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Tax Litigation Issues

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Accountant's Obligation to Maintain Client Confidences

Then the government conducts a criminal tax investigation, it is inevitable that federal prosecutors will reach out to the accountants who worked for the targeted individual or entity or prepared the tax returns at issue.

There is no question that in certain situations, such as receipt of a grand jury subpoena, Internal Revenue Service (IRS) summons or court order, an accountant is compelled to disclose client information, including information about the individual's tax returns.

Outside of such compulsion, however, an accountant's obligation is not so clear. Defense counsel consistently have taken the position that an accountant is not permitted, legally or ethically, to participate in an interview with the government regarding the accountant's client's affairs without the client's consent. There are a number of statutes and ethics rules supporting this position.

Federal and New York State Statutes

Section 7216 of the Internal Revenue Code (IRC) prohibits anyone "engaged in the business of preparing, or providing services in connection with the preparation of, [tax] returns [from] knowingly or recklessly (1) disclos[ing] any information furnished to him for, or in connection with, the preparation of any such return, or (2) us[ing] any such information for any purpose other than to prepare, or assist in preparing, any such return." Those who violate this provision are guilty of a misdemeanor. There is an exception, however, for proceedings involving the accountant. In those situations, an accountant properly may disclose tax return information to his attorney or any officer of a court in order to properly defend himself.¹

Section 6509 of the New York State Education Law defines professional misconduct, in part, as conduct that violates rules established by the Board of Regents, the body that governs the licenses of professionals in the state of New York, including

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accountants.² The Board of Regents, in turn, has adopted rules defining "unprofessional conduct" as the "[r]evealing of personally identifiable facts, data or information obtained in a professional capacity without the prior consent of the...client, except as authorized or required by law." Furthermore, specific to public accountants, the rules provide that "[u]nprofessional conduct shall also include revealing of personally identifiable facts, data or information obtained in a professional capacity without the prior consent of the client, except such information may be disclosed as necessary to other licensees of the profession conducting professional standards or ethics reviews, or as otherwise authorized by law."⁴

These provisions make clear that unless required by law, an accountant should not disclose confidential information he received from a client through their professional relationship. A violation of the federal statute may result in prosecution for a federal misdemeanor, while violation of the New York regulations may result in proceedings that might lead to the revocation of the accountant's license.

Accountancy Organizations

Organizations established to represent and serve public accountants have taken a similar stance. For instance, both the American Institute of Certified Public Accountants (AICPA) and the New York State Society of Certified Public Accountants (NYSSCPA) have adopted ethics rules prohibiting their "members in public practice [from disclosing] confidential client information without the specific consent of the client." In response to the government's prosecution of Leona Helmsley and others for tax evasion in the late-1980s, the NYSSCPA issued an opinion interpreting its rule as

prohibiting its members from voluntarily disclosing client confidences to the government in an informal interview.⁶

Rudolph Giuliani, then serving as the U.S. Attorney for the Southern District of New York, objected strongly to the NYSSCPA's interpretation, arguing that it "conflict[ed] seriously with legitimate and necessary law enforcement functions and actually would help insulate those accused of serious crimes by impeding the proper and logical presentation of evidence at trial." Maintaining its position, the NYSSCPA stated that it was not the organization's intention to require its members to act in any way that would violate federal law, but that if a member "elects to meet with the prosecutor and voluntarily divulge client confidences and that conduct is not required by law, [the Society] must...take appropriate action."

The cumulative effect of the statutes, regulations, and ethical rules set forth above should prevent accountants from disclosing confidential client information to government attorneys unless their client consents or they are compelled to do so by law. A client being investigated by the government can refuse to consent to stop his accountant's revealing client confidences in an informal setting. Namely, an accountant's failure to abide by his client's wishes may result in the client reporting him to prosecutors, a licensing authority or other organization to which the accountant may belong, resulting in disciplinary procedures or even the revocation of his license.

