Why attorney-client privilege with your accountant matters

By Robert W. Wood

Lawyers may take attorney-client privilege for granted, but if you have tax problems, you may be reminded how fundamental and important this privilege can be. Thanks to attorney-client privilege, if you tell your *lawyer* you are hiding money offshore, the IRS can't make your lawyer reveal that information.

Of course, under the U.S. Constitution, you cannot be forced to testify against yourself. You can assert your Fifth Amendment rights and decline to answer IRS questions, even in front of a judge. But if you have documents—such as foreign bank account records—the IRS can obtain them from you with a summons, subpoena or search warrant.

That may make you wonder if you aren't better off with sensitive information in the hands of your lawyer. If you ask your lawyer to obtain your foreign bank records, your lawyer generally can't be forced to hand them over to the IRS. In contrast, if *you* obtain *your own* foreign bank records, they're fair game.

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Attorney-client privilege is designed to be strong so that clients (in both civil and criminal cases) will be forthcoming with their lawyers. Communications with accountants, however, are not protected by 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.

Of course, as accountants are quick to point out, there is a statutory "tax preparation" privilege. It was added to the Internal Revenue Code in 1998 (IRC Section 7525(a)(1)). Yet it is quite narrow in scope, and in any event, is entirely inapplicable to criminal tax cases. That makes it of little practical value.

In sensitive tax matters, one should confide in and obtain advice from a lawyer. Yet lawyers cannot do everything themselves. In fact, many tax lawyers do not prepare tax returns at all.

The answer to this quandary—used successfully for the last 50 years—is the *Kovel* letter, named after *United States v. Kovel*, 296 F.2d 918 (2d. Cir. 1961). In a practiced procedure, your tax lawyer hires an accountant. In effect, the accountant is doing *your* tax accounting and tax return preparation, but is reporting as a sub-contractor to your tax lawyer.

That brings the work of the accountant under the auspices of the lawyer's privilege. There may be work product protection too, of course, but that is a separate and generally weaker privilege in any event. Properly executed, a *Kovel* letter imports attorney-client privilege to the accountant's work and communications.

The importance of this rule to the handling of even many pedestrian civil tax matters cannot be overstated. And when it comes to potential inquiries from the Criminal Investigation Division of the IRS, the *Kovel* letter is essential. However, recent IRS lawsuits are eroding some of traditional *Kovel* protections.

These IRS inroads into attorney-client privilege should motivate tax lawyers, accountants and the clients who hire them to be increasingly careful. Sometimes slips in communication protocols or in dual roles where the accountant is also working directly with the ultimate client can vitiate protection. For example, in *United States v. Richey*, 632 F.3d 559 (9th Cir. 2011), the Ninth Circuit refused to protect an appraisal that a taxpayer, lawyer and accountant sought to keep from the IRS.

In some cases the assaults are even more frontal. In *United States v. Hatfield*, 210 WL 183522 (E.D.N.Y. 2010), the court forced disclosure of discussions between the lawyer and accountant. These and other developments make clear lines of communication more imperative than in the past. The scope of the engagement is important, too.

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 (2d Cir.1995). The attorney is the client in a *Kovel* engagement. That means the accountant should address all correspondence to the lawyer.

It also means that 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. The *Kovel* agreement is so commonplace that lawyers, clients and accountants sometimes take them for granted. Some may even blithely assume that attorney-client protection will always apply.

You must, however, keep things as separate and well-documented as you can. Pre-existing relationships between the accountant and the ultimate client are especially prickly. A *Kovel* agreement should protect communications prospectively but clearly cannot protect the past. That can make hiring the client's *existing* accountant less than ideal, even though it may make sense to do so from the perspective of the accountant's historical knowledge.

There is no right answer to this situation, nor is there a single right way to handle it. However, it is better to consider the advantages and disadvantages of hiring a particular accountant or accounting firm than to ignore the issue. In some cases, you may want to use a different accounting firm for the audit or other work, or to switch to a new accounting firm entirely.

Fortunately, attorney-client privilege is rarely tested in this context. That is true even in criminal tax cases. However, you don't want to end up having to fight about disclosure before a judge, especially where the communications may be very revealing. Having a lawyer hire the accountant to try to import privilege is cautious and the practice remains widespread. But additional precautions, such as more rigid direction from the lawyer to the accountant and segregation of accounting and legal files, are good ideas.

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