Ethical Issues with Experts in Federal Tax Practice

Avoiding waiver of attorney-client privilege and / or work product protection when using experts in tax cases.

I. Attorney-client privilege
   a. “The attorney-client privilege ‘applies to communications made in confidence by a client to an attorney for the purpose of obtaining legal advice, and also to confidential communications made by the attorney to the client if such communications contain legal advice or reveal confidential information on which the client seeks advice.’” Bernardo v. Commissioner, 104 T.C. 677, 682 (1995).
   b. Extends to communications with one employed to assist the lawyer in rendering legal services. Id.
      1. Assistants, IT guy, etc. (ABA Model Rule 5.3, nonlawyer assistance, comment 3).
      2. Extends to communications with outside “experts”, such as accountants, whose services “interpreting” the tax code are necessary to render legal advice. United States v. Kovel, 296 F.2d 918 (2d Cir. 1961). See below Section III

II. Work product doctrine
    a. “The work product doctrine protects documents, interviews, statements, memoranda, correspondence, briefs, mental impressions, and tangible things prepared by an attorney in anticipation of litigation or trial.” Bernardo, 104 T.C. at 687.
       i. Broader than attorney-client privilege but does not provide absolute protection.

III. Understanding the scope and effectiveness of Kovel
    b. Kovel court concluded the attorney-client privilege protects communications made from a client to an accountant under the same circumstances under which the privilege would protect communications made in confidence to an interpreter where:

       (1) the client has brought an accountant to meet with the attorney;

       (2) the accountant works for the attorney and, at the attorney's request, either sits in on the meeting with the client
and the attorney, or meets with the client after the meeting with the attorney; or

(3) the attorney sends the client to an accountant whom the attorney has engaged for the purpose of assisting in the representation. Michael I. Saltzman & Leslie Book, IRS Practice and Procedure §13.04[3][a][ii] (Rev. 2nd ed. 2002, with updates through February 2018).

c. While the doctrine originated in the context of an accountant, the doctrine has been extended to a wide range of experts and consultants who may be engaged by an attorney with providing legal advice to the client.

d. Requirements

i. Purpose of the communication must be to obtain legal advice from the attorney, not simply to obtain the advice of the non-attorney. See United States v. Chevron Texaco Corp., 241 F. Supp. 2d 1065, 1072 (N.D. Cal. 2002) (privilege not extended “where the accountant is hired merely to give additional legal advice about complying with the tax code even where doing so would assist the attorney in advising the client”); Blumenthal v. Drudge, 186 F.R.D. 236, 243 (D.D.C. 1999) (privilege inapplicable where litigation consultant was retained for the value of his or her own advice, not to assist the defendant’s attorneys in providing their legal advice).

ii. Attorney must require (need) the non-attorney’s assistance to render legal advice to the client. See In re G-I Holdings, 218 F.R.D. 428 (D. N.J. 2003); United States v. Chevron Texaco Corp., 241 F. Supp. 2d 1065, 1072 (N.D. Cal. 2002); Cavallaro v. United States, 284 F.3d 236, 249 (1st Cir. 2002) (“The involvement of the third party must be nearly indispensable or serve some specialized purpose in facilitating the attorney-client communication.”).

iii. The non-attorney must act at the direction of the attorney, not independently or at the direction of the client, and the services provided by the non-attorney under the Kovel arrangement must be distinct from any other services that the non-attorney is providing the client.

e. Kovel Arrangements
i. Contemporaneous engagement letter from the attorney to the non-attorney reciting that the non-attorney is being retained to assist the attorney in providing legal advice, and stating that the non-attorney will be paid by, take direction from, and provide all reports, conclusions and documents to the attorney. See United States v. Adlman, 68 F.3d 1495, 1500 (2nd Cir. 1995).

ii. Practice Note: In practice, Kovel arrangements often provide that the client will pay the Kovel adviser directly, as a law firm do not customarily absorb the cost of advisers, interpreters, travel expenses, or many other client-related expenses.

f. Limitations

i. Privilege does not apply to all communications with attorney- or client-retained accountants

1. “If what is sought is not legal advice, but only accounting service, ... or if the advice sought is the accountant's rather than the lawyer's, no privilege exists.” Kovel at 922.

