

The *Kovel* Privilege: How Does It Work?

Keeping Accountant-Client Communications Confidential

By Sharon L. McCarthy

A client's communications with an accountant enjoy a limited privilege under the Tax Code. In noncriminal tax matters, that privilege applies to any communication that "would be considered a privileged communication if it were between a taxpayer and an attorney" [IRC section 7525(a)(1)]. In the criminal context, however, no such privilege applies to communications between an accountant and a client, except when the accountant assists an attorney in providing legal advice to a client. This has been well-established law since 1961, when the Second Circuit Court of Appeals decided *United States v. Kovel* [296 F.2d 918 (2d Cir. 1961)].

This article will describe the basis for the *Kovel* privilege in the criminal tax context, the types of communications covered by the privilege, and the steps that should be followed to ensure that the privilege will be upheld if, for example, an accountant is subpoenaed to testify before a grand jury.

Basis for *Kovel* Privilege

Louis Kovel was a former IRS agent who worked at a tax law firm, where he assisted the firm's attorneys in representing clients with tax issues. Kovel was subpoenaed to testify before a Manhattan federal grand jury that was investigating one of the firm's clients. Although the law firm informed the prosecutor that Kovel, an employee, had worked under the attorneys' direct supervision in representing the client and therefore could not reveal privileged communications, the prosecutor's position was that the attorney-client privilege did not extend to a non-attorney. The judge agreed, and instructed Kovel to answer all questions put to him in the grand jury. Kovel answered some, but not all, of the prosecutor's questions in the grand jury, again asserting that he was bound by the attorney-client privilege not to reveal his client's confidences. Kovel was held in contempt and sentenced to one year in prison.

On appeal, the Second Circuit Court of Appeals vacated the district court's finding of contempt and made specific findings

that have guided attorneys and accountants for decades. First, the court acknowledged the following:

The complexities of modern existence prevent attorneys from effectively handling clients' affairs without the help of others; few lawyers could now practice without the assistance of secretaries, file clerks, telephone operators, messengers, clerks not yet admitted to the bar, and aides of other sorts. "The assistance of these agents being indispensable to his work and the communications of the client being often necessarily committed to them by the attorney or by the client himself, the privilege must include all the persons who act as the attorney's agents." [*Kovel*, 296 F.2d at 921 (quoting 8 Wigmore, Evidence, section 2301; Ann., 53 A.L.R. 369 (1928)); emphasis added].

Next, the court, in rejecting the prosecution's argument that only client communications with "menial" office staff were covered by the privilege, noted that accountants are needed in complex tax cases in order to act, in effect, as interpreters for attorneys. The court noted that the primary question to ask when analyzing whether the attorney-client privilege applies is, "Was the communication made in confidence for the purpose of obtaining legal advice from the lawyer?" If the answer is "yes," the attorney-client privilege applies; if the answer is "no," and the advice sought was only "accounting service," the privilege does not apply.

The types of tasks an accountant may be asked to perform under a *Kovel* arrangement in order to assist an attorney in providing legal advice to a client might include analyzing the client's books and records to determine if any tax problems exist; verifying the government's tax calculations; or preparing mock tax returns, including any unreported income as well as any unclaimed deductions in order to support a defense argument that there is little or no additional tax due. All of these are tasks that most attorneys are ill equipped to perform, yet are crucial in advising a client who faces the specter of criminal tax charges.

Communications Covered by the Kovel Privilege

It is well established that “the attorney-client privilege protects communications (1) between a client and his or her attorney (2) that are intended to be, and in fact were, kept confidential (3) for the purpose of obtaining or providing legal advice” [*United States v. Meijia*, 655 F.3d 126, 132 (2d Cir. 2011)]. The contours of the *Kovel* privilege—when the attorney-client privilege includes communications that include an accountant—can be somewhat confusing, even to the courts.

