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**PROGRAM MATERIALS**

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## **Celesq® Master Tax Series - The Kovel Accountant**

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# Defense & Privileges: The Kovel Accountant

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# The *Kovel* Accountant

## *Kovel*: The Case

- The Facts
- Confidential Communications Privilege
  - Already applied to “ministerial” functions: Court recognized that in delivering legal services, an attorney relies upon non-lawyers, such as paralegals and secretaries. These individuals are regularly exposed to confidential information.
  - What would happen if the information obtained by these individuals – as a result of their participation in private meetings with the client – was not privileged?



# The *Kovel* Accountant

- The government would have a “field day” subpoenaing them to come into court to testify about what they learned in these “closed door” meetings!
- As Judge Friendly recognized, disclosure of information to these individuals does *not* constitute a waiver of the privilege.

# The *Kovel* Accountant

- Judge Friendly also recognized that there will be times when attorneys find it helpful to engage professionals from *outside* of the firm, especially in an area as technical as accounting.
- Judge Friendly made a shrewd observation: “Accounting concepts are a *foreign concept* to some lawyers in almost all cases.”



# The *Kovel* Accountant

## The Birth of the Kovel Accountant

- In applying this principal to accountants, an attorney may want an accountant to meet with his client and obtain information directly from him.
- In these cases, the attorney needs reassurance that the information disclosed by her client will be cloaked in the attorney-client privilege just as if the attorney obtained it directly from the client.
- The only way this can happen, according to Judge Friendly, is through an arrangement where the lawyer engages the accountant to become part of the legal team. This marked the “birth” of the *Kovel* accountant.



# The Kovel Accountant

- What is a Kovel accountant? An accountant that is brought under the cloak of the attorney-client privilege, which is a stronger privilege than the tax practitioner-client privilege



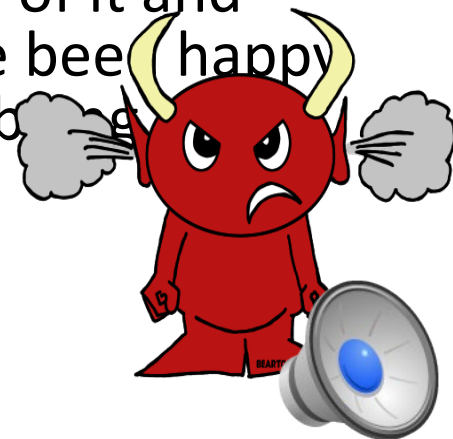
# The *Kovel* Accountant

- Burden: The government has the burden to disprove the privilege – the taxpayer does not have the burden of proof to establish it.

# The *Kovel* Accountant

## The Next Forty Years

- The government grudgingly codified *Kovel* into Section 7525 of the Internal Revenue Code. Section 7525(a)(1) of the IRC covers the common law protections of confidentiality that apply to *communications between a taxpayer and a federally authorized tax practitioner*.
- More precisely, the government codified some of it and ignored the rest. Judge Friendly could not have been happy because he clearly envisioned the privilege as being broad!
- Section 7525 made some key limitations.



# The *Kovel* Accountant

## Key Limitations of Section 7525

- (1) The privilege is only as broad as the attorney-client privilege. And when it comes to tax matters, the attorney-client privilege is *narrow*.
  - A. Privilege only protects communications involving “tax advice.”
  - B. Beware! We’re not talking about tax advice given by a *tax preparer*. Instead, we’re talking about tax advice given by an *attorney*.
  - C. What does this mean? Before a court will find that a tax preparer’s tax advice is protected by the attorney-client privilege, that tax advice must be a “*matter that is sufficiently within the professional competence of an attorney*.”
  - D. Tax matters that are *outside* the professional competence of an attorney are NOT privileged! One such example is the preparation of tax returns.



# Attorney-Client Privilege in Tax Realm

- The attorney-client privilege in the tax realm protects legal advice *and* tax advice. However, where the advice is tax advice, the scope of the privilege is *limited*.
- First, there is no privilege for communications relating to investment or business advice or services.
- Second, the preparation of tax returns is generally *not* considered to be legal advice within the scope of the privilege.

# Attorney-Client Privilege in Tax Realm

- A quick and dirty rule is that any legal advice given by a tax attorney that ultimately *ends up on the client's tax return* is treated as given as part of return preparation and is *not* covered by the privilege.
- For example, in *U.S. v. KPMG*, the court held that a tax opinion regarding the tax consequences of certain investment portfolio transactions was *not* subject to the attorney-client privilege because the opinion was “prepared in conjunction with preparation of a tax return.”

# Attorney-Client Privilege in Tax Realm

- However, the case of *U.S. v. Frederick* (7th Cir.) takes a more nuanced approach to the privilege stating that “it cannot be assumed that everything transmitted to the [tax attorney] by the taxpayer was intended to assist him in his tax preparation of a tax return and thus might be conveyed to the IRS.”
- The court recognized that information furnished to a tax attorney could just as easily have been offered by the client for the purpose of receiving legal advice.

# The *Kovel* Accountant

- (2) The privilege applies only in noncriminal tax matters before the IRS and noncriminal tax proceedings in Federal court brought by or against the United States.

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## Key Limitations of Section 7525 (cont'd)

- (3) The privilege applies only to communications between a “federally authorized tax practitioner” and the taxpayer. The latter includes those who are authorized to practice before the IRS, such as CPAs, EAs, and enrolled actuaries.
  - In *U.S. v. Arthur Young & Co.*, the Supreme Court of the United States held that accountants’ workpapers are *not* protected from an IRS summons under the work-product doctrine.
  - Information and documents that are already in the possession of a tax preparer are not privileged and thus could be obtained by IRS.
  
