

## Taxing discovery: Understanding when returns are privileged

By Joseph M. Cacace



It is no secret that tax returns contain a wealth of sensitive information about the taxpayer's financial condition, business arrangements, investments and more. Jointly filed tax returns contain sensitive financial information about both spouses.

Business competitors and litigation adversaries can use that kind of information to their advantage. In a lawsuit, the sensitive financial information in a tax return could impact the merits of the case and could affect the other side's approach to settlement.

For these reasons, litigants often request tax returns, but then, naturally, want to withhold their own. So it is critical for counsel to understand the rules governing when tax returns are discoverable.

### Massachusetts state tax returns — privileged in state court, maybe in federal court

The Massachusetts Guide to Evidence explains that "Massachusetts State tax returns are privileged, and a taxpayer cannot be compelled to produce them in discovery." Mass. Guide to Evid. §519(a)(2); G.L.c. 62C, §21.

There are exceptions to this general rule, such as divorces and some other probate matters, proceedings to determine or collect a tax, and certain criminal cases. But by and large, Massachusetts courts have held that state tax returns are privileged and not discoverable — at least while the returns are in the hands of the taxpayer.

One Superior Court judge, however, held that state tax returns in the hands of a tax preparer are subject to release pursuant to a court order upon a showing of relevance. *Greenleaf Arms Realty Trust I, LLC v. New Boston Fund, Inc.*, 30 Mass. L. Rptr. 477 (Mass. Super. Ct. 2012) (citing G.L.c. 62C, §74, which permits a tax preparer to disclose information related to state tax returns "pursuant to court order"). In *Greenleaf*, the court applied the "high standard of relevancy" required to compel production of federal tax returns, discussed below.

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If you are in federal court, on the other hand, the state tax return privilege is a bit less certain. The 1st U.S. Circuit Court of Appeals held that, in the criminal context, Massachusetts state tax returns are protected only by a qualified privilege equivalent to the protection afforded to federal tax returns. *In re Hampers*, 651 F.2d 19 (1st Cir. 1981). The 1st Circuit has not addressed the issue in a civil case.

Federal Rule of Evidence 501 is the starting point. It provides that, "in a civil case, state law governs privilege regarding a claim or defense for which state law supplies the rule of decision." So in a diversity case raising only state law claims governed by Massachusetts law, the absolute privilege should apply to state tax returns.

But if the case also involves federal claims, then things are a bit less certain. Some courts have held that state tax returns are only protected by a qualified privilege like the one that governs federal tax returns, while others have applied the absolute privilege under state law. Compare *Buntzman v. Springfield Redevelopment Auth.*, 146 F.R.D. 30, 32 (D. Mass. 1993), with *Tollefsen v. Phillips*, 16 F.R.D. 348 (D. Mass. 1954).

What is certain is that the issue is ripe for further litigation and clarification by the 1st Circuit.

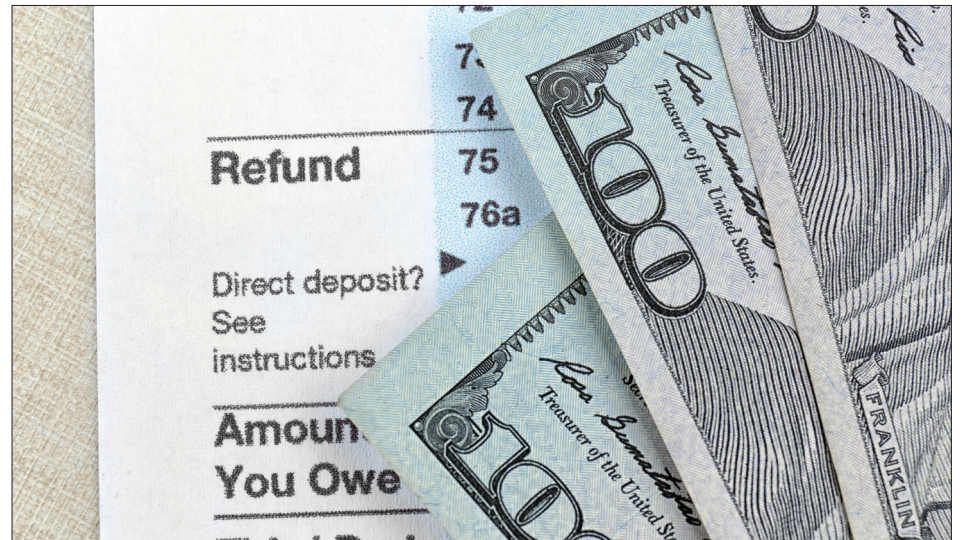
### Federal tax returns — qualified privilege in state and federal courts