2. Privilege does not protect every communication with an accountant hired by an attorney (“Nothing in the policy of the privilege suggests that attorneys, simply by placing accountants, scientists or investigators on their payrolls and maintaining them in their offices, should be able to invest all communications by clients to such persons with a privilege...” Kovel at 921).

g. Ethical Considerations

i. Circular 230 Issues.

1. Tax practitioners use Kovel arrangements in a variety of ways, including:

   a. to provide behind the scenes (non-testifying) accounting analysis in support of an examination, appeal, criminal tax matter, or tax litigation;

   b. to provide other behind the scenes technical support during an examination, appeal, criminal tax matter or tax litigation, such as valuation
expertise, engineering, interpreting, data analysis, sentencing consultants, etc;

c. to provide similar support in a transaction or pre-examination risk assessment;

d. Potential expert witnesses prior to the attorney naming the person as a testifying expert. Note: This engagement approach is common in litigation to prevent disclosing information related to an expert who reaches an adverse conclusion and is not ultimately engaged to testify;

e. The “face of the audit” – frequently used in egg-shell examinations or complex civil examinations when litigation is anticipated and maintaining privilege is critical. Note that IRC 7525 does not apply in criminal cases.

h. Cir. 230 issues may arise for the employing lawyer in varying ways, including when a Kovel is the face of the audit or working behind the scenes. Examples include:

i. Cir. § 10.20: Requires practitioners to promptly submit records to the IRS unless the practitioner believes in good faith and on reasonable grounds that the records and information are privileged. Improperly asserting a Kovel privilege (unreasonably and in bad faith) would violate § 10.20.

ii. Cir. 230 § 10.24/25: Assistance from disbarred or suspended persons; former IRS employees; former government employees; their partners and associates. Practitioners should ensure that a Kovel arrangement does not violate these provisions.

iii. Cir. 230 § 10.29: Conflicting interests. May arise where the accountant has personal or professional exposure for prior advice or relationships with the client.

iv. Cir. 230 § 10.34: Standards with respect to tax return and documents.

v. Cir. 230 § 10.36(3): A practitioner who has principal authority and responsibility over a firm’s tax practice must take reasonable steps to ensure that the firm has adequate procedures to ensure compliance with Circular 230. Such
procedures extend to individuals who are engaged or employed by the Firm, likely including Kovel advisers.

i. ABA Model Rules of Professional Conduct

   i. ABA Model Rule 5.3: Responsibilities Regarding Nonlawyer assistance: When a nonlawyer is employed or retained by a lawyer (such as through a Kovel arrangement) a lawyer is required to “make reasonable efforts” to ensure that the nonlawyer’s conduct is compatible with the professional obligations of the lawyer. A lawyer cannot order or ratify the conduct of a nonlawyer that violates the rules of professional conduct.

   ii. Potentially relevant Model Rules include:

       1. Diligence (R. 1.3)
       2. Communications (R. 1.4)
       3. Fees (R. 1.5)
       4. Confidentiality (R. 1.6)
       5. Conflicts (Rules 1.7-1.12)
       6. Safekeeping property (R. 1.15)
       7. Candor towards the tribunal (R. 3.3) – note that the IRS is not a tribunal. (ABA Opinion 314). But, there is a duty not to mislead the IRS by misstatements, silence, or permitting the client to mislead. Lawyers should exercise caution when a Kovel accountant is acting as the face of the audit.

j. Using Kovel experts in litigation

   i. Litigation support (Cir. 230 is not applicable, but bar rules apply);

   ii. Kovel as an expert witness (not recommended, as it creates issues of independence, etc.);

