

The limited discoverability of tax returns

Thomas J. Hall and Judith A. Archer, *New York Law Journal* — August 20, 2020

In their Commercial Division Update, Thomas J. Hall and Judith A. Archer indicate that the Commercial Division continues to exercise great caution to avoid unnecessary disclosure of tax returns, including by ordering in camera inspection to determine whether they should be produced.

Will Rogers is famously quoted as saying: “The income tax has made liars out of more Americans than golf.” That perception, whether or not accurate, is what may drive aggressive litigation counsel to salivate over the prospect of discovery of an adversary’s tax returns. Not only might they provide relevant information, but they could be a source of embarrassment and, more importantly, leverage.

While New York courts generally favor broad discovery, they are reluctant to permit the discovery of tax returns due to their confidential and private nature. Instead, New York courts apply a strict two-prong test, requiring a strong demonstration of the need for the tax returns as well as a showing that the information cannot be obtained through other means. In applying this test, the Commercial Division engages in a fact-intensive inquiry and closely scrutinizes the stated reasons why compelling disclosure is warranted. A recent Commercial Division decision confirms that the production of tax returns will be ordered only in rare circumstances.

General standard

New York law permits the discovery of “all matter material and necessary in the prosecution or defense of an action.” CPLR 3101(a). While there is no authoritative Court of Appeals decision on the discoverability of tax returns, all four Appellate Departments have held that a party seeking their production must make a strong, specific showing that the information is necessary or “indispensable” to the litigation. See *Matthews Indus. Piping Co. v. Mobil Oil Corp.*, 114 A.D.2d 772 (1st Dep’t 1985); *Altidor v. State-Wide*

Ins. Co., 22 A.D.3d 435 (2d Dep’t 2005); *Saratoga Harness Racing Inc. v. Roemer*, 274 A.D.2d 887 (3d Dep’t 2000); *Cottrell v. Spina*, 214 A.D.2d 946 (4th Dep’t 1995).

The requesting party has a second burden of proving that the sought after information in the tax returns cannot be obtained from other sources. See *Consentino v. Schwartz*, 155 A.D.2d 640 (2d Dep’t 1989). For example, in *DG&A Mgt. Services v. Sec. Indus. Ass’n Compliance and Legal Div.*, the Third Department upheld the trial court’s order that the limited liability corporation produce its tax returns where the reasonable value of services performed was at issue, and where the corporation had failed to maintain any other financial information that would reflect this. 78 A.D.3d 1316 (3d Dep’t 2010). Conversely, the First Department affirmed the denial of such discovery where the party’s tax motives for certain investments could be obtained through deposition or trial testimony. See *BRS & W Assoc. v. W.R. Grace & Co.*, 156 A.D.2d 249 (1st Dep’t 1989).

This heightened standard serves a number of important policy goals. For one, it protects the wide range of sensitive information contained in tax returns, such as the party’s financial condition, business partnerships and investments. Second, disclosing this information may give the nonproducing party unfair leverage in settlement discussions or a business advantage in future transactions. Finally, limiting disclosure also serves to encourage full and truthful declarations in tax returns, without fear that the statements will be used against them for other purposes. See *Webb v. Std. Oil Co. of Cal.*, 319 P.2d 621, 624 (1957).

Thomas J. Hall and **Judith A. Archer** are partners with Norton Rose Fulbright US.

Associate **Courtney Kan** assisted with the preparation of this article.

More than 50 locations, including London, Houston, New York, Toronto, Mexico City, Hong Kong, Sydney and Johannesburg.

Attorney advertising

Reprinted with permission from the August 20, 2020 edition of the *New York Law Journal* © 2020 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. www.almreprints.com – 877-257-3382 – reprints@alm.com.

Commercial division application

The Commercial Division has refined its approach to the discoverability of tax returns in a series of decisions. In *Lipco Elec. Corp. v. ASG Consulting Corp.*, 4 Misc.3d 1019(A) (Nassau Co. 2004), the court considered a motion for a protective order against a demand for a defendant's income tax records. In this action stemming in part from a partnership between the plaintiff and one of the defendants, the plaintiff sought to recover damages for breach of contract and an accounting. The plaintiff demanded production of its partner's tax returns to ascertain financial information regarding contracts entered into by the partnership. Justice Leonard B. Austin of the Nassau County Commercial Division found that the plaintiff had failed to make "a strong showing of necessity and an inability to obtain the information contained in the income tax return from any other source." *Id.* at 5. Since a key allegation was that the plaintiff had been denied access to the partnership books and records, the court reasoned that the plaintiff could obtain the information by instead being given access to the partnership's records. Thus, the court granted the defendant's motion for a protective order.