It is clear that the *Kovel* privilege does not apply to communications between an accountant and a client when the accountant has only been providing tax return preparation services. For example, if a client hires an accountant solely to prepare tax returns, no accountant-client communications—written or verbal—fall under the privilege. These include questions asked by the client about whether a certain deduction can be taken, or whether certain forms need to be filed. Even if the accountant conducts research in order to answer the client’s questions, including reading Tax Court opinions or legal articles, courts will not find those communications covered by the privilege, even though the advice provided is quasi-legal in nature. What is missing under such circumstances is the involvement of an attorney whose legal advice is being sought by the client.

On the other hand, it is clear that the *Kovel* privilege does apply to accountant-client communications when an attorney hires an accountant to assist in representing a client in a matter requiring the accountant’s expertise. In many such cases, an attorney may need the accountant to review the client’s previously filed tax returns and, taking into account new information (such as unreported income from a previously undisclosed foreign bank account), determine the client’s potential tax liability. The accountant’s analysis will be important for the attorney to advise the client on legal options, such as whether to plead guilty to criminal charges.

If, however, an accountant later prepares tax returns for a client that are ultimately filed with the IRS, any communications related solely to the return preparation will be deemed non-privileged. Courts have held that an accountant performing routine accounting work cannot have his work “magically” transformed into a protected *Kovel* relationship simply by being retained by an individual’s attorney. [See, for example, *United States v. Brooks*, 2010 WL 183522 *2 (E.D.N.Y. Jan. 8, 2010); and *Cavallaro v. United States*, 284 F.3d 236, 249 (1st Cir. 2002): “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.”]

The lines could blur, however, when a client confides about a potential criminal problem to his accountant who has solely been preparing his tax returns. For example, a client who has been visited by an IRS agent and asked questions about his undisclosed foreign bank account instinctively may turn to his tax return preparer for advice. In doing so, the client undoubtedly will reveal facts implicating himself in a crime (e.g., failure to report an offshore bank account to the IRS). If the accountant in that situation gives the client advice without the involve-

ment of an attorney, those communications will not be covered by the *Kovel* privilege.

The courts have held, however, that when a client reveals incriminating facts to an accountant for the purpose of obtaining the accountant’s advice in seeking legal advice, those limited communications may fall under the privilege. For example, in a case in the Fourth Circuit [*In re Grand Jury Proceedings Under Seal*, 947 F.2d 1188, 1188 (4th Cir. 1991)], an accountant who had done work for a client and his business was told by the client that he had some legal problems. They decided that, based upon the nature of the legal problems, the client should hire an attorney. After that decision was made, the client revealed the facts underlying his legal problem. Thereafter, the accountant participated in a meeting with the client and an attorney the client was considering retaining; at that meeting,

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the accountant provided most of the facts to the attorney. Although that attorney was not retained, the court found that when the client revealed the details underlying the legal problem, the attorney-client privilege related back to the communications that occurred prior to the meeting involving the attorney. This was because the purpose of the accountant-client communications had been to help the client obtain legal services. It also appears to have been relevant to the court that, at the meeting with the potential attorney, it was the accountant who explained the tax issue to the attorney, thus serving the role of an “interpreter” to the attorney. [See, for example, *United States v. Ackert*, 169 F.3d 136, 139 (2nd Cir. 1999): “*Kovel* recognized that an accountant can play a role analogous to an interpreter in helping the attorney understand financial information passed to the attorney by the client.”]

Steps to Follow

When entering into a *Kovel* relationship, attorneys and accountants need to be familiar with the contours of the privilege. An accountant who has previously provided tax return preparation services to a client may be tempted to stay on as the *Kovel* accountant once a criminal tax problem arises; however, such a strategy could backfire. First, the accountant may have a conflict with the client because, when criminal tax problems arise, the client’s initial instinct frequently is to blame the accountant for giving poor advice or missing a reporting issue. Second, even if there initially is no conflict, the accountant’s communications with the

client before the *Kovel* relationship began all will be fair game. The accountant then may find herself being called to testify about prior communications with the client up until the time of the attorney's involvement in the matter; it can be quite difficult in those circumstances to parse out which communications are and are not covered by the *Kovel* privilege.

