

# Practice

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## Basic Overview: The *Kovel* Accountant and Privileged Communications

By Charles P. Rettig

**D**efending a civil examination involving potentially sensitive issues where civil or criminal fraud potential exists requires the utmost of judgment, discretion and caution. It also typically requires both a lawyer and an accountant working together. The potential fraud/criminal exposure is often based on items on a return such as unreported income, improper deductions or some other false or inaccurate statement on the return or the overall economic lifestyle of the taxpayer. In these examinations, the taxpayer's potential criminal exposure is often a more significant concern than the dollar value of any potential adjustments on the return.

### Common Law Privilege

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There is a common law privilege of confidentiality for confidential communications between an attorney and a client with respect to the rendition of legal advice. The attorney-client privilege does not apply where the attorney is acting in other capacities or where the purpose of the communication is the commission of a crime or a tort. Communications to counsel acting as business advisor, negotiator or scrivener are not privileged since they do not have a legal purpose. All types of verbal and written communications or exchanges of documents between a client and an attorney may be protected by the common law attorney-client privilege. The privilege is intended to encourage clients to be forthcoming and candid with their attorneys so that the attorney is sufficiently well informed to provide sound legal advice.

The attorney-client privilege is the oldest of the privileges for confidential communications recognized by law. For centuries, the confidentiality of certain communications between an attorney and a client has been protected. The seminal definition of the "attorney-client privilege" was provided by Judge Wyzanski in *United Shoe Machinery Corporation*<sup>1</sup> as:

1. A privilege protecting the person to or by whom the communication was made if the other person is (a) a lawyer and (b) acting as a lawyer in connection with the communication,
2. The communication relates to a fact of which the lawyer was informed (a) by his client, (b) without the presence of strangers and not communicated



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- to outside parties, (c) for the purpose of securing (i) an opinion of law, (ii) legal services (as opposed to business advice or services) or (iii) assistance in some legal proceeding (d) not for the purpose of committing a crime or fraud (crime-fraud exception),
3. The privilege has been claimed and not waived by the client, and
  4. The asserted holder of the privilege is or sought to become a client of the lawyer.

Since effective legal assistance requires full disclosure of a client's legal problems, the client can only be expected to reveal the details required for effective representation if they know their confidential communications will be adequately protected. As such, the attorney-client privilege was developed at common law to encourage free and open communications between a client and a lawyer in order to promote informed, effective representation in the protection of a client's legal rights. However, the attorney-client privilege is strictly construed because the privilege has the effect of keeping a witness holding relevant information from the finder-of-fact. This privilege applies only when and to the extent necessary to achieve its purpose and only protects communications necessary to obtain informed legal advice that would not have occurred absent the privilege.

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## Tax Return Information

The mere preparation of tax returns is not generally legal advice within the scope of the attorney-client privilege, even if prepared by counsel or at the direction of counsel, since it is primarily an accounting-related service. Further, since tax return information is transmitted to an attorney with the intent that the information will be transmitted to a third party—the IRS—it is not deemed a confidential communication.

Information provided to an attorney for inclusion in a tax return is not deemed intended to be confidential because it is provided with the intention to be included in a return to be provided to the IRS.<sup>2</sup> Further, information used to file an amended income tax return may not be privileged.<sup>3</sup> However, communications made to

counsel in order to obtain legal advice about what should be set forth on a tax return may be privileged.<sup>4</sup> Matters communicated to counsel intended to form part of a document or pleading that is published in court records, public documents or tax returns are not protected by the attorney-client privilege.<sup>5</sup> There must be a determination as to the capacity in which an attorney is acting at the time the communication occurs.

Contrary to popular belief, documents provided to counsel do not become privileged merely because they are communicated or provided to an attorney. Also, documents prepared by an accountant hired to prepare a taxpayer's return are not within the attorney-client privilege merely because the accountant communicated with the taxpayer's attorney during the course of the audit.<sup>6</sup> The privilege only protects documents that embody confidential communications between an attorney and the client. To the extent it applies, all privileges must be claimed on a document-by-document basis.<sup>7</sup>

## Waiver of the Privilege

To become privileged, a communication must be made in confidence. To remain privileged, the communication must remain confidential. A disclosure of confidential communications to third parties, including government agencies, constitutes a waiver both as to the disclosed communication and as to other communications relating to the same subject or transaction (“opening the door”).

If otherwise privileged communications are utilized in a manner inconsistent with maintaining their confidentiality, the privilege may be deemed to have been waived. As a general rule, disclosure of privileged communications to a person outside the attorney-client relationship manifests indifference to confidentiality and waives the protection of the privilege. The primary determination is whether there has been an objective attempt to safeguard the confidential nature of the communications.

