Kovel and the Practitioner Privilege

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The authors explore the question whether the *Kovel* doctrine applies to communications of tax advice protected from disclosure under section 7525. They consider the text of the statute and the purpose of its enactment and conclude that section 7525, which incorporates the federal common law of attorney-client privilege into nonattorney adviser contexts, should be read to allow communications of tax advice involving *Kovel* agents.

Introduction

The premise of this article is that the *Kovel* doctrine applies to communications of tax advice that are otherwise protected from disclosure under section 7525, ''Confidentiality Privileges Relating to Taxpayer Communications.''

> With respect to tax advice, *the same common law protections* of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply between a taxpayer and a federally authorized tax practitioner, to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. Section 7525(a)(1) (emphasis added).

Through this statutory privilege, communications between a taxpayer and tax practitioner relating to tax advice are protected to the extent that the common law would protect those communications if the tax practitioner were an attorney. The *Kovel* doctrine is a development of the common law that extends the protections of the attorney-client privilege to communications with certain nonministerial third parties. Therefore, the *Kovel* doctrine applies to section 7525 communications.

The *Kovel* Doctrine

The attorney-client privilege provides an absolute protection from disclosure of confidential communications between attorney and client.[1] As a general rule, the presence of third parties during a communication, or disclosure to third parties of a communication, removes the confidential nature of the communication and therefore negates the privilege. Courts have recognized exceptions to this general rule so that persons other than the attorney and client can be privy to communications without destroying the privilege. For example, ministerial assistants to an attorney, such as secretaries, file clerks, and messengers, are extensions of the attorney, and communications with these assistants are protected by the privilege.[2]

Courts have also recognized that communications involving certain nonministerial third parties can also be covered by the attorney-client privilege if those third parties *facilitate* the attorney's rendering of legal advice to the client. The seminal case is *Kovel v. United States*, 296 F.2d 918 (2d Cir. 1961). Kovel was a former IRS revenue agent hired by a law firm to assist in tax matters. In the course of his duties, he was privy to conversations between the attorney and a client, and he received information from the client to assist the law firm in applying the tax law in the preparation of the client's return. The client became a prosecution target, and Kovel was called as a witness before the grand jury. He refused to answer some questions on the grounds of attorney-client privilege and was found to be in contempt.

On appeal of the contempt ruling, the Second Circuit recognized that some third parties, like interpreters or translators, are critical to effective communication between attorney and client. 296 F.2d at 921. For instance, an accountant, like Kovel, might act as a kind of ''translator'' who aids an attorney in understanding complex accounting matters. *Id.* The court reasoned that the assistance of accountants in tax cases could be ''necessary, or at least highly useful, for the effective consultation between client and lawyer which the privilege is designed to permit.'' *Id.* at 922. Finding that Kovel's assistance facilitated the attorney's tax advice to the client, the Second Circuit held that communications with Kovel

[1] *See* 8 Wigmore, *Evidence* section 2292 (McNaughton rev. ed. 1961) (noting that privilege applies when (1) legal advice is sought, (2) from an attorney, and (3) the communications relating to that advice are (4) made in confidence, (5) by the client). An accepted corollary is that the privilege applies to communications from the attorney to the client relating to the client's request for legal advice.

[2] *See, e.g., Edney v. Smith*, 425 F. Supp. 1038 (E.D.N.Y. 1976), *aff'd*, 556 F.2d 556 (2d Cir. 1977).

could be protected under the attorney-client privilege, and the court remanded the case for further factual development.

The Second Circuit's decision in *Kovel* thus extended the protections of the common-law attorney-client privilege to include communications involving nonministerial facilitators of the attorney. It set forth guidelines consistent with the general requirements of the privilege and the underlying rationale for the extension of the privilege — that is, the third party's expertise was useful to the attorney in rendering effective legal advice. First among those is that ''the communication [involving the third party] must be made in confidence for the purpose of obtaining legal advice from the lawyer.'' *Id*. And to confirm that the third party is acting in the appropriate role as facilitator to the attorney, a court should inquire into several areas: (1) what sort of advice the client is seeking — accounting or legal; (2) from whom the advice is being sought — the accountant or the lawyer; and (3) with whom the client first communicated regarding the issue — the accountant or the lawyer. *Id.* If the facts indicate that the third party is not facilitating an attorney's provision of legal advice or that the client is not seeking advice from the attorney but from the third party primarily, the *Kovel* protection may not apply.[3]

The Development of the *Kovel* Doctrine

The Second Circuit understood the scope of the potential application of its holding, noting that attorneys might employ ''accountants, scientists and investigators'' in an effort to keep communications with these assistants privileged. Subsequent courts have recognized the potential breadth of the doctrine and have found that a variety of third parties are *Kovel* agents.[4] In each case, the court found that the third party facilitated the rendering of effective legal advice to the client. Courts have also rejected claims of *Kovel* protection when the relationship between the third party and the client was the primary relationship and the legal advisory relationship was practically nonexistent or merely an addition.[5]

