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TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

Accountants and the Attorney-Client Privilege

VIRTUALLY EVERY important tax case requires the services of an accountant. The trick is to make certain that, whenever possible, his involvement does not result in unwanted disclosures to potential adversaries. Depending on the context as well as on the role of the attorney and that of the accountant, communications between the taxpayer and these tax professionals may or may not be privileged. In order to provide the best representation to the client, while maximizing the confidentiality of related communications, the attorney must understand the scope of applicable privileges and structure the relationships between client, attorney, and accountant in order to maximize their reach. Lack of attention to detail and form may lead to harmful disclosures.

No Meaningful Privilege

Traditionally, there was no federally recognized accountant-client privilege.¹ Beginning in *United States v. Kovel*,² however, courts have extended the attorney-client privilege to cover certain communications involving accountants to the extent that the accountant furthered communications between the lawyer and client and were in furtherance of legal, rather than accounting advice. Thus, in *Kovel*, the Second Circuit

John J. Tigue Jr. is a principal in Morvillo, Abramowitz, Grand, Iason & Silberberg and a fellow of the American College of Trial Lawyers. **Jeremy H. Temkin** is a principal in Morvillo, Abramowitz, Grand, Iason & Silberberg. **Judith L. Mogul**, an attorney, assisted in the preparation of this article.



John J. Tigue Jr.

Jeremy H. Temkin

held that the privilege will not be waived where the “presence of the accountant is necessary, or at least highly useful, for the effective consultation between client and lawyer.”

The *Kovel* doctrine, which has been widely adopted by other circuits, is generally considered to protect the confidentiality of communications involving in-house or outside accountants. While *Kovel* has been applied both in the context of transactional advice and work performed by forensic accountants in anticipation of and during litigation, courts have repeatedly cautioned that communications involving accountants and other consultants will not be cloaked in privilege merely because the attorney has placed such professionals on his payroll.³

IRC §7525 — A Limited Accountant’s Privilege and a Trap for the Unwary Taxpayer. Until recently, *Kovel* was the sole mechanism for protecting federally a client’s communications with an accountant.⁴ If a taxpayer sought the advice of an attorney on the tax implications of a contemplated transaction or in administrative proceedings before the IRS, that consultation would be privileged, while the identical

consultation occurring between the taxpayer and his accountant would not.

Ostensibly to provide greater uniformity in the confidentiality accorded taxpayer communications with their advisors, in 1998, Congress enacted a limited accountant’s privilege as part of the “Taxpayer Bill of Rights.”⁵ 26 USC §7525 provides that “[w]ith 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 practitioner⁶ to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.”

Several important limitations make clear that this privilege is not coextensive with the attorney-client privilege and may lead an unsophisticated taxpayer to place undue reliance on the statute. Indeed, the statute provides little guidance as to what types of communication will enjoy the privilege and the contours of the privilege, which applies only to communications made after July 1998, have yet to be addressed by any court. While the privilege is afforded only to “tax advice,” that phrase is defined as advice given within the scope of an individual’s authority to practice before the Internal Revenue Service, without further clarification. Because the privilege is unavailable in a criminal proceeding, unless the attorney or accountant can rule out any possibility that a tax matter may become the subject of a criminal investigation, communications between the taxpayer and the accountant may ultimately shed their privileged status.

Furthermore, because the privilege only attaches in federal court and only to cases in which the federal government is a party, even if communications involving an accountant would otherwise qualify for protection under §7525, there is no bar to their disclosure in an action brought by or against state taxing authorities, or by private parties in any forum.

Thus, whatever its theoretical scope, an attorney working with an accountant should not generally assume that §7525 will protect communications involving the accountant. As the Supreme Court has noted, "uncertain privilege ... is little better than no privilege at all."⁷ Section 7525 is so fraught with uncertainty, that an attorney utilizing an accountant in connection with a tax matter should rely on that privilege at his own peril. Ensuring that an accountant's exposure to privileged information comports with *Kovel* thus remains the only viable option to avoid a waiver.

Procedural Requirements

Because maintenance of the privilege is of paramount importance at the outset of a criminal investigation, it will always be better for an attorney to hire an accountant who has had no prior dealings with the client. But this is not always feasible. An accountant may be so familiar with the client's complex financial structure and history, that neither money nor time will permit bringing in a new expert. Although it is the safer practice, *Kovel* does not require that the accountant be retained by the lawyer, rather than by the client, but it is critical that the attorney establish an independent relationship with any consulting accountant at the earliest possible juncture, whether the attorney is providing transactional advice to the client, or representing him in an actual or potential litigation.