## Statutory Privilege—Code Sec. 7525

With respect to “tax advice,” the same common law protections of confidentiality that apply to communications between a taxpayer and an attorney shall also apply to communications between a taxpayer and any “federally authorized tax practitioner” to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. The term “tax advice” means advice given by an individual with respect to a matter that is within the scope of the individual's authority to practice before the IRS. Statutory privilege

may be waived in the same manner (*i.e.*, disclosure) as attorney-client privilege.

The statutory privilege may only be asserted in non-criminal tax matters before the IRS and noncriminal tax proceedings in federal court brought by or against the United States. It does not apply to any other federal or state regulatory agencies or to state tax proceedings for states that have not conformed with Code Sec. 7525.

## Kovel

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The attorney-client privilege provides an absolute protection from disclosure of confidential communications between attorney and client. While preparing tax returns is generally not legal advice falling within the privilege, the preparation of tax returns may fall within the attorney-client privilege if performed ancillary to the provision of legal services. The seminal case is *L. Kovel*.<sup>8</sup> Kovel was a former IRS revenue agent having accounting skills who had long been employed by a law firm specializing in tax law. During a grand jury proceeding, the government subpoenaed Kovel to appear and testify. The law firm responded that since Kovel was an employee under the direct supervision of the partners, Kovel could not disclose any communications by the client of the result of any work done for the client, unless the client consented.

In a criminal contempt proceeding, the government basically asserted that the attorney-client privilege was confined to communications to nonlawyer employees with “a menial or ministerial responsibility that involves relating communications to an attorney.”

Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. Hence the presence of an accountant ... while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege ... the presence of the accountant is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit. By the same token, if the lawyer has directed the client, either in the specific case or generally, to tell his story in the first instance to an accountant engaged by the lawyer, who is then to interpret it so that the lawyer may better give legal advice, communications by the client reasonably related to that purpose ought fall within the privilege; there can be no more virtue in requiring the lawyer to sit by while the client pursues these possibly tedious preliminary conversations with the accountant than in insisting on the lawyer's physical presence while the client dictates

a statement to the lawyer's secretary or in interviewed by a clerk not yet admitted to practice. What is vital to the privilege is that the communication.

Recognizing that the privilege would surely apply where a client who spoke only a foreign language furnished his confidential information to an interpreter employed by the attorney to translate for the attorney's benefit, the Second Circuit observed that accounting concepts can be as incomprehensible as a foreign language to attorneys be made in confidence for the purpose of obtaining legal advice from the lawyer.<sup>9</sup>

*Kovel* very clearly extended the protections of the common law attorney-client privilege to include communications involving nonministerial facilitators of the attorney.

## Frederick<sup>10</sup>

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Frederick was both an attorney and an accountant and provided legal representation to and prepared the tax returns of a corporation and its two individual owners. In the course of an investigation being conducted by the IRS, the government issued summonses to Frederick directing him to hand over hundreds of documents. Claiming some were protected by either the attorney-client privilege or the work-product privilege (or both), Frederick refused to disclose all of the requested documents.

*Engagement of the accountant by counsel should be designed to extend the attorney-client privilege to communications and rendered by the accountant pursuant to the engagement.*

Most of the documents at issue were created in connection with Frederick's preparation of the tax returns. They included drafts of the returns (including schedules), worksheets containing the financial data and computations required to fill in the returns and correspondence relating to the returns. These are the kinds of documents that accountants and other preparers generate as an incident to preparing their clients' returns or that the taxpayers themselves generate if they prepare their own returns.

The Seventh Circuit noted that a lawyer's privilege is no greater when he is doing accountant's work but

acknowledged that a complicating factor occurs when the lawyer was serving a dual purpose—as counsel and as return preparer, especially at a time he was representing the clients during an investigation being conducted by the IRS, *albeit* in connection with different tax years.

But people who are under investigation and represented by a lawyer have the same duty as anyone else to file tax returns. They should not be permitted, by using a lawyer *in lieu of* another form of tax preparer, to obtain greater confidentiality than other taxpayers. *By using Frederick as their tax preparer, the [clients] that his legal cogitations born out of his legal representation of them would creep into his worksheets and so become discoverable by the government. The [clients] undoubtedly benefited from having their lawyer do their returns, but they must take the bad with the good; if his legal thinking infects his worksheets, that does not cast the cloak of privilege over the worksheets; they are still accountants' worksheets, unprotected no matter who prepares them.* (Emphasis added.)<sup>11</sup>

*Retention of a new accountant avoids issues relating to whether information possessed by the accountant may have been obtained prior to the accountant's engagement by counsel.*

The Seventh Circuit qualified the applicability of Code Sec. 7525 by stating: “Nothing in the new statute suggests that these nonlawyer practitioners are entitled to privilege when they are doing other than lawyers’ work . . . .”<sup>12</sup>

## Engaging the Kovel Accountant

Engagement of the accountant by counsel should be designed to extend the attorney-client privilege to communications and rendered by the accountant pursuant to the engagement. A critical inquiry is often whether counsel should retain the taxpayer’s prior accountant or a new accountant. Many practitioners prefer to engage a new accountant to avoid the necessity of delineating between nonprivileged communications (communications prior to counsel’s engagement of the accountant) and privileged communications (communications following counsel’s engagement of the accountant). Retention of a new accountant avoids issues relating to whether information possessed by the accountant may

have been obtained prior to the accountant’s engagement by counsel.