The *Kovel* doctrine continues to find new applications. Testament to its vitality is the 2003 decision of the U.S. District Court for the Southern District of New York in *In re Grand Jury Subpoenas Dated March 24, 2003 Directed to (A) Grand Jury Witness Firm and (B) Grand Jury Witness.* The court's analysis concluded that effective legal counsel in high-profile cases demands effective public relations and, therefore, the assistance of litigation media communications experts. What is important is that the decision approves the application of *Kovel* in the context of nontraditional legal advice. In other words, the type of legal advice that was being facilitated by the proposed *Kovel* agent was not a particular interpretation of the tax law, patent law, or securities law. The legal advice related to how to defend the client's interests in the court of public opinion. In this case, the client was a well-known and wealthy individual (given the court and the timing of the decision, it was likely Martha Stewart). The district court noted that a vigorous defense of a client's position in the media can be just as important to the defense in court during trial. Reports and articles can influence prosecutors, potential jury pools, and even judges. Thus, to preserve a fair prosecution as much as possible, the court reasoned that an attorney had to effectively communicate with and through the media.

Kovel and Nonattorney Tax Advisers

It is not difficult to conceive of situations in which the *Kovel* doctrine is properly applied to federally authorized tax practitioners. For example, accountants frequently prepare section 41 research credit studies of the expenses incurred by corporations in researching and developing new technologies. Under section 41, those expenses give rise to the credit to the extent they are qualified research expenses and meet a series of other statutory requirements. Because of the technical nature of the issues involved in determining whether an expense is for qualified research, tax practitioners will turn to technical experts to enable them to understand the technology involved and whether the expenses contributed to the development of a new or improved function, performance, or reliability. One can see the necessity of experts in a hypothetical situation involving a developer and manufacturer of semiconductors. While an accountant may understand the requirements of section 41, it is unlikely that he would be knowledgeable about how expenses and the related labor contributed to the improvement of a semiconductor's function, performance, or reliability. Thus, to provide tax advice to the semiconductor company regarding whether expenses are qualified research expenses, the accountant would need the assistance of a technical expert. As a practical matter, those experts could be the employees of the company,[6] but third-party

[3] *See, e.g., United States v. Adlman,* 68 F.3d 1495 (2d Cir. 1995) (rejecting claim of privilege regarding accounting firm tax opinion when circumstances indicated client sought tax advice from accountant and not assistance for in-house counsel's formulation of legal advice).

[4] *See, e.g., United States v. Bornstein*, 977 F.2d 112 (4th Cir. 1992) (extending privilege to accounting services ancillary to legal advice); *In re Grand Jury Subpoenas Dated March 24, 2003 Directed to (A) Grand Jury Witness Firm and (B) Grand Jury Witness*, 265 F. Supp.2d 321 (S.D.N.Y. 2003) (extending privilege to litigation media communications consultant); *Tri-State Outdoor Media Group, Inc. v. Official Comm. of Unsecured Creditors*, 283 B.R. 358 (Bankr. M.D. Ga. 2002) (extending privilege to actuaries); *Segerstrom v. United States*, 87 A.F.T.R. 2d 2001-1153 (N.D. Cal. 2001) (extending privilege to financial and tax adviser hired by client); *United States v. Alvarez*, 519 F.2d 1036 (3d Cir. 1975) (extending privilege to psychiatrists).

[5] *See, e.g., Adlman*, *supra* note 3; *Calvin Klein Trademark Trust v. Wachner*, 198 F.R.D. 53 (S.D.N.Y. 2000) (finding that retention of historic public relations firm was for ordinary public relations services in connection with pending litigation and did not support *Kovel* relationship).

(Footnote continued in next column.)

[6] Whether or not *Kovel* applies in the context of section 7525, communications between tax advisers and corporate employees would likely be protected by extension of the ruling in *Upjohn v. United States*, 449 U.S. 383 (1981) (affirming protection of attorney-client privilege for communications generated in the

(Footnote continued on next page.)

experts could also provide assistance and an independent evaluation of the nature of the work for which the expenses are incurred. In these circumstances, it is logical that any communications between the accountant and the technical experts, whether they be employees of the client or third-party consultants, would be privileged under the *Kovel* doctrine as incorporated by section 7525. If that were not the case, a situation could arise in which a lawyer providing a research credit analysis to the semiconductor company would have a privileged communication with a technical expert, while an accountant providing a similar analysis would not. That does not appear to be a justifiable result and seems contrary to the purpose of section 7525.[7]

A Closer Look at Section 7525

We have proceeded in this article under the assumption that the clear language of section 7525 requires the importation of federal common-law doctrines relating to the attorney-client privilege, including the *Kovel* doctrine. But does it? Let's review the language: ''With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply between a taxpayer and a federally authorized tax practitioner, to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.'' Perhaps a hypertechnical reading of this language could support the notion that only communications ''between a taxpayer and a federally authorized tax practitioner'' are protected and not communications between the tax adviser and any other person.

