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# Federal Tax Controversies: Privilege, Protection, and the *Kovel* Doctrine

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*Understanding legal safeguards in tax-related disputes*

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# Agenda

- Attorney–Client Privilege in Federal Tax Controversies
- Waiver Triggers and Safeguards in Tax Practice
- Attorney Work-Product Protection and Related Doctrines
- Tax-Practitioner Privilege under I.R.C. § 7525
- Common-Interest, Joint-Defense, and Fifth-Amendment Doctrines
- IRS Policy of Restraint and Tax-Accrual Workpapers
- The *Kovel* Doctrine: Extending Privilege to Non-Lawyer Experts
- Designing and Implementing a Defensible *Kovel* Architecture

# **Attorney–Client Privilege in Federal Tax Controversies**

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# Elements and Limitations of Attorney–Client Privilege

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## Four Elements of Privilege

Attorney–client privilege requires a communication, between a lawyer and the client, made in confidence, and for the purpose of seeking, obtaining, or providing legal advice to the client.

## Scope of Privilege

Privilege excludes business advice, tax work such as tax return preparation, and non-legal communications even if from an attorney.

## Non-Attachment Cases

Privilege does not apply to business records like accounting files, engagement letters, or legal service invoices.

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# Burden of Proof for Privilege Assertion

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## **Burden on Privilege Asserter**

The party claiming attorney-client privilege must prove its applicability with specific evidence.

## **Specific Facts Required**

Blanket assertions are insufficient; detailed facts must demonstrate privilege on each item.

## **Document-by-Document Assertion**

Privilege must be asserted individually for each document or question to maintain validity.

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# Distinguishing Business Advice from Legal/Tax Advice

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## **Attorney-Client Privilege Scope**

Privilege applies only to communications seeking legal advice, not business advice.

## **Legal and Tax Advice**

Legal (tax law) advice from attorneys is protected under attorney-client privilege.

## **Business Advice Exclusion**

Business advice communications lack attorney-client privilege protection even if those communications are with an attorney.

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# Corporate Context and *Upjohn* Principles

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## **Client Identity in Corporate Law**

The client is the corporate entity, not individual employees, which controls any waiver of privilege.

## ***Upjohn* Warning Essentials**

Counsel must clarify representation of the entity, privilege ownership, and possible disclosure by the entity.

## **Definition of Client Representative**

Client representatives are employees who provide information to counsel for legal advice, per court standards.

# **Waiver Triggers and Safeguards in Tax Practice**

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# Frequent Waiver Triggers in the Tax Arena

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## **Third-Party Email Disclosure**

Copying outside auditors or tax return preparers on privileged emails may trigger a subject matter waiver of attorney-client privilege.

## **Forwarding Privileged Documents**

Forwarding tax opinions or privileged legal memos to outside accounting personnel can trigger a subject matter waiver of the subject matter of the communication.

## **Penalty Defense Implications**

Asserting a penalty defense that refers to taxpayer's state of mind creates an implied waiver of all related communications.

## **Public Reference to Privileged Advice**

Executives' testimony or IRS submissions referencing privileged advice can cause waiver depending on content detail.

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# Practical Safeguards to Preserve Privilege

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## **Label Privileged Communications**

Clearly label all privileged documents as “Privileged & Confidential” to aid electronic discovery processes.

## **Segregate Privileged Files**

Keep privileged files separate from business files using locked folders or legal-only SharePoint sites for security.

## **Privilege Training for Teams**

Conduct regular training for tax, finance, and treasury teams using real examples to ensure understanding of privilege.

## **Control Legal Advice Sharing**

Implement rules preventing employees from forwarding legal advice outside without counsel’s prior approval.

## **Waiver Requires Initial Privilege**

Realize that, if something is not in fact privileged, sharing the information does not result in subject-matter waiver.

# **Attorney Work- Product Protection and Related Doctrines**

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# Statutory Basis and Types of Work Product

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## **Statutory Protection Basis**

Federal Rule of Civil Procedure 26(b)(3) and Tax Court Rule 70(c)(3) protect documents prepared in anticipation of litigation.

## **Fact Work Product**

Fact work product includes objective data like chronologies and interview summaries discoverable under substantial need.

## **Opinion Work Product**

Opinion work product contains counsel's mental impressions and strategies and is rarely discoverable except in exceptional cases.

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# Anticipation of Litigation in Tax Matters

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## **Sliding-Scale Test for Litigation**

Courts use a sliding-scale test to determine if litigation was reasonably foreseeable, not just a possibility.

## **Common Tax Audit Triggers**

Typical triggers include IRS audit opening letters, IDRs on contentious issues, and Notices of Proposed Adjustment.

## **Importance of Litigation Holds**

Issuing litigation holds helps document anticipation of litigation and can prevent spoliation claims during tax disputes.