The impact of an accountant's cooperation with the government is demonstrated in the U.S. Court of Appeals for the Second Circuit case, United States v. Schwimmer. 9 The defendant, Mr. Schwimmer, was convicted of a racketeering conspiracy, conspiracy to defraud the United States and tax evasion. On appeal, Mr. Schwimmer sought a reversal based in part on the fact that the government had obtained information, including work papers, from his accountant before trial. The accountant had been hired by Mr. Schwimmer and his codefendant, Mr. Renda, to assist in the preparation of their defense. After Mr. Renda pleaded guilty, the government met with the accountant, purportedly to determine a reasonable forfeiture amount for Mr. Renda. While prosecutors instructed the accountant not to reveal any confidential communications during the course of their interview, they nonetheless obtained a copy of the accountant's workpapers which detailed the allocation of commissions between the

two defendants. The government asserted that this information was used solely to determine a reasonable forfeiture amount for Mr. Renda's sentence.

The defendant argued that the government improperly obtained privileged information as contained in his accountant's workpapers, demanding an automatic reversal. The court rejected Mr. Schwimmer's argument, determining that the government's actions in this regard were not manifestly corrupt because they had cautioned the accountant not to reveal any confidences. Further, the court found that Mr. Schwimmer had suffered no prejudice as a result of the government's actions because "no preview of defense strategy was derived from the workpapers and...no other violative use of privileged information had occurred."

Accountant Privilege

A client also may prevent the disclosure of confidential information imparted to an accountant where the accountant-client privilege, established with the enactment of the IRS Restructuring and Reform Act in July of 1998, applies. The IRS Restructuring Act was the culmination of pressure on the IRS to become more "customer-friendly" after the national media reported numerous stories of the IRS's mistreatment of taxpayers. Before the creation of the accountantclient privilege, a client seeking tax advice had two options: (1) meet with an accountant who could not guarantee the confidentiality of their conversations; or (2) meet with a tax attorney who could guarantee confidentiality through the application of the attorneyclient privilege and work product doctrines, unless the attorney was performing nonlegal functions such as tax preparation. Clients usually sought the latter option, putting accountants at a disadvantage. 10

Before the passage of the IRS Restructuring Act, an accountant who sought to protect his communications with a client would have to form a relationship with an attorney who would engage the accountant to assist him in representing the client, thereby cloaking the accountant-client relationship with attorney-client confidentiality. This methodology, sanctioned by the Second Circuit's opinion in *United States v. Kovel*, ¹¹ was cumbersome and costly. The extension of the privilege in these cases applies to reports prepared for the lawyer and information imparted to the lawyer, but does not apply to any of the client's books or records that are examined by the accountant. ¹²

The accountant-client privilege, codified in 26 USC §7525, provides that "with respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication 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 taxpaver and an attorney." The term "federally authorized tax practitioner" is defined as "any individual who is authorized under Federal law to practice before the [IRS]." The statute further defines "tax advice" as that "given by an individual with respect to a matter which is within the scope of the individual's authority to practice."13

There are important limitations to the accountantclient privilege created in this statute. First, it applies only to noncriminal tax matters before the IRS or proceedings in federal court in which the United States is a party.¹⁴ In other words, no privilege exists in the context of a criminal case, even if the case grew out of a civil matter. 15 Second, the privilege does not extend to any communication between an accountant and his client, including directors, officers, employees, agents or representatives of a corporate entity, regarding tax shelters.16 A "tax shelter" is defined in the IRC as any partnership or other entity, investment plan or arrangement created for the purpose of avoiding or evading federal income tax.¹⁷ Finally, the statute is silent as to whether the confidentiality privilege extends to an accountant's work product.18

Before the IRS Restructuring Act, an accountant seeking to protect communications with a client would need a relationship with an attorney who would engage the accountant to assist him in representing the client.

Like the attorney-client privilege, the right of privileged communication under this statute belongs to the client. Accordingly, when summoned to provide information, a tax practitioner should decline to do so without the client's consent. However, in writing the statute, Congress effectively left individuals seeking tax advice without protection in criminal proceedings and matters brought in state court or before regulatory bodies other than the IRS. Accordingly, it is conceivable that the IRS may seek confidential information from other proceedings for which the privilege is not available. This "backdoor approach" is counter to the purpose of the accountant-client privilege to allow "taxpayers to consult with other qualified tax advisers in the same manner they currently may consult with advisors that are licensed to practice law."19