- (3) No protection exists for tax shelters.





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## The Takeaway

- These limitations, along with case law place a great deal of uncertainty in *Kovel* agreements.
- Example: While some courts deny the privilege when it comes to communications made solely for tax preparation, others acknowledge an element of legal advice in the preparation of returns.
- Case in point: Ninth Circuit Court of Appeals. It extends the privilege to communications made to obtain legal advice about a reporting position on a return, such as whether an item can be claimed as a deduction.



# The *Kovel* Accountant

## To Summarize:

- In tax cases, attorneys routinely hire forensic accountants to assist the attorney in delivering legal services to the client. The lawyer may want the accountant to meet with the client and obtain information directly from him, and cloak that information in the attorney-client privilege just as if the lawyer obtained the information directly from the client.
- The traditional method by which that is done is through an arrangement where the lawyer engages the accountant to become part of the legal team.
- Under this arrangement, the attorney-client privilege extends to the accountant.



# Strategy for Use of Kovel Accountant

- The Kovel accountant should be engaged as *early in the process as possible* in order to derive the maximum benefit from the accountant's work
- If the budget permits, three professionals should be engaged during an *egg shell audit*: (1) tax attorney, (2) forensic accountant, and an (3) independent accountant.
- The Kovel accountant would assist the tax attorney in gathering all potentially relevant information and the tax attorney would determine what portion of the information to disclose to the independent return preparer.

# Strategy for Use of Kovel Accountant

- In that way, while the independent preparer's knowledge is discoverable by the IRS, the information disclosed to the Kovel accountant would remain privileged under the attorney-client privilege.
- Keeping the roles of the original preparer and the Kovel accountant *distinct* best preserves the attorney-client privilege. Why?

# Strategy for Use of Kovel Accountant

- Using the original preparer as the Kovel accountant is a recipe for disaster (even though it saves money) because the risk is too great that the original preparer will not be able to distinguish between what he learned *prior* to the time the privilege attached and what he learned *after* the privilege attached. Only the latter would be covered by the attorney-client privilege.

# Strategy for Use of Kovel Accountant

- Moreover, the initial preparer already possesses enough information to provide a roadmap to the fraud making him witness number one in the Government's case against the taxpayer-defendant

# The *Kovel* Accountant

## How To Create An Airtight *Kovel* Agreement

- (1) Unless you want your accountant spilling his guts to a grand jury, metaphorically speaking, a written *Kovel* agreement that is specific to the client and the case must be drafted.
- (2) Second, the attorney should engage the *Kovel* accountant and *not* the client. This ensures that the accountant is working for the lawyer and not for the client.



# The *Kovel* Accountant

- (3) Finally, a new accountant, rather than the client's existing accountant, should be hired. And the roles of the original accountant and the new accountant must be kept distinct so that the new accountant is cloaked in the attorney-client privilege.





# The *Kovel* Accountant

- Reasons to start fresh and hire an independent accountant from the “get go”
  - Because the accountant-taxpayer privilege is so narrow, it is unlikely that the information and documents obtained by the preparer who prepared the original returns will be privileged.
  - Similarly, in preparing the amended returns, the preparer – regardless of whether he is the original preparer or a “new” one – is likely to uncover additional information that confirms that there were serious problems with the original return and that might even provide a roadmap to the fraud.



# The *Kovel* Accountant

- This is where things could go south fast! If the original preparer is used to amend the returns, he may not be able to distinguish between what he learned *prior* to the time the *Kovel* agreement went into effect and what he learned *after* the *Kovel* agreement went into effect.
- But only that which was learned within the scope of the *Kovel* agreement is protected by the attorney-client privilege. That which was learned pre-*Kovel* is par for the course.
- The net result is that if the defense cannot convince the judge that information subpoenaed by the IRS was obtained within the scope of the *Kovel* agreement, the judge will order the defense to turn it over to the government. It will be fully discoverable!
- And it just might be the “smoking gun” that the government needs to convict your client!

# The *Kovel* Accountant

## Obstacles to Overcome When Dealing With Your Client

- Your client will surely want to use his own accountant, citing any one of a number of “good” reasons, from budgetary concerns to relationship issues to level of comfort.
- You must convince him that this is not a risk worth taking and that he should start out “fresh” with a new accountant.
- However, if the budget truly does not permit hiring a new accountant and there is no other choice but to use the existing one, precautionary steps must be taken to ensure that information obtained during the course of the *Kovel* engagement is kept separate and distinct from information that was obtained *prior* to the engagement!



# The *Kovel* Accountant

- (4) Properly executed, a *Kovel* agreement gives the taxpayer's preparer the freedom to communicate with the taxpayer and his attorney ensuring that the taxpayer gets the best possible representation.



# Bonuses

(1) Download a **free** sample Kovel Agreement!

[www.deblislaw.com/wp-content/uploads/2015/03/Sample-Kovel-Agreement.pdf](http://www.deblislaw.com/wp-content/uploads/2015/03/Sample-Kovel-Agreement.pdf)



# Bonuses

(2) “The Greatness of Mickey Mantle and Louis Kovel”

<http://www.deblislaw.com/wp-content/uploads/2015/03/Mickey-Mantle-And-Louis-Kovel.pdf>

Global Tax Weekly, Feb. 26, 2015, p. 20





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