Counsel’s engagement of the accountant should be in writing and should indicate that the accountant is acting under the direction of counsel in connection with counsel’s rendering of legal services to the client, communications between the accountant and the client are confidential and are made solely for purposes of enabling counsel to provide legal advice; the accountant’s work papers are held solely for counsel’s use and convenience and subject to counsel’s right to demand their return; and the accountant is to segregate their work papers, correspondence and other documents gathered during the course of the engagement and designate such documents as property of counsel.

A typical engagement letter from the attorney to the accountant would likely provide:

In connection with the retainer of our firm to render legal services to (client), we have the express authority to retain your and (accountant’s) services to work under our direction and report directly to us. This work contemplates services of a character and quality that are necessarily adjunct to our services as attorneys.

In connection with said employment, all communications between you, (accountant) and our client, (client), as well as communications between you, (accountant) and any attorney, agent or employee acting on our behalf, relating to the tax affairs of (client), shall be confidential and made solely for the purpose of assisting counsel in giving legal advice to (client). You and your firm will not disclose to anyone, without prior written permission, the nature and content of any oral or written communications, nor any information gained from you and (accountant) from the inspection of any record or documents submitted to you, including information obtained from corporate records or documents, or coming into (accountant’s) possession during the performance of services hereunder, nor permit inspection of any papers or documents without our prior written permission.

In this regard, please open separate files at your office entitled ‘Property of Law Firm—(client),’ and place all work papers, records or other documents, regardless of their nature and the source from which they emanate in that file. This file shall be held by (accountant) solely for our convenience and subject to our unqualified right to instruct you with respect to its possession and control. (Accountant) will immediately return our file to us at our request.

## Summary

In civil tax audits that include potentially sensitive issues, counsel will often engage a team of representatives, including a forensic accountant. The protections afforded by Code Sec. 7525 are not available when truly needed the most—when a civil tax proceeding moves into the criminal arena. It also may not be available in state-related tax proceedings or nontax civil litigation. Although Code Sec. 7525 extends common law protections of confidentiality to tax advice rendered between a taxpayer and a federally authorized tax practitioner (to the extent such communications would be considered privileged if they occurred between a taxpayer and counsel), this statutory privilege clearly does not apply to criminal tax matters before the IRS or the Department of Justice nor to criminal tax prosecutions in federal court.

Non-*Kovel* accountants are frequently compromised into testifying against their client in criminal tax proceedings as a result of a mistaken belief that Code Sec. 7525

extended the privilege to criminal as well as civil proceedings. If the accountant is appropriately engaged by counsel, the common law attorney-client privilege should apply to *all* communications rendered in furtherance of the legal services being provided to the client, both during the examination stages of the audit and, if necessary, during *any* subsequent civil or criminal proceedings.

## ENDNOTES

- <sup>1</sup> *United Shoe Machinery Corp.*, DC-MA, 89 FSupp 357, 358–59 (1950).
- <sup>2</sup> *E.E. Colton*, CA-2, 62-2 ustr ¶9658, 306 F2d 633.
- <sup>3</sup> *D.E. Cote*, CA-8, 72-1 ustr ¶9268, 456 F2d 142.
- <sup>4</sup> *C.L. Abrahams*, CA-9, 90-1 ustr ¶50,310, 905 F2d 1276.
- <sup>5</sup> *Colton*, *supra* note 2.
- <sup>6</sup> *B.C. Bernardo*, 104 TC 677, Dec. 50,705 (1995).
- <sup>7</sup> *In re L.J. Klein*, CA-7, 85-2 ustr ¶9701, 776 F2d 628; *D.L. Holifield*, CA-7, 90-2 ustr ¶50,423, 909 F2d 201; *B.C. Bernardo*, *supra* note 6; *C.L. Abrahams*, *supra* note 4, 1283.
- <sup>8</sup> *L. Kovel*, CA-2, 62-1 ustr ¶9111, 296 F2d 918.
- <sup>9</sup> *Id.*, at 922.
- <sup>10</sup> *R.A. Frederick*, CA-7, 99-1 ustr ¶50,465, 182 F3d 496, 500–01.
- <sup>11</sup> *Id.*, at 502.
- <sup>12</sup> *Id.*

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