
MEMORANDUM

RE: UNREPORTED INCOME (IRS): ATTORNEY-CLIENT
 PRIVILEGE (CPA'S): U.S. V. KOVEL

DATE: MAY 8, 2008

If retained by an attorney, client accountants may receive the benefits of Attorney-Client privilege. In **United States v. Kovel**, 296 F.2d 918 (2d Cir. 1961), the Attorney-Client privilege was extended to accountants retained to assist the attorney in understanding taxpayer's financial records.

The IRS Restructuring & Reform Act of 1998 extended Attorney-Client privilege to communications with federally authorized practitioners with respect to tax advice. (IRC § 7525)

IRC § 7525 applies to:

1. Any non-criminal matter before the IRS, or in Federal Court brought by or against the U.S.
2. IRC § 7525(b) provides the privilege will not apply to representation of a corporation involved in the promotion or the direct or indirect participation of any such corporation in any tax shelter.
3. The IRC § 7525 privilege does not extend to criminal tax investigations.

A federally authorized tax practitioner is any individual who is authorized under federal law to practice before the IRS. This includes attorneys, CPAs, and enrolled agents. IRC § 7525(a).

Tax advice is advice given by an individual on a matter for which he is authorized to practice before the IRS. IRC § 7525(a). In general, the privilege, like the common-law privilege, applies to the content of the advice, not the identity of the person seeking the advice.

For communications made on or after October 22, 2004, the privilege does not apply to written communications concerning tax shelters. Thus, the privilege does not apply to any written communication between a tax practitioner and any person, director, officer, employee, agent, or representative of a person, or any other person holding a capital or profits interest in a person, in connection with the promotion of the direct or indirect participation of the person in any tax shelter. IRC § 7525(b).

A tax shelter is a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, if a significant purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax. IRC § 6662(d)(2)(C). (This exception was limited to communications concerning corporate tax shelters, IRC § 7525(b), prior to amendment by Pub. L. 108-357, American Jobs Creation Act of 2004, Section 813.)

The IRS's position is that the Attorney-Client privilege also does not apply to tax accrual workpapers (tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on audited financial statements).

These workpapers are not generated in connection with seeking legal or tax advice, but are developed to evaluate a taxpayer's deferred or contingent tax liabilities in connection with a taxpayer's disclosure to third parties of the taxpayer's financial condition. IRS Announcement 2002-63, 2002-2 C.B. 72.

The crime-fraud exception may be asserted to defeat the claim of tax practitioner privilege for communications that were made for the purpose of getting advice for the commission of crime or fraud. This prevents a party from seeking advice to commit a crime or fraud and then claiming that the communication is privileged.

To assert the crime-fraud exception, (1) there must be a prima facie showing of a crime or fraud, and (2) the communications in question must be in furtherance of the misconduct. U.S. v. BDO Seidman, 368 F.Supp. 2d 858 (N.D. Ill. 2005). If the IRS shows sufficient evidence

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that the communication was made in furtherance of a crime or fraud, then the taxpayer may respond by providing an explanation that would rebut the IRS's evidence. The crime-fraud exception will apply only if the court finds the taxpayer's explanation unsatisfactory. U.S. v. BDO Seidman, No. 02 C 4822 (N.D. Ill. May 17, 2005), aff'd on this issue and vacated and remanded on other grounds, No. 05-3260 & 05-3518 (7th Cir. July 2, 2007).

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