PRIVILEGED COMMUNICATIONS AND ECONOMIC REALITY

The Internal Revenue Service has embarked upon its "economic reality" approach to audits. Historically, audits primarily focused on the return itself and other issues merely became relevant to the extent discovered during the course of reviewing the return. However, under the economic reality approach, a taxpayer's total financial situation is evaluated to ensure that the tax return accurately reflects reportable income. It is essentially an audit of the taxpayer's lifestyle or business activities.

To determine whether income reported on a return is accurate, an economic reality audit will utilize various indirect methods of proof, including some or all of:

(1) The net worth method - whereby any unexplained increase in the taxpayer's net worth during the tax year may be deemed attributable to current taxable income;

(2) The expenditures method - whereby reportable income is reconstructed based upon the taxpayer's expenditure of funds during the tax year;

(3) The bank deposit method - whereby unexplained bank deposits are deemed to represent current taxable income;

(4) The mark up method - whereby a taxpayer's profits determined by applying an acceptable industry-wide percentage to the taxpayer's gross sales, gross receipts or costs of goods sold or;

(5) A highbred method utilizing several of the foregoing indirect methods.

It can be anticipated that the government will remain flexible in pursuing various acceptable methods of reconstructing a taxpayer's income in order to determine whether taxable income has been appropriately reported.

Unfortunately, upon receipt of an audit notice, a taxpayer typically contacts their accountant, rather than their attorney. Prior to the commencement of any audit, an experienced representative typically scrutinizes the taxpayer's returns for the proposed audit period and at least one year prior to the audit period. It has also become somewhat common practice for the taxpayer's representative to review bank account statements either in connection with the preparation of the returns or in connection with the preparation of the information to be provided during the course of the audit. Further, with the advent of "economic reality" audits, the taxpayer's standard of living and the nature of the taxpayer's business activities should be closely scrutinized prior to the commencement of an audit. However, in reviewing this information with the taxpayer, the accountant will receive information that is discoverable by the government.

Clearly, there is no federal accountant-client privilege. Questions posed to the taxpayer by the accountant in preparation for the audit might reveal improper activities that would not be protected by privilege. If the scope of inquiry by the accountant is limited to the return

preparation, the accountant may not be adequately prepared for the audit. Alternatively, a more diligent inquiry may confirm unreported income or overstated deductions that could be discoverable by the government. As such, if there are any even somewhat remote suspicions of improprieties on the part of the taxpayer, the accountant should strongly consider having the taxpayer interviewed by counsel prior to commencement of the audit preparation in order to preserve potentially privileged information. In turn, retained counsel should consider engaging the accountant to coordinate the audit on behalf of the taxpayer.

Under the doctrine of United States v. Kovel(1), an investigative accountant may be clothed with an extension of the attorney's privilege. The attorney-client privilege "applies to communications made in confidence by a client to an attorney for the purpose of obtaining legal advice, and also to confidential communications made by the attorney to the client if such communications contain legal advice or reveal confidential information on which the client seeks advice."(2) Further, the attorney-client privilege undeniably extends to communications with "one employed to assist the lawyer in the rendition of professional legal services."(3) However, the critical factor for purposes of the attorney-client privilege is that the communication be made "in confidence for the purpose of obtaining legal advice from the lawyer."(4)

In this regard, the attorney-client privilege "must be `strictly confined with the narrowest possible limits consistent with the logic of its principle.'"(5) In fact, materials provided by a taxpayer to their attorney for tax preparation purposes are intended to be disclosed to the Internal Revenue Service and the taxpayer is considered to have waived the attorney-client privilege as to such information.(6) Communications to an accountant not engaged by the attorney will not be embraced within the privilege. Even if engaged, there are limits since the attorney-client privilege "does not attach to tax work prepared by accountants unless the accountant is translating complex tax terms into a form intelligible to a lawyer at the lawyer's behalf."(7) In addition, the attorney-client privilege is waived by any voluntary disclosure to a third party.(8) Further, voluntary disclosure to a third party implies a waiver of all communications on the same subject.(9)