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# Compatibility with *Kovel* and Sharing Work Product

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## *Kovel* Doctrine Overview

The *Kovel* doctrine extends the attorney-client privilege to communications with third-party experts **retained by** and acting **under counsel's direction** – such as accountants or economists – **solely to assist counsel in furnishing legal advice**, with confidentiality preserved and scope limited to that purpose; *Kovel* does not extend to ordinary, non-legal accounting services of tax return preparation work.

**Tax-Practitioner  
Privilege under  
I.R.C. Section 7525**

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# Overview and Key Limitations

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## Privilege Scope

Section 7525 applies attorney-client privilege to federally authorized tax practitioners in non-criminal, federal tax matters.

## Limited Applicability

Privilege is limited to federal civil tax proceedings and does not protect against disclosure in criminal matters, state litigation (including state tax matters), SEC litigation and other non-tax contexts, and private litigation.

## Exclusions from Privilege

No privilege protection for tax return preparation, criminal investigations, or tax shelter promotions. Be careful about asserting the privilege if IRS would attempt to break the privilege by seeking a judicial determination that the taxpayer engaged in a tax shelter.

## Practical Implications

The privilege often does not apply when most needed, limiting its practical usefulness for taxpayers.

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# Waiver Rules and Strategic Use

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## Waiver Rules Explained

Disclosing protected information to third parties permanently waives Section 7525 protections, unlike work-product rules.

## Strategic Use of Section 7525

Section 7525 may suit certain routine civil exams but is often inadequate for large corporate or complex tax cases requiring counsel involvement.

# **Common-Interest, Joint-Defense, and Fifth-Amendment Doctrines**

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# Common-Interest and Joint-Defense Doctrines

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## **Purpose of Doctrines**

These doctrines allow clients facing common legal threats to communicate without waiving privilege.

## **Prerequisites for Application**

Requires common legal interest, communications advancing shared strategy, and maintained confidentiality.

## **Litigation Requirement Variance**

Some jurisdictions require pending or anticipated litigation; others permit use in transactional contexts.

## **Documentation Best Practices**

A short, written agreement describing parties, objectives, loyalty disclaimers, and confidentiality is recommended.

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# Fifth-Amendment Considerations in Tax Controversies

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## Privilege Scope

Fifth Amendment protects only natural persons' testimonial communications, not corporate entity records.

## Individual Rights in IRS Interviews

Individuals may assert the Fifth Amendment per question; counsel should prepare detailed scripts and use corporate records if possible.

## No Blanket Refusals

Witnesses must assert privilege question-by-question; generalized refusals can lead to contempt charges.

## Adverse Inferences in Civil Cases

IRS may draw negative inferences in civil cases when privilege is asserted, but not in criminal cases.

# **IRS Policy of Restraint and Tax- Accrual Workpapers**

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# IRS Policy and Historical Context

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## IRS Policy of Restraint

The IRS maintains a policy of restraint and does not routinely request tax accrual workpapers during examinations.

## Historical Legal Establishment

The Supreme Court affirmed the IRS's right to obtain tax accrual workpapers in *United States v. Arthur Young & Co.* in 1984.

## Current IRS Guidelines

The IRS's current tax accrual workpaper policies are detailed in the Internal Revenue Manual and various official announcements.

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# Definitions and Interaction with Schedule UTP

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## **Tax-Accrual Workpapers**

Documents estimating current, deferred, or contingent tax liabilities, such as FIN 48 memos, which are important for tax compliance.

## **Tax-Reconciliation Workpapers**

Schedules reconciling book and tax figures used in tax returns, which receive no special deference by IRS.

## **Schedule UTP Interaction**

Filing Schedule UTP does not waive privilege or make opinions discoverable, but the IRS may summon underlying documents.

**The *Kovel*  
Doctrine:  
Extending  
Privilege to Non-  
Lawyer Experts**

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# Origin, Rationale, and Core Requirements

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## ***Kovel* Case Foundation**

The *Kovel* case extended the attorney-client privilege to the work and communications of a third-party expert if the expert was hired “for the purpose of obtaining [confidential] *legal advice from the lawyer*.” The expert’s work product is also likely protected because the expert is not an adversary.

## **Judicial Purpose and Scope**

*Kovel* protects confidential communications when technical expertise is essential, but it is applied narrowly by courts.

## **Core Requirements for *Kovel***

Expert must be engaged by counsel; must be to assist counsel in providing legal advice to the client; communications must be kept confidential; scope of engagement must be tailored to the expertise provided; and must have genuine attorney participation in the use of the expert.

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# Multiple-Hat Pitfalls and Practical Solutions

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## **Return Preparer as *Kovel* Expert**

The same firm preparing tax returns and acting as technical expert may raise court suspicions about role conflict.

## **Practical Separation Solution**

Separate teams, client codes, and electronic folders prevent conflicts and maintain clear boundaries in engagements.

