July, 1999

The New Accountant-Client Privilege Provision: A Partial Step Forward for Nonattorney Practitioners

Francine J. Lipman
James E. Williamson

Available at: https://works.bepress.com/francine_lipman/14/
The New Accountant-Client Privilege Provision: A Partial Step Forward for Nonattorney Tax Practitioners

Francine J. Lipman, LL.M., MBA, CPA
Tax Attorney, O'Melveny & Nyers LLP, Newport Beach

James E. Williamson, PhD, CPA
Professor of Accounting and Taxation, San Diego State University

Introduction

For years accountants have argued that nonattorney tax preparers’ communications with their clients should be protected by the same privilege that applies to attorney-client communications. Accountants argue that without such privileged confidentiality, clients might be reluctant to disclose information that tax practitioners must have to properly prepare their clients’ tax returns. Accountants also believe that to properly represent their clients in IRS investigations, their accountant-client communications must be protected. Without such privilege, nonattorney tax practitioners are often hesitant to probe into areas that should be analyzed, because of their legitimate concerns that their accountant-client communications are not protected. On the other side of the debate, extending the attorney-client privilege to non-lawyers has generally been, and was recently opposed by the American Bar Association.

During the summer of 1998, Congress ended this heated debate when it passed and President Clinton signed into law the Internal Revenue Service Restructuring and Reform Act of 1998. New Section 7525 of the Internal Revenue Code of 1986, as amended (the "Code"), extends the attorney-client privilege to CPAs and enrolled agents and actuaries in certain federal noncriminal tax matters for communications made after July 22, 1998. Specifically, the new accountant-client privilege extends to taxpayers confidentiality protection for "tax advice" given by CPAs and enrolled agents and actuaries in matters before the IRS or in cases before a federal court in which a federal tax is involved.

While tax practitioners may have initially believed that they made significant strides in their quest for protection for their client communications, the new accountant-client privilege is limited and significantly narrower than the attorney-client privilege. For instance, the new privilege extended to accountants does not apply to criminal proceedings or written communications concerning the promotion of corporate tax shelters. Additionally, Congress did not extend the privilege to accountants who are not CPAs or enrolled agents.

Limitations and Uncertainties Concerning the New Privilege

Now that the privilege is law, accountants have an added burden of trying to comprehend another level of complexity in an already muddled area. Moreover, because of the limitations and uncertain scope and application of new Code Section 7525, tax practitioners should be cautious when relying upon this privilege to protect their accountant-client communications. The overriding reality is that the accountant-client privilege is much narrower than the attorney-client privilege, which generally protects communications between a client and attorney in all proceedings and for all times, unless the client waives protection.

The New Privilege Only Protects "Tax Advice"

The accountant-client privilege is expressly limited to "tax advice." Congress has defined "tax advice" in this context as advice given with respect to a matter within the scope of the tax practitioner’s authority to practice before the IRS. Consequently, the privilege will not protect accountant-client communication when tax practitioners act in any other capacity such as business advisor, because it is not to distinguish "tax advice" from general business or accounting advice, in practice it is not clear when "tax advice" becomes business advice that is not covered by the privilege. Unfortunately, there is little judicial guidance that can help accountants regarding this distinction, between legal tax advice and business tax adv-
vice. These already vague issues become even more muddied when a corporate client engages the same accounting firm to provide a combination of tax, audit, accounting and information system services. The interaction among accounting firm professionals performing these different, but interdependent, advisory services and business planning services necessarily occurs on a routine basis. Accordingly, because of the likely sharing of tax information by tax practitioners with non-tax practitioners within the same accounting firm, the privilege for "tax advice" may provide little protection for full service corporate clients.

Beware of Unintentional Waiver of the New Privilege

Furthermore, if a client voluntarily discloses an accountant-client communication to anyone other than the tax practitioner, the client, or certain persons under the direction and control of the practitioner or client, the client has intentionally or unintentionally waived the privilege. Waiver may occur by express and voluntary surrender of the privilege, by partial disclosure of a privileged document, by selective disclosure to some "outsiders" or by inadvertent overhearing or disclosure. Not surprisingly, a client's federal tax return, which is filed with and disclosed to the IRS, is not protected by the privilege. Perhaps more significantly, the underlying basis for the numbers on such tax returns (including supporting tax work papers and related memoranda) and calculations are outside of the scope of the privilege. Even the voluntary, but unintentional disclosure in a divorce proceeding might constitute a waiver of the privilege as to the IRS.

