BY MATTHEW BOCH AND KELVIN LAWRENCE

Lawyers Face Confidentiality Ethics Risks in Their Own State Tax Compliance

Lawyers (and other tax professionals[1]) are in the business of providing advice and representation, but what happens when the nature of that advice affects their own tax liabilities? With states moving toward market-based sourcing of sales for income or gross receipts tax apportionment and toward imposing sales tax on professional services, clients' locations and the nature of the services being provided will increasingly be relevant to a law firm's own tax obligations. In these situations, an audit of the law firm will necessarily have significant client confidentiality implications that need to be addressed.

States are increasingly targeting law firms for tax and are using destination-based sourcing. Market-based sourcing for state income taxes and the expansion of state sales taxes are changing the nature of law firms' tax obligations and associated audit inquiries. Under the traditional state tax status quo, law firms did not face too many questions that implicated their confidential client relationships: generally origin-based sourcing for income tax sales factor purposes (or even separate accounting based on office location), and nontaxability as non-enumerated services under sales and use taxes.

Trends toward market-based sourcing of sales for income tax apportionment purposes (often coupled with a single sales factor formula) and toward imposing sales tax on professional services mean that the taxation of law firms increasingly turns on where those services or their benefits are being received. Additionally, law firms, with their members traveling frequently to visit clients, appear in tribunals, or attend meetings, are attractive enforcement targets for state tax authorities, and audits and nexus inquiries seem to be on the rise.

As states seek to raise revenue or offset income tax cuts, sales taxes on professional services are seen as an attractive option. A handful of states (Hawaii, New Mexico, and South Dakota) currently impose sales tax on legal services. Sales and use taxes on legal services generally look to where the service is received. For example, South Dakota applies its sales tax based on customer billing address (or the attorney's office if provided in person), and its use tax based on where the client is considered to have "used" the services. Consider this example provided by the South Dakota Department of Revenue in its guidance for attorneys.[2]

"A Corporation from Iowa has 5 store locations in South Dakota. They purchase legal services for these locations from a law firm in Iowa. Because the corporation is using the legal services for the store locations in South Dakota, use tax is due. If the corporation does not have a breakout of the services by store location, the attorney fees may be allocated between the 5 locations."

As demonstrated in the example, the requirement of local sourcing means that the situs of the benefit from the legal services needs to be assigned or allocated with extreme granularity so as to pay the correct local taxes. Thus, if a state has a sales tax on legal services and audits a law firm, it will likely demand some review of client invoices to determine whether the provision of services was taxable, and if so, where the benefit of those services was received.

The problem is broader in the arena of income taxes or other business activity taxes, although sourcing at the local level is seldom as much of a problem. Using a market-based sourcing approach, the New York draft apportionment regulations provide an example of the type of scrutiny that destination sourcing questions can create for law firms.[3] The general test for sourcing services looks to where the benefit of the service is received. The draft regulation has professional services included in this general rule,[4] and one of the examples has a law firm sourcing litigation receipts not to where the tribunal is located, but rather to the geographic location to which the underlying dispute relates:

"Law Corp, located in State C, is hired by Client Corp to handle a major litigation matter concerning the sale of its manufacturing plant located in New York. Client Corp has manufacturing plants in New York State and State B. The trial takes place in State C, which is the location of the opposing party in the lawsuit. Because Law Corp's entire service is related to the manufacturing plant, which is real property, the benefit is received by Client Corp at the location of the manufacturing plant in New York State."[5]

This type of inquiry as to where a client is receiving the benefit of legal

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services necessarily implicates the nature and substance of the services that a law firm is providing to a client. While in the case of litigation in open court the law firm's representation is a matter of record, many other legal services relate to confidential matters. Imagine the types of invasive questions an auditor might ask to determine where a client was receiving the benefit of advice concerning confidential legal issues.

