Maintaining Privileges When *Kovel* Accountants Prepare Tax Returns

by Evan Davis

Evan Davis is a principal at Hochman Salkin Rettig Toscher & Perez PC in Beverly Hills, California, where he specializes in criminal and civil tax litigation. Before entering private practice, he was a trial attorney with the Justice Department Tax Division and a prosecutor with the U.S. attorney's office for the Central District of California.

In this article, Davis suggests how lawyers using *Kovel* accountants can minimize the risk of losing privilege protections and giving the government a window into the attorney-client relationship.

Suppose a client walks in with a slew of problems like nonfiling, prior false returns, and failure to file foreign bank account reports. You and the client are concerned about how to correct the problem without increasing the chances of criminal prosecution. You resort to the tax lawyer's long-standing tool: a *Kovel* accountant[1] to help you analyze the magnitude of the problem so you can best advise your client while protecting communications with the accountant.

What happens to the privileged nature of the accountant communications when the client uses the same *Kovel* accountant to file a tax return or other document to correct an error? Preparing returns is generally not protected by the attorney-client privilege or the work product doctrine, and there's no telling how far a judge will go in defining the breadth of any waiver.

Is this merely a theoretical problem? No. The IRS and Justice Department are pursuing *Kovel* communications aggressively. Lawyers who aren't careful about how and when they use *Kovel* accountants are at serious risk of losing privilege protections and giving the government a window into the attorney-client relationship.

Although it's impossible to entirely avoid risk in this area, here are suggestions for best practices when using *Kovel* accountants.

A Refresher

The attorney-client privilege is designed to facilitate open communication between lawyer and client, but because it restricts the truth-finding process, it only applies in limited circumstances. The Ninth Circuit, which has ruled much like other circuits on this issue, determined in *Graf*[2] that a privileged communication:

i. regarding legal advice of any kind;
ii. from a professional legal adviser in that capacity;
iii. related to the purpose of providing legal advice;
iv. made in confidence;
v. by the client;
vi. are at his instance permanently protected;
vii. from disclosure by himself or by the legal adviser;
viii. unless the protection is waived.

Section 7525 protects similar legal or tax advice by an accountant, but only in civil cases (not in criminal cases, when the protection is needed the most).

[1] Named after *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961), which first recognized that a lawyer could hire an accountant to perform accounting tasks beyond the lawyer's competence to aid the lawyer in giving legal advice without waiving the attorney-client privilege.

[2] *United States v. Graf*, 610 F.3d 1148, 1156 (9th Cir. 2010).

The work-product doctrine, in contrast, generally protects records created by or at the direction of an attorney in anticipation of litigation, which arguably includes an IRS audit.[3]

Documents prepared for both litigation and another purpose can be covered by work-product protection, depending on the circuit.[4]

The protection is not absolute and can be overcome, for example, through showing a substantial need as referenced in Fed. R. Civ. P. 26(b)(3)(A).

Return Preparation — Not Privileged

Courts generally have found that the act of preparing tax returns is not protected by the attorney-client privilege, even if prepared by or under the direction of an attorney. Rationales for this conclusion include: (1) Return preparation can be done by non-lawyers, so any advice is not legal advice and any return preparation is not done in the capacity of a lawyer; (2) the client knows that the return will be filed, so none of the communications were made in confidence with the intention that they remain confidential; and (3) even if there were legal aspects of return preparation, and even if the client anticipated that the advice would remain confidential, the client's act of filing the return effects a waiver of the privilege.[5]

The same issues apply to the work-product doctrine to the extent that underlying communications and documents are not disclosed with the filing of the return, although work-product protection can survive some disclosures, unless the disclosure "substantially increases the opportunity for potential adversaries to obtain the information."[6]

Filing an amended return doesn't necessarily waive the work-product protection.[7]

What's Included in 'Return Preparation'?

Assuming return preparation is not protected, what documents and oral communications relating to return preparation are also unprotected? Courts have not reached a consensus.

If the purpose of seeking legal advice is to decide whether to file a return (for example, a nonfiler under investigation), then this should be considered legal advice.[8]

Advising a client what positions to take on a tax return in advance of filing as opposed to how to handle problems post-filing may also be legal advice.[9]

However, context matters, so if the attorney is performing legal services beyond return preparation, the return preparation is more likely to be viewed as partly or entirely legal advice.[10]

Courts have distinguished among documents held by lawyers, ruling some are tax return documents and others are not.[11]

[3] *See In re Grand Jury Subpoena (Mark Torf/Torf Environmental Management)*, 357 F.3d 900, 907 (9th Cir. 2004); and *United States v. Roxworthy*, 457 F.3d 590, 600 (6th Cir. 2006) (holding that a document is prepared in anticipation of litigation if the likelihood of an IRS audit of a specific transaction is "quite concrete despite the absence of any overt indication from the IRS that it intends to pursue litigation against the taxpayer").

[4] *See United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998).