The recommended approach is for an entirely objective accountant to be hired by the attorney to assist in representing the client in a criminal tax matter. Ideally, the attorney will first be retained by the client and then have the initial communication with the accountant in order to explain the matter and determine whether the accountant has the necessary expertise to assist. Once the attorney and

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accountant agree to work together, the attorney will retain the accountant by providing a written agreement setting forth the terms of the engagement. The attorney's engagement letter should include the following clear statements:

- The attorney is retaining the accountant to assist in representing a specific client.
- The accountant is to work under the attorney's direction and report directly to the attorney.
- The accountant should bill the attorney for these services, and the attorney will in turn bill the client.
- All communications between the accountant and the client, and between the accountant and any attorney, agent, or employee acting on behalf of the client, will be regarded as privileged and made solely for the purpose of assisting the attorney in giving legal advice to the client.
- The attorney retains ultimate control over the accountant's work papers generated in the course of the engagement.
- Unless the attorney gives written permission, the accountant is not to disclose to anyone any information obtained either orally or from any written communication provided to the accountant during the course of the engagement.
- The accountant will immediately notify the attorney if any third party attempts to gain access to the accountant's work product or any information generated or obtained by the accountant during the course of the engagement, including a court order, subpoena, or summons.

The engagement agreement should relate back to the date of the attorney's initial conversation with the accountant so that it is clear when the *Kovel* relationship began. For example, if the

Kovel agreement is dated May 4, 2014, but the attorney first spoke with the accountant about the matter on May 1, 2014, the body of the letter should refer to the agreement entered into on the earlier date.

While the above sets forth the ideal circumstances of entering into a *Kovel* relationship, reality can sometimes be messier. If an accountant with a prior relationship with the client is later engaged by an attorney to assist in providing legal advice to that client, the attorney-client privilege can apply to post-retention communications. In those situations, the accountant should make sure to maintain separate files—one containing privileged, and one containing non-privileged materials. That small effort will add support to the argument that post-retention, non-return-preparation communications are covered by the attorney-client privilege. Without such an effort, it will be more difficult for both the attorney and the accountant to identify which specific communications should be protected from disclosure.

How Privilege Is Asserted

In the course of conducting a criminal investigation, the government may seek evidence through a number of means, such as in-person interviews and grand jury subpoenas. Consistent with the terms of a *Kovel* agreement suggested above, an accountant faced with an interview request from the government or a grand jury subpoena should immediately notify the retaining attorney. It is the attorney's job to assert the attorney-client privilege on behalf of the client and, if necessary, to litigate the issues. The burden of proving the confidentiality of communications rests on the party asserting the privilege which, in the *Kovel* context, is the client [e.g., *United States v. Bump*, 605 F.2d 548, 551 (10th Cir. 1979)].

Of course, if the accountant is surprised by a visit from the government and has no opportunity to contact the retaining attorney, the accountant should inform the government that she is assisting the attorney in providing legal advice and therefore is unable to answer questions about the substance of communications with the client or the attorney without violating the attorney-client privilege. The accountant then should notify the attorney of the encounter.

Attention to Detail Is Important

For a *Kovel* agreement to withstand scrutiny and the attorney-client privilege to apply, it is crucial that attorneys and accountants pay close attention to the details of the engagement in order to avoid blurring the lines between legal and accounting advice. As discussed above, communications that stray into accounting advice and do not assist an attorney in providing legal advice are unlikely to be protected from disclosure. Although it may be easier and cheaper in the short term for a client to seek accounting advice from the *Kovel* accountant, if the issue has to be litigated because of murky facts, the client may end up paying much more in the end. □

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