We cannot resolve this question; only the courts can do that. However, reason requires that some considerations be taken into account in answering the question. First, the subject matter of the section 7525 privilege is covered by ''the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney.'' It seems clear that one of those common-law protections is the *Kovel* protection. While communications protected by *Kovel* are by definition not directly and solely between attorney and client, the courts have judged that *Kovel* agents ought to be treated as within the scope of the privilege for the sake of fostering effective legal assistance. The *Kovel* agent is an agent of either the attorney or the client and under the doctrine is treated as an extension of the attorney or client, just as ministerial agents are treated.

Second, the relatively sparse legislative history sheds light on the purpose of the tax practitioner privilege, namely to remedy the unbalanced treatment of advice provided by nonattorney tax advisers compared to the same advice given by tax lawyers. The House originally proposed legislation similar to the final statute. The House report stated that ''the privilege of confidentiality under [the proposed] provision applies in the same manner and with the same limitations as the attorney-client privilege of present law.''[8] The Senate amended the House version to expand the application of the privilege, in short so the privilege applied to federal court proceedings involving the IRS in addition to proceedings before the IRS.[9] The joint House-Senate committee approved the Senate version with one additional exception to the privilege for communications in connection with the promotion of corporate tax shelters.[10] Sen. Connie Mack, one of the legislation's sponsors, felt that the law was needed to prevent the ''unfair penalty'' on taxpayers who used nonattorney tax advisers for tax advice instead of tax attorneys.[11] Rep. E. Clay Shaw Jr. expressed a similar sentiment during floor debates.[12] Thus, interpreting section 7525 to incorporate the same common-law protection of *Kovel* to nonattorney tax advisers would seem to agree with the purpose of the statute as expressed in the legislative history.

Reasonable tax policy might also suggest the extension of *Kovel* to section 7525 communications. In one respect, equalizing the protection of tax advice rendered by attorneys and other tax professionals reduces the overall burden on taxpayers whose primary tax adviser is not an attorney. Those taxpayers would otherwise be pressured to seek the advice of attorneys when they have perhaps more sensitive tax issues and transactions to discuss. Taxpayers, however, should be able to seek advice from their historic and trusted tax adviser (for example, an accounting firm) or from an expert they know (for example, an attorney at an accounting firm) without building into their choice of adviser the privilege factor. This rationale seems persuasive, considering that many accounting firm tax advisers are attorneys by training and experience. Thus, when a taxpayer receives advice from a recognized accounting firm expert, the availability of the privilege should not skew the taxpayer to someone other than a first choice. *Kovel* is an important facet of the attorney-client privilege, and if section 7525's policy goal is to minimize the privilege factor in the choice of tax adviser, extension of this doctrine fits with that goal. Take the following example.

Assume that a company has worked extensively with its accounting firm on developing facts to support the company's claim for the research credit. Suppose further that the company decides it is in its best interest to have an engineer involved in the evaluation of the claim. When the accounting firm has been the laboring oar, has competent tax advisers, and can otherwise handle the matter, good tax policy would suggest that the accounting firm should be able to retain that engineer as a *Kovel*

course of an internal investigation between outside counsel and knowledgeable company employees).

[7]An extension of this logic would also protect communications between accountants when the tax accountant does not understand relevant, subtle financial accounting concepts or rules.

[8]H.R. Rep. No. 105-364, pt. 1, at 66 (1997).
[9]S. Rep. No. 105-174, at 70 (1998).
[10]H.R. Rep. No. 105-599 (1998) (Conf. Rep.).
[11]144 *Cong. Rec.* S7667 (daily ed. July 8, 1998).
[12]144 *Cong. Rec.* H5359 (daily ed. June 25, 1998).

agent instead of forcing the company to retain an attorney for the purpose of protecting communications with the engineer.

Conclusion

This short discussion is a consideration of one of the implications of section 7525. By incorporating the body of federal common law relating to attorney-client privilege into tax adviser communications, Congress accessed a long history of cases, distinctions, and developments. The attorney-client privilege is one of the oldest of our testimonial privileges.[13] The *Kovel* doctrine is one of the developments of the privilege, and the cases interpreting *Kovel* are themselves numerous. Our suggestion here is that, based on the plain language of the code and tax policy rationale, *Kovel* can apply to tax adviser communications protected under section 7525.

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[13]*See, e.g., Evergreen Trading LLC v. United States*, 80 Fed. Cl. 122 (2007) (tracing the privilege to Roman law).