[5] *See Olender v. United States*, 201 F.2d 795 (9th Cir. 1984) (communications concerning activities in the ambit of an accountant, such as tax return preparation, are not privileged if performed by a lawyer); and *United States v. Lawless*, 709 F.2d 485 (7th Cir. 1983) (same). *But see Evergreen Trading LLC v. United States*, 80 Fed. Cl. 122 (2007) (return preparation by lawyer isn't simple math and at least some communications with lawyer surrounding return preparation aren't discoverable).

[6] *See, e.g., Samuels v. Mitchell*, 155 F.R.D. 195, 200-201 (N.D. Cal. 1994) (finding that disclosing work product to EY did not waive work product; and distinguishing disclosure to auditors, who have a duty to disclose adverse information to stockholders, and accountants, who are obligated to keep client information confidential); *see also Adlman*, 134 F.3d at 1200 n.4 (noting that there should be no waiver if there was a "good reason" to show work product to another person); and *Merrill Lynch & Co. Inc. v. Allegheny Energy Inc.*, 229 F.R.D. 441, 448 (S.D.N.Y. 2004) (holding plaintiff's disclosure of an investigative report to outside auditor did not waive work-product protection because auditor was not an adversary or a conduit to a potential adversary).

[7] *See In re Grand Jury Subpoena Duces Tecum*, 566 F. Supp. 883, 883-884 (S.D.N.Y. 1983).

[8] *See United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972); *see also United States v. Edward Adams*, 17 CR 64, at 13 (D. Minn. Mar. 12, 2018).

[9] *United States v. Chevron Texaco Corp.*, 241 F. Supp.2d 1065, 1076 (N.D. Cal. 2002) ("Determining the tax consequences of a particular transaction is rooted virtually entirely in the law. The advisor must analyze the tax code, IRS rulings, decisions of the Tax Court, etc. Communications offering tax advice or discussing tax planning or the tax consequences of alternate business strategies are 'legal' communications.").

[10] *In Re Shapiro*, 381 F. Supp. 21 (N.D. Ill. 1974); *United States v. Abrahams*, 905 F.2d 1276, 1284 (9th Cir. 1990).

[11] *Colton v. United States*, 306 F.2d 633 (2d Cir. 1962) (finding documents used to prepare the return were not privileged, but documents specifically prepared by the client for legal advice were privileged, if not expressed on the filed return).

Given the Risks, What Are Best Practices?

Never use the original return preparer as a *Kovel* accountant if you can avoid it. The return preparer will have to segregate and silo pre- and post-*Kovel* information, placing *Kovel* information at risk of inadvertent disclosure. Moreover, the original preparer is usually the government's primary witness against the taxpayer, so you should avoid alienating the preparer for that reason.

Make the *Kovel* accountant's obligations clear from the beginning — orally and in writing. The accountant should know that she is assisting the lawyer, not the client. *Kovel* accountants should keep files marked as the property of the law firm employing them, and all *Kovel* materials should be marked as attorney-client privileged and work-product protected. You should also study the case law of your circuit, including the ramifications of how the *Kovel* accountant is paid.

Reinforce the obligations of the *Kovel* accountant frequently. If you see a misstep, identify it instead of letting it pass. Remind the accountant that if an IRS agent wants to speak to him concerning any subject matter possibly covered by the *Kovel* arrangement, his sole response should be to direct the IRS to the lawyer. Moreover, ensure that the *Kovel* accountant and the client send all communications through the attorney, and involve the *Kovel* accountant only when necessary.

To the extent that the *Kovel* accountant performs any return preparation functions or other duties that could be beyond the scope of the *Kovel* arrangement, ensure that these are siloed from the *Kovel* work. Make sure that emails do not address both *Kovel* and non-*Kovel* issues (this applies to lawyers, clients, and accountants), and remember that email subject lines are not protected so keep them generic (or, even better, label all *Kovel* emails with just "*Kovel* communication" in the subject line).

Consider not having the *Kovel* accountant prepare any returns or other documents to be filed with the IRS, even though the client may balk at paying a new accountant to become familiar with the returns. If the *Kovel* accountant assists the client by preparing schedules based on source documentation, it's possible that another accountant would take those source documents from the client and prepare a return based on them. Doing so would disconnect the *Kovel* accountant from the act of preparing returns. Presumably, the new accountant would have few questions for the client if the client presented appropriate schedules, so there would be little information for the IRS to discover if the new accountant were interviewed or ordered to turn over documents.

If the client is sufficiently sophisticated, he could choose to prepare the returns on his own based on the *Kovel* accountant's schedules. If he were already under criminal investigation, the general prohibition on subpoenaing a target of the investigation should prevent both a document and testimony subpoena of the return preparer (that is, the client). However, the client would lose the ability to claim reliance on a return preparer, and the government could challenge this approach if it learned about the *Kovel* accountaint's role, by arguing that the *Kovel* accountant essentially prepared the return and is subject to a subpoena on that basis (if the IRS learns about the *Kovel* accountant). ■