Corporate tax clients may also voluntarily, but unintentionally waive the privilege with respect to certain documents that they are required to disclose to the public. Publicly traded corporate taxpayers must routinely disclose financial information, including certain tax items, which tax accountants have likely supported with tax work papers and advice memoranda. Because these corporations disclose financial information to the SEC and other regulatory agencies, any privilege that may have attached to the underlying tax documents has been waived. Similarly, tax opinions and tax advice memoranda, if disclosed to bankers, security brokers, financial or any other advisors not involved in the tax advice process, are not protected by the privilege.

Therefore, accounting firms should develop and implement internal guidelines and controls to avoid unintentional waiver of a tax client's privilege.

The New Privilege Does Not Apply to Criminal Matters

Additionally, the accountant-client privilege explicitly does not extend to criminal tax matters. Consequently, a critical and challenging issue for tax practitioners and potential tax clients is determining at what point an ordinary tax matter becomes a criminal matter. The IRS has a great deal of discretion in handling tax matters by relying on fraud or related penalties or by handing such matters off to criminal prosecutors. Therefore, accountants and their clients may want to engage competent tax attorneys at the first hint of a criminal investigation for the significantly more certain protection of the attorney-client privilege.

However, accountants need to be aware that, even when an attorney is engaged for a criminal investigation, the attorney-client privilege may not protect a tax client who was not represented by an attorney during the "pre-criminal" period. It appears that the IRS may be able to strip away the accountant-client privilege retroactively, back to the beginning of the matter before the parties discovered any criminal aspects. Given this situation, the IRS may be able to obtain all communications between the accountant and her client even if they occurred during the "pre-criminal" period. A period during which both the accountant and the client thought the privilege protected their communications. Because the attorney-client privilege continues in criminal matters when the accountant-client privilege does not, tax practitioners need to be aware of these issues regarding the distinction between noncriminal and criminal matters and the critical timing of this potentially subtle distinction. Eventually, regulations or litigation may clarify these uncertain and unsettled issues.

Beware of Connections to Any Tax Shelter for Corporate Clients

Additionally, the accountant-client privilege expressly does not apply to any written communication between the tax practitioner and a director, shareholder, officer, employee, agent or representative of a corporation in connection with the promotion of the direct or indirect participation of such a corporation in any tax shelter. For this purpose, Congress uses an extremely broad definition of "tax shelter." A "tax shelter" is a partnership, entity, plan or arrangement of a significant purpose of which is the avoidance or evasion of federal income tax. The stated reason for the carve-out of the "tax shelter" exception from the privilege is that Congress does not consider the promotion of tax shelters as part of the routine relationship between a tax practitioner and a client. This carve-out, however, may be inconsistent with an accountant's tax advice to corporate clients regarding structuring pending transactions to minimize or even eliminate their federal tax costs. The unanswered question here is when does tax savings advice become advice in connection with the promotion of a tax shelter?

Summary

Because of the lack of clarity in the scope of the newly enacted accountant-client privilege, tax practitioners and tax clients should be extremely cautious when relying upon the privilege in their communications. Tax practitioners and clients who believe their communication is protected by this narrowly drafted privilege may under certain circumstances find themselves completely stripped of the privilege even retroactively. It is extremely important that tax practitioners and their clients examine each situation in order not to be misled into believing that information is protected under the privilege when it is not. Accountants relying upon the new privilege have a significant educational burden in terms of helping their clients and themselves understand what is at best a voidable privilege.

Francine J. Lipman is a tax attorney working in the Newport Beach office of O'Melveny & Myers LLP. She holds a LL.M. in taxation from New York University and has taught tax at Chapman University and Golden Gate University. Lipman is also a CIA. James L. Williamson is a professor of accounting and taxation at San Diego State University. He holds a Ph.D., from the University of Minnesota and has also taught at CUNY Baruch and UCSD. Williamson is also a CPA. Lipman and Williamson have previously collaborated on articles in Tax Notes, Trusts & Estates, Real Estate Law Journal, The Practical Tax Lawyer, Journal of Real Estate Taxation and Los Angeles Lawyers, among other journals.