Massachusetts state and federal courts both apply a qualified privilege to federal tax returns. While "[t]he taxpayer is entitled to a presumption that the returns are privileged and are not subject to discovery," "[a] taxpayer who is a party to litigation can be compelled to produce Federal tax returns upon a showing of substantial need by the party seeking to compel production." Mass. Guide to Evid. §519(b).

The fact that a party failed to file a federal tax return, however, is not protected by the conditional privilege. *A.C. Vaccaro, Inc. v. Vaccaro*, 80 Mass. App. Ct. 635 (2011).

A two-part analysis typically governs a motion to compel federal tax returns. "[F]irst, the tax returns must be relevant to the action; second, the information contained in the returns must not be otherwise obtainable." *Buntzman*, 146 F.R.D. at 32.

The party seeking the federal tax returns has the burden to show relevance, and the party opposing disclosure has the burden to show that there are other sources for the



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information. *Id.*

Massachusetts state and federal courts have ordered production of federal tax returns in various circumstances.

The federal District Court has ordered the production of tax returns when the plaintiff claimed loss of earnings as damages and then could not recall his past earnings at his deposition and denied having any records that would refresh his recollection.

The federal court has also compelled production of federal returns when the plaintiff's financial condition was relevant to the central dispute in the case (plaintiff's ability to develop certain real estate) and the plaintiff failed to show an alternative source of equivalent information.

Likewise, the Supreme Judicial Court has allowed regulators to require businesses to produce federal returns in light of expert testimony that the returns were needed to verify financial data in other reports without requiring the businesses to undergo full audits.

On the other hand, courts have denied motions to compel production of federal tax returns when the relevance of the returns was questionable and similar information was available elsewhere.

For example, the federal courts have denied motions to compel when the moving party could obtain the information through less intrusive means, including depositions, interrogatories or public records searches.

A federal District Court has also denied a motion to compel when the plaintiff sought federal tax returns as evidence of net worth to support a punitive damages claim. The court held that such evidence was not needed to support an award of punitive damages and similar information was available

through other sources (e.g., credit reporting agencies).

Finally, a motion to compel was denied when the plaintiff filed joint tax returns containing irrelevant and sensitive information from his spouse, and the plaintiff had already produced federal corporate tax returns with information about his lost earning capacity.

### Key takeaways

These are some key pointers to keep in mind when propounding or responding to discovery for tax returns:

- Massachusetts state tax returns are generally privileged, but may only enjoy a qualified privilege in federal court.
- Federal tax returns are protected by a qualified privilege only.
- If your client is asked to produce its tax returns in litigation, you should review the returns and discuss with your client any concerns about producing them. Consider objecting on privilege grounds. If the other side makes a showing of relevance, you need to be prepared to explain why the returns are not relevant and how the same information is available from other less intrusive sources.
- If your client is requesting tax returns, you need to be prepared to explain why the information in the returns is relevant and why you cannot obtain that information from another less intrusive source.
- You should consider negotiating a compromise by stipulating to certain information or producing redacted tax returns that disclose only the relevant information. See, e.g., *Rubenstein v. Kleven*, 21 F.R.D. 183 (D. Mass. 1957).
- Consider a protective order or confidentiality agreement to govern the production of returns if your client is ordered to produce them or if you reach an agreement to do so. MLW