Outside the limited protection provided in §7525, courts have recognized that "there is no common law accountant's or tax preparer's privilege."20 Accordingly, common-law remedies usually are unavailable to clients' whose confidences have been disclosed. In Block v. Razorfish, Inc., a corporation brought a third-party action against its accountant claiming that the accountant had breached his fiduciary duties in disclosing confidences to a third party. Noting that the conduct may have been unprofessional and constitute grounds for a grievance complaint, the court found, nonetheless, that New York courts "do not generally regard the accountant-client relationship as a fiduciary one" and dismissed the thirdparty action.²¹ Furthermore, there is no remedy provided in §7525. When an accountant improperly waives the privilege without the client's consent, the only course of action may be a malpractice suit.²²

Some have argued that the accountant-client privilege should be extended beyond civil or other

noncriminal actions, especially in light of the fact that accountants are under an ethical obligation to preserve the confidences of their clients. Accountants argue that confidentiality is critical to the development of their professional relationship and the maintenance of sound accounting practices. Opponents of extending the privilege argue, however, that in most instances the business and financial information conveyed to tax practitioners concerns matters intended to be made public through the filing of tax return documents, so that the expectation that the information will be kept confidential is lacking.²³

Conclusion

Nevertheless, where the statutory accountantclient privilege does not apply, the federal and New York State statutes and regulations and various ethical rules detailed in this article do restrict an accountant's ability to share client information. Accordingly, the government should be on notice that accountants are bound not to reveal confidential information about their clients without legal compulsion and accountants should be cautions in responding to government inquiries.

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- 1. See Internal Revenue Service Reg. 301.7216-3.
- 2. New York State Education Law §6509(9).
- 3. Rules of the Board of Regents, General Provision §29.1(b)(8).
 - 4. Id. at §29.10(c).
- 5. NYSSCPA Ethics Rule 301; AICPA Rule 301 ("[a] member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client").
- 6. See Letter from Robert W. Berliner, NYSSCPA Professional Ethics Committee Chairman, to Edward J. Daus, Sept. 23, 1988.
- 7. Letter from Rudolph W. Giuliani to Robert W. Berliner, Oct. 21, 1988.
- 8. Letter from Robert L. Gray, Executive Director of NYSSCPA to Rudolph W. Giuliani, Nov. 18, 1988. 9. 924 F2d 443 (2d Cir. 1991).
 - 9. 924 F2d 443 (2d Cir. 1991). 10. Brian Yacker, "The New Accountant-Client Privilege–
- Real or Illusory Benefits for Taxpayers?" Asset Protection Journal (Summer 1999).
 - 11. 296 F2d 918 (2d Cir. 1961).
- 12. Yacker, "The New Accountant-Client Privilege—Real or Illusory Benefits for Taxpayers?"
- 13. 26 USCA §7525(a)(3).
- 14. Id. at §7525(a)(2).
- 15. See IRS General Litigation Bulletin 200017039, "Accountant Privilege—Criminal Law," 2000 WL 1874048 (February 2000).
 - 16. Id. at §7525(b).
 - 17. 26 USCA §6662(d)(2)(C)(ii).
- 18. See Long-Term Capital Holdings v. United States, 2002 WL 31934139 at *4 (D. Conn. Oct. 30, 2002) (stating that \$7525 does not protect work product); United States v. Frederick, 182 F3d 496, 502 (7th Cir. 1999) (concluding, in dicta, that \$7525 does not protect accountant work product).
- 19. Alicia K. Corcoran, "The Accountant-Client Privilege: A Prescription for Confidentiality or Just a Placebo?" New England Law Review (Spring 2000) (citing sources in which "backdoor" approach is discussed).
- 20. See Long-Term Capital Holdings v. United States, 2002 WL 31934139, *4 (D.Conn. Oct. 20, 2002).
- 21. 121 FSupp2d 401, 403 (SDNY 2000). 22. Amy Van Vleck, "A New Privilege Extended to Taxpayers:
- 22. Amy Van Vleck, "A New Privilege Extended to Taxpayers: Clients Should Know Their Rights," Smartpros, Ltd. (Aug. 28, 2000) (available at http://accounting.pro2net.com/x19509.xml).
- 23. Charles Alan Wright and Kenneth W. Graham, Jr., Federal Practice and Procedure, Federal Rules of Evidence, Chapter 6 §5427.

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