Lawyers' duty of confidentiality extends to government audits. A state's tax audit inquiry into a law firm's representations potentially conflicts with the firm's duty to maintain client confidences. A lawyer's duty of confidentiality is very broad, much broader than the evidentiary rules of the attorney-client privilege and attorney work product doctrine. The basic proposition is that a lawyer generally must not share information about clients (including former clients) unless doing so is necessary to carry out the representation or the client has provided consent. For example, the ABA model rules provide that in general, "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent" or "the disclosure is impliedly authorized in order to carry out the representation . . . ."[6]

There are several exceptions to the general rule, allowing a lawyer to reveal information "to the extent the lawyer reasonably believes necessary."[7] These exceptions include situations such as prevention of certain death or substantial bodily harm, prevention of a crime, or compliance with a court order or other law. Presumably state tax audit compliance falls under the compliance with other law requirement. However comment 15 to the model rule reminds that a lawyer should strenuously contest requests for disclosure of confidential client information even when disclosure might be required by law:

"Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the order is not authorized by other law or that the information sought is protected against disclosure by the attorney-client privilege or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal to the extent required by Rule 1.4. Unless review is sought, however, paragraph (b)(6) permits the lawyer to comply with the court's order."

Under that guidance, simply acquiescing to an auditor's request to provide confidential records appears to be an insufficient defense of the client's right to confidentiality.

A law firm must also be particularly vigilant about protecting privileged information. While this is a narrower subset of the information protected by a lawyer's duty of confidentiality, the consequences could be particularly dire if provision of information to an auditor was considered to have waived the privilege.

In addition, the situation of a tax audit of a law firm is particularly challenging because of the potential for a conflict between the law firm's interest in minimizing its audited tax liability and the client's interest in preserving the confidentiality of the information related to its engagement. A law firm may be asked to disclose the nature of its representation in order to prove that the services should not be sourced to or taxed by a jurisdiction.

Ways to mitigate confidentiality issues with destination-based sourcing. While trends to increasing destination-based state taxation put law firms in a conundrum for their own tax compliance, there are ways to mitigate the ethical problem by seeking relief from clients and from the state. Ways to address the issue include the following:

- **Client consent:** A client's informed consent can authorize disclosure of confidential information to third parties. Law firms should consider putting language in standard engagement letters authorizing disclosure of confidential information to government auditors as long as confidentiality will be preserved and the firm does not believe that the client will be adversely affected. For particularly sensitive situations, the firm should seek additional, express consent to disclosure.
- **Anonymization and redaction of firm records:** Lawyers should attempt to manage audits so that the financial information provided to auditors shows only non-identifying information like client number and client location. This is particularly important in situations where disclosure of the very fact that an engagement exists may adversely affect a client. (And bear in mind that client location may be identifying if providing specialized legal services to a business client in a "company town.") Similarly, if invoices must be provided, they should be redacted as much as possible.
- **Nondisclosure agreement with the state:** States occasionally are willing to enter into nondisclosure agreements regarding particularly sensitive topics, so as to provide additional protection beyond normal taxpayer confidentiality provisions. Confidential information regarding a law firm's clients and matters may be a good fit for a nondisclosure agreement.
- **Willingness to fight to protect confidentiality:** In some audit situations, a law firm can and should fight to protect confidential information against unreasonable requests by auditors. Government lawyers or revenue department leadership with legal backgrounds may be particularly sympathetic to a law firm's predicament in complying with an audit while protecting client confidentiality.

In sum, state tax audits of law firms where destination-based sourcing is at issue will raise difficult issues about preserving client confidentiality while proving that the firm is in compliance and paying the correct tax. While there is a fundamental tension between these two requirements, reasonableness by clients and auditors can facilitate a robust audit process that protects client confidences. ■

1 While this article focuses on the potential conflict between lawyers' ethical obligations and state tax regimes, similar issues appear to exist for accountants or other professionals providing confidential advice or services.

2 *See* South Dakota Department of Revenue, Tax Facts: Attorneys (Mar. 2011), *available at* http://dor.sd.gov/Taxes/Business_Taxes/Publications/PDFs/attorneys.pdf.

3 Draft Reg. § 4-4.6 Receipts from Other Services and Other Business Activities (Oct. 15, 2015), *available at* https://www.tax.ny.gov/bus/ct/corp_tax_reform_draft_regs.htm.

4 Draft Reg. § 4-4.6(c)(2)(ii)(A).

5 Draft Reg. § 4-4.6(c)(4), Example 9.

6 American Bar Association Model Rules of Professional Conduct, Rule 1.6(a). The duty of confidentiality also extends to former clients. *See* ABA Model Rule 1.9(c)(2).

7 ABA Model Rule 1.6(b).