The taxpayer's filing of amended returns on the advice of his attorney waives the privilege respecting the accountant's workpapers.(10) The initially engaged accountant's function is deemed an adjunct to that of the lawyer and therefore his workpapers are initially privileged. However, the filing of amended returns that communicate at least part of the substance of the work papers constitutes a waiver of the privilege as to all of the workpapers as well as to the underlying details of the amended returns. Thus, even when an accountant's assistance is necessary for the attorney to formulate a recommended course of action and to render legal advice, if that action involves publication of some client communications, there will be a waiver just as if the accountant had been hired only to prepare returns.

Recently, in Bernardo v. Commissioner(11) the accountant representing the taxpayers during the course of an audit and before the Appellate Division of the Internal Revenue Service in connection with a claimed charitable contribution, also prepared the returns. During the course of representation, the accountant prepared and received certain documents that were subsequently claimed to be privileged. Since the accountant had not been engaged by the taxpayer's counsel,

documents prepared by and received by the accountant were required to be divulged to the government.

Of possibly more significant importance to the accountant, an accountant might become the subject of a malpractice action by the taxpayer if information revealed to the accountant during or in preparation for an audit is ultimately required to be divulged to the government. In order to preclude the accountant from becoming the principle witness on behalf of the government or a potential source of recovery on behalf of the taxpayer, it is imperative that counsel be engaged to interview the taxpayer as early as possible if there is any hint of improper reporting by the taxpayer.

If sensitive information is discovered during the interview of the taxpayer, counsel must also determine whether to retain the present accountant or to retain a new accountant to assist in the audit. If the client's present accountant is retained to assist the lawyer, it will be difficult to distinguish what the accountant already knew from what they learned in their Kovel capacity. Certainly, there might be a possibility of cloaking some otherwise non-privileged information within the ambit of Kovel. However, retention of the taxpayer's own accountant certainly restrict the ability to shift a portion of the blame from the taxpayer to their now former accountant (who might be perceived as less than competent). Statements from the new accountant would seemingly provide the best method of demonstrating the incompetence of the former accountant.

Economic reality audits are certain to explore sensitive issues. Privileged information must be protected to the extent possible. Prior to the commencement of an audit it is imperative that counsel interview the taxpayer (without others being present) to determine whether there are any potentially sensitive issues that must be protected.

1. 0 292 F.2d 918 (2d Cir. 1961)

2. 0 Hartz Mountain Industries v. Commissioner TC 521, 525 (1989) Citing Upjohn Company v. United States 449 U.S. 383, 389 (1981); Bernardo v. Commissioner 104 TC No. 33 (June 20, 1995).

3. 0 Supreme Court Standards 503(a)(3), 503(b), cited in United States v. (Under, Seal) 748 F.2d 871, 874 n.5 (4th Cir. 1984).

4. 0 FTC v. TRW, Inc. 628 F.2d 207, 212 (DC Cir. 1980); United States v. Cote 456 F.2d 142, 144 (8th Cir. 1972); United States v. Judson 322 F.2d 460, 462-463 (9th Cir. 1963).

5. 0 Linde Thomson Langworthy Kohn and Van Dyke, P.C. v. Resolution Trust Corporation 5 F.3d 1508, 1514 (DC Cir. 1993).

6. 0 Oleander v. United States 210 F.2d 795, 806 (9th Cir. 1954).

7. 0 United States v. El Paso Company 682 F.2d 530, 541 (5th Cir. 1982).

8. 0 In Re Horowitz 482 F.2d 72, 81 (2d Cir. 1973); Bernardo v. Commissioner 104 TC No. 33 (June 20, 1995).

9. 0 Hartz Mountain Industries v. Commissioner 93 TC @ 526.

10. 0 United States v. Cote 456 F.2d 142 (8th Cir. 1972).

11. 0 104 TC No. 33 (June 20, 1995).