In *Lipp v. Zigman*, 18 Misc.3d 1127(A) (Nassau Co. 2008), the Nassau County Commercial Division considered whether to compel production of the defendant's personal tax returns. Plaintiff and defendant were 50% shareholders of a corporation that operated an auto body shop. The plaintiff alleged the defendant had misappropriated or diverted corporate funds and opportunity, and had breached his fiduciary duty to the corporation. The plaintiff moved to compel production of the defendant's personal tax returns, arguing that the defendant's assets and lifestyle belie his claim that the corporation had been losing money for years. For example, it was alleged that the defendant had purchased the land upon which the partnership's building was located for more than \$600,000 and that his wife drove a new luxury car. Justice Leonard B. Austin noted that the personal tax returns "may well contain information that is relevant to this action," but that the court could not make this determination without reviewing them. *Id.* at 5. The court then directed an in camera inspection of Zigman's personal income tax returns to determine whether they should be subject to discovery.

While efforts to obtain tax returns in the Commercial Division usually fail, the Nassau County Commercial Division permitted partial discovery of tax information in *Int'l Oil Field Servs. Corp. v. Fadeyi*, 19 Misc.3d 1114(A) (Nassau Co. 2008). The plaintiff asserted that, between 1993 and 2003, it had paid substantial sums to defendants to act as its agents in Nigeria to identify and secure business opportunities. The defendants allegedly instead undermined the plaintiff's reputation in Nigeria and set up a competing business that diverted plaintiff's business opportunities. The plaintiff sought discovery of the defendants' personal income tax returns to demonstrate that plaintiff had paid defendants, which defendants had denied, to determine when they acquired interests in the competing business, and to impeach their deposition testimony. Justice Leonard B. Austin rejected these arguments on the grounds that the plaintiff had

other means of obtaining this information, and any impeachment value was "clearly outweighed by the strong policy disfavoring disclosure of tax returns." *Id.* at 3. In addition, whether the defendants breached their fiduciary duty was "dependent upon their actions, not their income." *Id.* Nonetheless, the court reasoned that the plaintiff was entitled to some of the information contained in the returns, as "[a]n agent who breaches his fiduciary duty must account to his principal for the secret profit and must also forfeit any compensation earned during the period of disloyalty." *Id.* at 3-4. The court ordered limited production of any tax documents, including IRS Forms 1099 received from their competing business reflecting income paid to them.

These three Commercial Division decisions reflect that, in applying the heightened standard for discoverability of tax records, New York courts engage in a measured, fact-intensive analysis. Even if the court orders production, it will take steps to ensure that only the most relevant portions are disclosed to the opposing party. This approach advances important privacy interests and encourages parties to find less intrusive means for obtaining similar information.

The safir decision

Recently, in *Safir v. Charm City Hous.*, 2020 NY Slip Op. 31619(U), 2020 WL 2733838 (Kings Co. April 22, 2020), the Kings County Commercial Division reaffirmed that the disclosure of tax returns is heavily disfavored and will not be ordered absent a strong showing of necessity. In *Safir*, the defendant moved to dismiss the complaint for plaintiff's alleged failure to comply with court-ordered discovery of tax returns and W-9 forms. Justice Lawrence Knipel soundly rejected all of the defendant's arguments for such discovery. First, the court reasoned that the tax documents were not material, let alone indispensable, to the defense. Since the case involved allegations that the defendants owed the plaintiff money, "the initial source(s) of plaintiff's funds and how he subsequently accounted to the taxing authorities regarding those funds" were irrelevant. *Id.* at 2. In addition, the tax returns contained very little impeachment value as the issue of whether the plaintiff may have made false statements to the taxing authorities was not central to the case.

Conclusion

Given the sensitive and private nature of tax returns, it is critical for litigation counsel to understand the needle that must be thread to obtain discovery of tax documents. Recent decisions by the Commercial Division decisions reaffirm that the court will not order the production of tax returns unless a very high bar is met, or that special circumstances exist such as a principal-agent relationship. The Commercial Division continues to exercise great caution to avoid unnecessary disclosure of tax returns, including by ordering in camera inspection to determine whether they should be produced.