PERSPECTIVE

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Establishing Attorney-Client Privilege With Your Accountant

By Robert W. Wood

Even *thinking* about tax filing may make you nervous. How aggressive are you being? Are you claiming something that the IRS may view as over the top? Do you have exposure for past tax years, and would amending past returns make the situation better or worse?

How much can you safely tell your accountant, and how much can you reveal in writing without fear it will be used against you? And what about non-tax return forms, like FBARs for foreign bank accounts? Accountants normally complete these, but the potential penalty liability (civil and even criminal) can dwarf tax evasion penalties.

All in all, it can make you want to stick your head in the sand (but don't). Make no mistake, the IRS and Justice Department want you to think carefully before you get to the penalties of perjury language on the signature line of your tax return. The same goes for non-tax forms like FBARs.

The government wants to keep reminding you to fly right. But even flying right may be somewhat nuanced. Taxes are complex, and the line between creative tax planning and tax evasion can be less clear than you might think. What is good planning, what is over the line? What is fraud, and how long do you have to worry?

You must sign tax returns under penalties of perjury. The numbers you report must be true and correct to the best of your knowledge. They are not an opening offer. During President Barack Obama's years in office, case recommendations brought by the IRS to the DOJ have soared. And with non-cash items you must report on your taxes, foreign accounts, and many other items, you are bound to be confused.

Thanks to attorney-client privilege, if you tell a *lawyer* secrets (say you are hiding money offshore), the IRS cannot make your lawyer talk. The IRS generally can't even make your lawyer produce documents. The attorney-client privilege is strong precisely so that clients (in both civil and criminal cases) will be forthcoming with their lawyers.

Accountants, however, do not have this privilege. If you make statements or provide documents to your accountant, he or she can be compelled to divulge them no matter how incriminating they may be. For completeness, it is worth noting that there is a statutory "tax preparation" privilege.

This provision was added to the tax code (IRC Section 7525(a)(1)) in 1998. But it is quite narrow, and is completely inapplicable to criminal tax cases. That makes it of little value. In contrast, attorney-client privilege is worth a great deal and provides enormous protections under the law.

So if you fear exposure under the Panama Papers, have undisclosed offshore income, two sets of books, unpaid payroll taxes, or other serious tax issues, there is only one answer. In sensitive tax matters, the answer to this quandary is the *Kovel* letter, named after *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961). First, you hire a lawyer.

Then, your lawyer hires an accountant. In effect, the accountant is doing *your* tax accounting and return preparation, but reporting as a subcontractor to your lawyer. Usually, the lawyer you hire will probably be a tax lawyer, but that is not a requirement.

Properly executed, the *Kovel* letter imports attorney-client privilege to the accountant's work and communications. It is reasonably safe too, although it is true that there have been a few IRS lawsuits eroding it. For example, in *United States v. Richey*, 632 F.3d 559 (9th Cir. 2011), the 9th U.S. Circuit Court of Appeals refused to protect an appraisal that a taxpayer, lawyer, and accountant were trying to keep out of the hands of the IRS.

Furthermore, in *United States v. Hatfield*, No. 06-CR-0550, 2010 WL 183522 (E.D.N.Y. Jan. 8, 2010), the New York district court forced disclosure of discussions between the lawyer and accountant. Tax lawyers say that the IRS and the courts have tried to chip away at *Kovel* over the years. On the whole, however, the *Kovel* letter has withstood the test of time, and probably will for generations to come.

There is also a practical aspect. The mere fact that a *Kovel* arrangement in place can make it unlikely that the IRS will push for disclosure around the edges. Moreover, having a *Kovel* agreement can make accountants feel more comfortable and more responsive as well. At a minimum, having a *Kovel* agreement means that the accountant who is called by the IRS to produce a file will ask the lawyer. That in itself is quite valuable.

Ideally, the *Kovel* agreement will introduce a new accountant to the situation, so all communications and all documents are covered by the privilege. In the real world, of course, many clients may want their usual accountant with whom they already have a relationship to do the accounting work. That is not prohibited, but it can blur the line between what is protected and what is not.

Thus, pre-existing relationships between the accountant and the ultimate client before the *Kovel* agreement can be prickly. A *Kovel* arrangement is premised on the notion that the accountant's communications were "made in confidence for the purpose of obtaining legal advice from the lawyer." See *United States v. Adlman*, 68 F.3d 1495 (3d Cir. 1995). The attorney is the client in a *Kovel* engagement, so the accountant should address all correspondence to the lawyer.

That means information acquired by an accountant under a *Kovel* agreement should be distinguished from information collected by the accountant as an auditor or in some other capacity. It is appropriate to keep things as separate and well-documented as you can. That may include using a different accounting firm for the audit or other work where possible.

Ultimately, though, a *Kovel* agreement almost never can hurt and usually will help. It can even make the respective roles of accountant and tax lawyer much clearer. Surprisingly, attorney-client privilege is rarely tested in this context. That is good, because unless you have to, you do not want to end up having to fight about disclosure before a judge.

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