A lawyer hiring an accountant should be careful to document that the accountant is assisting the attorney-client relationship through a "*Kovel* letter," which asserts that the lawyer is retaining the accountant to assist the lawyer in providing legal advice to the client. Such letters generally specify that bills are to be sent directly to the attorney, and that the accountant's workpapers

and documents generated by the accountant are the property of the attorney. A *Kovel* letter should also instruct the accountant regarding the specific tasks to be performed, and to maintain the confidentiality of all information received or generated. While *Kovel* letters are not dispositive and courts will look beyond such letters to the actual substance of the relationships involved, they provide useful evidence in support of the privilege. Where the role of the accountant is not immediately clear, particularly where the accountant has had prior involvement with the client, the absence of a *Kovel* letter can be devastating, especially because the party asserting a privilege has the burden of proof, often in an unfriendly judicial environment.

Recently, in *Cavallaro v. United States*,⁸ the U.S. Court of Appeals for the First Cir-

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cuit denied a privilege claim for documents created by, or disclosed to an accounting firm, concerning a merger between two closely held corporations. The companies, which were owned by the taxpayers and their sons respectively, merged as a prelude to their sale to a third party. Following these transactions, the IRS commenced a fraud investigation centering on the whether the pre-merger values of the companies had been improperly manipulated to avoid taxation.

Prior to the merger, the parents employed a law firm to advise them on estate planning and other personal issues as well as on matters relating to their corporation. During the same period, the sons and their corporation received tax planning and other financial advice from an accounting firm. The IRS sought documents from the accounting firm relating to the transaction; and the taxpayers moved to quash the summons as applied to any documents generated after a meeting at

which the attorneys had requested the accountants' assistance. They acknowledged that prior to that time, the accountants had been rendering accounting advice to the sons and their companies, but asserted that following the key meeting, the accountants began to assist the parents' attorneys and that all subsequent communications involving the accountants were privileged.

The First Circuit affirmed the district court's refusal to quash the summons, finding that the accountants were not hired to assist the attorneys. Consistent with the notion that form is important in this area, the court observed that whether the accountants were hired by the law firm, as opposed to the family, was probative to a determination of the accountants' function. The court noted that typically agents of an attorney are retained by or at the attorney's discretion and under the attorney's supervision. It concluded that the accountants were acting independently of the attorneys, working on separate tracks, albeit in a coordinated fashion. In a cautionary note, the court observed that "when a party hires an accountant to provide accounting advice, and only later hires an attorney to provide legal advice, it is particularly important for the party to show that the accountant later acted as an agent necessary to the lawyer in providing legal advice." Had the attorneys in this transaction executed a *Kovel* letter, the taxpayers would have been far better equipped to support their claim of privilege.

Must Be Legal Advice

No matter how thoroughly and effectively an attorney documents the formalities of an accountant's retention, communications involving the accountant will only remain privileged if the advice being sought is of a legal, rather than an accounting nature. While the line between legal and accounting advice is not always clearly defined, certain activities clearly fall outside the scope of legal advice.

Preparation of returns has consistently been regarded as a nonlegal function, unprivileged even when performed by an attorney,⁹ in part because a taxpayer has no expectation of privacy in information

transmitted for inclusion in a tax return, so that those communications are not considered confidential.¹⁰ As a consequence, attorneys representing taxpayers in litigation, or where litigation is a reasonable likelihood, should guard against mixing tax advice with return preparation and should also endeavor, whenever possible, to obtain expert accounting assistance from an accountant who has not participated in preparing the taxpayer's returns.

The problems of commingling tax advice and return preparation are illustrated in *United States v. Frederick*¹¹ where the Seventh Circuit ordered the taxpayers' attorney, who also served as their accountant, to produce to the IRS documents used in preparing the taxpayers' returns and in representing them in audits. The court noted that an audit can be both "a stage in the determination of tax liability" and a "possible antechamber to litigation." It further observed that where the audit is merely a verification of a return's accuracy, the taxpayer's representative is performing accountant's work, and remains as such even if the assistance is rendered by a lawyer, whereas if the lawyer is there to address issues of statutory interpretation or case law, the lawyer is functioning in his capacity as legal adviser, and the attorney-client privilege would attach. The court concluded that there was no indication that the audit documents requested in the summons related to legal, rather than accounting advice, and were accordingly unprivileged.

