “quick peek” for the documents in the other two categories.

As to the lawyer who initially was employed by Firm X that had promoted the transaction, but then became employed by the law firm representing the taxpayer, the court ruled that he acted throughout by providing legal advice. Therefore, the privilege attaches and the taxpayer had not waived it.

The government claimed that some of the communications from lawyers was not legal advice and some was purely legal advice that did not reveal any communication from the client to the lawyer. The court was able to resolve these issues without having an in camera review of the documents because the taxpayer agreed to a quick peek procedure whereby the government could review the documents without a waiver resulting.

The quick peek technique is most advantageous to the discovering party and to the court. Presumably, the taxpayer believes the parties will reach an agreement that most of the documents are privileged.

The “pure legal advice” category is somewhat surprising. The court cited cases indicating that if the advice does not reflect something about the taxpayer’s facts, then it may be pure legal advice and thereby not privileged. But if, for example, a taxpayer with stock outstanding requested and received an opinion on when Section 305(c) could cause a deemed dividend, no matter how pure the opinion might be, it could still indicate that the taxpayer had communicated concern about a deemed stock dividend.

## *Conclusion*

This case involves two-thirds of a billion dollars in tax. Disputes over discovery presumably are worthwhile and very common in such cases. Nevertheless, the court’s opinion reflects a surprising lack of agreement about what the privilege rules mean.

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