

TAX LITIGATION ISSUES

Expert Analysis

Protecting Privileged Communications With a ‘Kovel’ Accountant

Because criminal and civil tax cases often turn on complicated accounting principles, attorneys representing clients in such cases need to work with accountants in a privileged setting. There is, however, no accountant-client privilege at common law,¹ and while section 7525 of the Internal Revenue Code establishes a narrow privilege for “tax advice” in some noncriminal matters, it is inapplicable in private civil actions and criminal investigations.² Thus, with limited exceptions, an accountant’s work for a taxpayer is subject to discovery in a criminal investigation.

Beginning with the Second Circuit’s decision in *United States v. Kovel*,³ courts have recognized the indispensable role accountants play in assisting counsel representing clients in criminal tax investigations. Indeed, one of the first steps defense counsel will take at the outset of an investigation is to retain an accountant to work under his direction. That accountant—commonly known as a *Kovel* accountant—is brought within the attorney-client privilege and his work is protected from discovery.

As with all privileged relationships, if the government seeks to discover the *Kovel* accountant’s work, the taxpayer will bear the burden of establishing that the communications in question are protected by the privilege. As a result, counsel needs to take care to ensure that the accountant’s work is covered by the *Kovel* doctrine and that the privilege is not waived.

The ‘Kovel’ Doctrine

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In *Kovel*, an accountant employed by the law firm representing the target of an investigation was subpoenaed to appear before the grand jury investigating the target. When the accountant refused to answer questions, he was held in contempt and sentenced to a year in prison.

On appeal, the U.S. Court of Appeals for the Second Circuit reversed the conviction

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holding that attorney-client communications did not lose their privileged nature by virtue of having been shared with the accountant. Rather, the court analogized the accountant’s role to that of an interpreter facilitating communications between an attorney and a non-English speaking client:

Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. Hence the presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege...; the presence of the accountant

is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit.⁴

Thus, while disclosure of client confidences to a third party would ordinarily constitute a waiver of the attorney-client privilege, the *Kovel* doctrine allows an attorney to engage an accountant to assist in his representation of a client while protecting the confidentiality of communications among the accountant, the client and the attorney. However, *Kovel* does not cover all activities undertaken by an accountant and, depending on the context of the engagement and the tasks performed by the accountant, the communications may either fall outside the doctrine or lose their privileged nature by virtue of a waiver.

Services Covered by ‘Kovel’

Kovel and its progeny stress that in order to maintain privilege, the communication between an attorney and an accountant must be “made in confidence for the purpose of obtaining legal advice from the lawyer.”⁵ Thus, the privilege will attach to analysis performed by an accountant to determine, for example, the extent of income generated in the client’s previously undisclosed offshore accounts, which enables the attorney to advise the client on the legal risks associated with the conduct. Conversely, the privilege does not apply where the accountant provides accounting services or business advice. This line is often encountered when the taxpayer-client argues that communications with her return-preparer are privileged.

In *United States v. Frederick*,⁶ the taxpayers asserted privilege over documents used by their accountant in preparing their income tax returns and in representing them during an IRS

audit. While the return-preparer in *Frederick* was also an attorney, the U.S. Court of Appeals for the Seventh Circuit rejected this dual role as a basis for protecting all communications from discovery. Rather, the court noted the absence of a common law accountant's or tax preparer's privilege, and held that "a taxpayer must not be allowed, by hiring a lawyer to do the work that an accountant, or other tax preparer, or the taxpayer himself or herself, normally would do, to obtain greater protection from government investigators than a taxpayer who did not use a lawyer as his tax preparer would be entitled to."

The Seventh Circuit also rejected the government's assertion that communications with the attorney-accountant could never be privileged, noting that while the transmission of information to a return preparer with the intent that it be incorporated in a filed return was not privileged, there was no presumption that "everything transmitted to [the attorney-accountant] by the taxpayer was intended to assist him in his tax-preparation function and thus might be conveyed to the IRS, rather than in his legal-representation function." Finally, the court distinguished between the performance of an accounting function during an audit—such as verifying the numbers on the return—and a legal function, such as addressing issues of statutory interpretation or case law. While the former conduct is not privileged, the latter constitutes "lawyer's work and the attorney-client privilege may attach."