The *Frederick* court was unpersuaded by the argument that the accounting documents in question should be protected from disclosure because they reflected the attorney's legal thinking. It noted that by using their attorney to prepare their returns and represent them at audits, the taxpayers "ran the risk that his legal cogitations born out of his legal representation of them would creep into his worksheets and so become discoverable," holding that "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." The court went on to find

that even dual-purpose documents, generated both for return preparation and for litigation purposes were non-privileged, because otherwise those involved in or contemplating litigation would be able to use an attorney to prepare their returns, and thus shield the related documents from disclosure, while other taxpayers could not. Finally, the court noted, in dicta, that §7525 would not change its analysis even if it were applicable,¹² because "[n]othing in the statute suggests that ... nonlawyer practitioners are entitled to privilege when they are doing other than lawyers' work."

*United States v. Ackert*¹³ further demonstrates that formulaic incantation of *Kovel* provides little protection where the accountant's relationship to the client is other than as a consultant to the attorney. In *Ackert*, the Second Circuit found that communications between an in-house attorney and an investment advisor for the purposes clarifying details and tax consequences of a proposed transaction were not privileged. The court held that the privilege applies only where the expert improves the communication between attorney and client, in the manner of a translator or interpreter, and not where he or she provides information, no matter how useful, that is not within the client's possession. Here, the investment advisor imparted new information to the attorney, making *Kovel* inapplicable, and the communications unprivileged.

While litigation regarding the application of *Kovel* frequently focuses on the attorney-client privilege, it is important for parties seeking protection of communications involving accountants to consider application of the work-product doctrine. Accountants often do more than merely enhance communication between attorney and client, bringing valuable independent information to the table. In such instances, the work-product doctrine may provide protection from disclosure even where the attorney-client privilege does not. Work-product protection is most easily invoked when the accountant is rendering litigation assistance. But it can also extend to transactional advice where such advice is rendered at least partially in anticipation of litigation,

notwithstanding the fact that the advice serves a business purpose rather than litigation assistance. Such was the case in *United States v. Adlman*, where the Second Circuit found that an accountant's assessment of likely IRS challenges to a contemplated transaction could qualify as work-product,¹⁴ even though it did not fall within the scope of the attorney-client privilege.¹⁵ The court rejected the notion that the work-product doctrine applies only to those documents created "primarily or exclusively to assist in litigation," holding instead that so long as they were prepared "because of" existing or expected litigation they should be protected from disclosure. It concluded that if the document would not have been prepared in substantially the same form without the threat of the anticipated IRS challenge, it was prepared because of litigation and should be protected under the work-product doctrine. Attorneys should thus consider the applicability of the work-product doctrine in addition to the attorney-client privilege whenever possible.



(1) See, e.g., *Couch v. United States*, 409 US 322 (1973); *United States v. Bein*, 728 F2d 107 (2d Cir.), cert. denied, 469 US 837 (1984).

(2) 296 F2d 918 (2d Cir.1961) (Friendly, J.).

(3) See, e.g., *Kovel*, 296 F2d at 921; S.R. Intern. Business Ins. Co. v. World Trade Center Properties, LLC, No. 01 Civ. 9291, 2002 WL 1455346 (S.D.N.Y. July 3, 2002).

(4) Some states have adopted an accountant/client privilege.

(5) 26 USC §7525.

(6) A federally authorized tax practitioner is defined as any individual who is authorized under federal law to practice before the IRS, which includes lawyers, CPAs and enrolled agents.

(7) *Upjohn Co. v. United States*, 449 US 383 (1981).

(8) 284 F3d 236 (1st Cir. 2002).

(9) See, e.g., *In re Grand Jury Investigation*, 842 F2d 1223 (11th Cir. 1987) (collecting cases); *United States v. Frederick*, 182 F3d 496 (7th Cir. 1999), cert. denied, 528 US 1154 (2000).

(10) See, e.g., *Couch*; *United States v. Lawless*, 709 F2d 485 (7th Cir. 1983).

(11) 182 F3d 496 (7th Cir. 1999).

(12) The documents at issue were generated before the statute's effective date.

(13) 169 F3d 136 (2d Cir. 1999).

(14) *United States v. Adlman*, 134 F3d 1194 (2d Cir. 1998) (*Adlman II*). One of the authors represented the taxpayer in this case and in *Adlman I*, cited below.

(15) *United States v. Adlman*, 68 F3d 1495 (2d Cir. 1995) (*Adlman I*) (holding that taxpayer had not established that accountant was assisting lawyer in rendering legal advice, rather than providing accounting advice on tax implications of transaction).