IV. Understanding implications of using experts and the differences between testifying experts and non-testifying experts

   a. How experts are used

      i. Civil
ii. Criminal
   1. Expert testimony by an IRS agent or other tax expert which expresses an opinion as to the proper tax consequences of a transaction is admissible, but not testimony that goes to the defendant’s state of mind. United States v. Duncan, 42 F.3d 97, 101–02 (2d Cir.1994); United States v. Stadmauer, 620 F.3d 230 (3d Cir. 2010); United States v. Moore, 997 F.2d 55, 58–59 (5th Cir.1993); United States v. Sabino, 274 F.3d 1053, 1067 (6th Cir.2001), modified on other grounds, 307 F.3d 446 (6th Cir.2002); United States v. Pree, 408 F.3d 855, 870 (7th Cir.2005); United States v. Bedford, 536 F.3d 1148, 1158 (10th Cir.2008).
      a. Must testify based only on facts in evidence – cannot testify based on unproven facts.
      b. Cannot testify about defendant’s state of mind.
      c. Cannot testify directly about “the law,” but instead merely describe the outcome.

\textit{Compare}

“The law requires taxpayers to pay capital gains tax on the sale of stock”

\textit{with}

“When the taxpayer sold stock he bought for $1 a share for $101 a share, this generated a capital gain of $100 a share, which should have been included on his tax return”

b. Federal Rule Civil Procedure 26
   i. Former Rule 26 resulted in wide-spread disclosure of expert opinions and, as a result, attorneys feared disclosure of work product. FRCP 26 and Tax Court Rule 70 were both amended in 2010 to curtail discovery of work product and Rule 70 of the United States Tax Court Rules of Practice and Procedure was amended in 2012 to largely follow Rule 26 of FRCP.

   c. Implications of changes to FRCP 26 and Tax Court Rule 70 in Tax Cases
      i. Testifying Experts
1. Before the 2010 amendment, Rule 26 required a testifying expert’s report to contain “the data or other information considered by the witness in forming” opinions. Now the rule requires disclosure only of “facts or data” and not the “other information” considered.

2. Under the new Rule, drafts of reports or disclosures required are protected
   
   ii. FRCP 26 and Tax Court Rule 70 now protect:
   1. Drafts of expert reports required under Rule 143
   2. Communications between attorneys and witnesses required to provide a report under Rule 143 (exceptions below)
   
   iii. Non-testifying / Consulting Experts
   1. FRCP 26 and Tax Court Rule 70 do not expressly address or protect:
      
      a. Drafts or communications for witnesses not required to submit a report.
         
         i. Consider implications, if any, for Kovel accountant. Attorneys must ensure that they are taking steps to preserve the Kovel relationship
         
         ii. Must rely on traditional attorney-client privilege and / or work-product doctrine for non-testifying experts
            
            
      b. FRCP and Tax Court Rule 70 expressly exempt from protection communications that:
         
         i. Relate to compensation for the expert’s study or testimony
         
         ii. Identify facts or data the party’s counsel provided to the expert and the expert considered in forming opinions to be expressed
         
         iii. Identify assumptions the party’s counsel provided and that the expert relied on in forming the opinions to be expressed.
c. Courts have also allowed discovery into whether and to what extent counsel has assisted in preparing the expert report.

V. Tax Workpapers and client confidentiality
   a. Accountant’s Audit or Tax Return Work Papers Generally Not Protected.
      i. Accountant’s work papers and work product generally are not privileged unless derived from the attorney’s work product privilege. *United States v. Arthur Young & Company*, 465 U.S. 805 (1984). The court noted that guidelines issued by the IRS during the course of litigation provided that the examiner should seek tax accrual work papers only in “unusual circumstances” and only as a “collateral source” for factual data.”
      ii. IRS has a general policy of restraint

b. Litigation

c. Dual Purpose Documents – “Because of” or “Principal purpose” Tests
d. Is an auditor an adversary?