The line between protected work serving a legal purpose and unprotected accounting services is reflected in *United States v. Gurtner*.⁷ In *Gurtner*, an attorney directed a client to consult an accountant for the purpose of preparing tax returns. The U.S. Court of Appeals for the Ninth Circuit rejected a claim that the accountant's services were privileged reasoning that the primary purpose for consulting the accountant was to obtain accounting services (i.e., preparing tax returns) as opposed to legal advice from the lawyer. Similarly, in *Valero Energy v. United States*,⁸ the Seventh Circuit recently confirmed that worksheets containing financial data, estimating tax liability, discussing deductions and calculating gains and losses "contain the type of information generally gathered to facilitate the filing of a tax return, and such accounting advice is not covered by the privilege...whether or not the information

made it on the [filed tax returns]."

Transactional Advice

This line between legal and accounting advice also arises in the transactional context. For example, in *United States v. Adelman*,⁹ a corporate taxpayer had retained an accounting firm to provide advice regarding a proposed transaction. The court rejected the taxpayer's assertion of privilege, finding that it had failed to establish that the accountant was assisting lawyers in rendering legal services, as opposed to providing accounting advice.¹⁰

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accountant's activities in determining whether the communications in question are privileged. In *Bodega Investments v. United States*,¹¹ the taxpayer brought an action to challenge the IRS's disallowance of a \$28 million deduction that had been generated through a tax shelter predicated on foreign currency transactions. During discovery, the IRS sought to compel disclosure of various communications, including a number of otherwise privileged documents that were shared with non-parties to the attorney-client relationship.

In upholding the claim of privilege, Magistrate Judge Michael Dolinger of the Southern District of New York accepted the taxpayer's argument that if, as the IRS alleged, the transaction was "entirely tax-driven and lacked any commercial substance," then the "design of the structure and the planning of the deals" would be primarily the legal work of sophisticated attorneys so any communications with third parties would be for the purpose of providing legal advice to the client.

Pre-existing Relationships

Clients frequently want to use their own

return-preparer as the *Kovel* accountant, either because they have a long-standing relationship with the accountant, they perceive it as a way to save money or they want the lawyer to have ready access to the accountant's historical perspective. However, the use of the return-preparer in this fashion creates risks with respect to the *Kovel* privilege. In cases where the perceived benefits of using a return-preparer as the *Kovel* accountant outweigh the potential risks, the attorney should enter into a separate engagement letter with the accountant¹² and the accountant should set up an ethical screen within her office so that professionals who prepared the taxpayer's prior returns (or who will be working on the current or future year returns) will not have access to privileged communications.

Moreover, all parties should keep in mind that since the *Kovel* doctrine requires that communications be made for the purpose of obtaining legal advice, creating a *Kovel* relationship with the return preparer cannot protect the client's previous communications with the accountant from discovery. In *Black & Decker v. United States*,¹³ Magistrate Judge Beth Gesner of the District of Maryland identified the existence of a prior relationship between the client and the *Kovel* accountant as one of four factors to be considered in determining the applicability of the *Kovel* privilege. Gesner's analysis suggests that the privilege is most likely to be recognized where (a) there is no preexisting relationship between the client and the accountant, (b) the accountant's advice is provided directly to the attorneys, (c) any in-house counsel involved in the matter is not also a corporate officer, and (d) the attorneys initiated or received the accountant's communications.

In *Construction Industry Services v. Hanover*,¹⁴ the plaintiff relied heavily on advice from its outside accountant, including the accountant's evaluation of "the strength of the claims against the defendants" and his advice regarding "the choice of attorneys to conduct the litigation." The accountant's advice was based on the discussions with the attorneys who subsequently became counsel in the litigation, and the plaintiff argued that numerous letters and memoranda from the outside accountant to its CEO were protected from discovery under *Kovel*.

Magistrate Judge William Wall of the Eastern District of New York rejected this claim.

Citing an earlier Second Circuit decision, Wall explained that the outside accountant had provided litigation advice to the client—some of which was shared with the attorneys and some of which was not. Although the accountant and the client believed that these communications would be privileged because of their connection to litigation, in light of the timing of the communications, Wall concluded that plaintiff had failed to meet its burden of demonstrating that the documents were anything more than “communication between the party and that party’s outside accountant regarding litigation.”

Necessity of Services

Another requirement for *Kovel’s* application is that the “presence of the accountant is necessary, or at least highly useful, for the effective consultation between the client and lawyer which the privilege is designed to permit.”¹⁵ Courts have interpreted this requirement strictly, with the Second Circuit stating that privilege does not attach “solely because the communication proves important to the attorney’s ability to represent the client.” Rather, *Kovel* applies where the attorney is relying on the third party “to translate or interpret information [provided] by his client.”¹⁶

A recent Eastern District of New York case illustrates the relationship between the tasks performed by a *Kovel* accountant and the scope of the privilege. In *Ravenell v. Avis Budget Group*,¹⁷ the court denied a privilege claim asserted by a company that used an outside consulting firm to help classify its employees in compliance with the Fair Labor Standards Act. The consulting firm created an online platform to distribute and collect employee questionnaires and then, working from criteria provided by in-house counsel, summarized the data in a chart and made preliminary determinations about whether employees met the requirements for exempt positions under the act. The in-house attorneys made final decisions regarding the status of individual employees.

The court found that the first task—the implementation of a survey system—was privileged¹⁷ under *Kovel* because the employer and its in-house counsel “lacked the technological capacity to carry out this task.” In this regard, the consulting firm was “a necessary facilitator in the communication between counsel and client.” The court,

however, rejected the claim of privilege with respect to the consulting firm’s classification and analysis of the contents of the data, concluding that “in-house counsel had the ability to make [the classifications] themselves.”

Conclusion

An attorney engaging an accountant to assist in an investigation needs to take steps to ensure that the accountant is brought within the attorney-client umbrella and performs tasks that are necessary to facilitating his representation of the client. By limiting the accountant’s role in this way, the attorney maximizes the likelihood that both his and the client’s communications with the accountant will remain privileged.



1. *Couch v. United States*, 409 U.S. 322 (1973).
2. 26 U.S.C. §7525 only applies to noncriminal proceedings involving the United States to the extent that a communication would be privileged between a taxpayer and an attorney. While a number of states have statutory accountant-client privilege provisions, these provisions vary in scope and several do not apply to information subpoenaed by the government or sought in investigations of the accountant. See, e.g., Ky. Rev. Stat. Ann. §325.440(2)(b) (confidentiality provision does not “affect in any way a licensee’s obligation to comply with a validly issued subpoena or summons enforceable by order of court”); 225 Ill. Comp. Stat. 450/27 (accountant-client privilege does not “apply to any investigation or hearing undertaken pursuant to” the Illinois Public Accounting Act).
3. 296 F.2d 918 (2d Cir.1961).
4. The privilege has also been extended to some other third-party consultants including public relations consultants, *In re Grand Jury Subpoenas Dated March 24, 2003*, 265 F.Supp.2d 321 (S.D.N.Y. 2003) and financial advisers, *Urban Box Office Network v. Interfase Managers*, No. 01 Civ. 8854, 2006 WL 1004472, at 3 (S.D.N.Y. April 17, 2006).
5. 296 F.2d at 918.
6. 182 F.3d 496 (7th Cir. 1999).
7. 474 F.2d 297 (9th Cir. 1973).
8. 569 F.3d 626 (7th Cir. 2009).
9. 68 F.3d 1495 (2d Cir. 1995) (*Adlman I*).
10. In a later decision, however, the court accepted the taxpayer’s argument that the accounting firm’s assessment of likely IRS challenges to the transaction under consideration could be protected under the work-product doctrine so long as the analysis was prepared “because of” existing or expected litigation. See *United States v. Adelman*, 134 F.3d 1194 (2d Cir. 1998) (*Adlman II*).
11. No. 08 Civ. 4065, 2009 WL 1456642 (S.D.N.Y. May 14, 2009).
12. See *Adlman I*, 68 F.3d at 1500 (absence of contemporaneous

documentation reflecting that the engagement was being performed pursuant to a different arrangement and direct communication of recommendations to management as factors weighing against finding of privilege).

13. 219 F.R.D. 87 (D. Md. 2003).

14. 206 F.R.D. 43 (E.D.N.Y. 2001).

15. 296 F.2d at 922.

16. *United States v. Ackert*, 169 F.3d 136, 139 (2d Cir. 1999); see also *Cavallaro v. United States*, 284 F.3d 236, 249 (1st Cir. 2002) (holding that “[t]he involvement of the third party must be nearly indispensable or serve some specialized purpose in facilitating the attorney-client communications”); *In re Refco Sec. Litig.*, 280 F.R.D. 102, 105 (S.D.N.Y. Sept. 30, 2011) (communications not privileged even when an attorney relied on a third party’s “experience and specialized knowledge” if there was no “evidence that there was information [the attorney] could not understand without [the third party] translating or interpreting raw data for him”).

17. No. 08-CV-2113, 2012 WL 1150450 (E.D.N.Y. April 5, 2012).