## **Auditor Independence Constraints**

Auditor independence rules usually prevent audit teams from providing litigation support; using affiliates and ensuring disclosure of affiliate relationships and roles is recommended.

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# Recent Judicial Attacks and Case Law Lessons

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## **Work-Product Doctrine**

Work-product protection applies when documents are prepared in anticipation of litigation, even if analysis informs business decisions.

## **Common-Interest Privilege**

Common-interest privilege protects shared communications among parties with aligned legal interests, such as banks and accountants.

## **Attorney-Client Privilege Waiver**

Sharing privileged information with third parties in non-legal contexts may waive attorney-client privilege but not work-product protection.

## **Key Judicial Themes**

Courts require actual lawyer involvement and anticipation of litigation; facts are generally not privileged.

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# Interaction with § 7525 and Work- Product Protection

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## ***Kovel* Privilege Extension**

*Kovel* extends attorney-client privilege independently from § 7525, with § 7525 rarely protecting failed *Kovel* communications.

## **Work-Product Protection**

Work product shields documents prepared for anticipated litigation when documented in a timely manner by counsel.

## **Practical Engagement Sequence**

Engage experts through *Kovel* first, mark deliverables privileged, and use § 7525 for routine tax advice only.

## **Fallback Protection**

Work-product protection may apply if attorney-client or § 7525 privileges are waived.

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# International and Cross-Border Dimensions

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## **Non-U.S. Accountant Privilege**

U.S. legal privilege may not be recognized internationally for non-U.S. accountants.

## **Cross-Border Document Transfer**

When documents cross borders, local counsel should consider documents such as *Kovel* arrangements for compliance.

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# Best-Practice Checklist for Maintaining *Kovel* Protection

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## Early Engagement

Engage early, before substantive information flows, to ensure proper protection is maintained.

## Privilege Communication

Use explicit privilege legends like “PRIVILEGED & CONFIDENTIAL –PER KOVEL” on every communication.

## Attorney Inclusion

Copy at least one attorney on all substantive emails to maintain legal oversight and protection.

## Training Workshops

Hold kickoff workshops with expert staff to explain privilege boundaries and proper procedures.

# Designing and Implementing a Defensible *Kovel* Architecture

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# Timing and Triggers for *Kovel* Arrangements

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## **Pre-transaction Planning**

Engage accounting experts early in complex restructurings to secure privilege before sensitive data is shared.

## **Audit Notice Trigger**

Receipt of an audit selection notice signals that litigation is reasonably foreseeable, often initiating the need for *Kovel* arrangements.

## **30-Day Letter Indicator**

Receiving a 30-day letter strongly indicates potential litigation and prompts re-evaluation of *Kovel* expert engagement.

## **Retrofitting *Kovel* Engagements**

Counsel must issue fresh engagement letters and quarantine materials to preserve privilege in ongoing tax controversies.

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# Drafting the Engagement Letter: Key Clauses

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## **Purpose Clause**

Defines the expert's role to assist Counsel with legal advice for IRS examination and related litigation. The agreement should specify that it is a "Kovel Agreement" and should cite the case. It also must replace any existing engagement between the client and the expert with respect to the same subject matter. For instance, regular tax return preparation and other audit work should be under a separate agreement.

## **Confidentiality and Privilege**

Ensures strict confidentiality and protection under attorney–client privilege and work-product doctrine. Watch for boilerplate provisions that purport to authorize an accounting firm to make disclosures to third parties.

## **Scope and Deliverables**

Clearly describes tasks related to legal issues, carving out non-privileged tasks into separate engagements.

## **Termination and Dispute Resolution**

Outlines procedures for returning privileged materials and mechanisms for dispute resolution and claw-back provisions. The attorney or the client owns the files and the work product.

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# Communication Protocols to Preserve Privilege

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## **Email Discipline**

Use subject legends like “PRIVILEGED & CONFIDENTIAL / PER KOVEL” and always copy an attorney on substantive emails.

## **Virtual Data Rooms Access**

Segregate *Kovel* folders and restrict access, disabling external downloads without counsel approval.

## **Meetings and Video Conferences**

Include privilege legends in calendar invites and discourage AI transcriptions to prevent privilege waiver.

## **Draft Document Handling**

Watermark drafts as “FOR LEGAL REVIEW” and avoid circulation without written counsel approval.

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# Training, Monitoring, and Change Management

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## **Team Training on *Kovel***

Train the team on privilege basics, *Kovel* letter terms, email legends, and IDR response workflow to ensure compliance.

## **Quarterly Privilege Audits**

Conduct regular quarterly audits to review adherence to privilege protocols and immediately address any breaches.

## **Change Management Process**

Issue amended *Kovel* letters when expert roles expand or change to maintain updated documentation and compliance.

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# Key Take-Aways for *Kovel* Protection

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## **Maintaining Privilege Discipline**

Every email, file name, and meeting invite must be handled carefully to maintain *Kovel* protection privilege.

## **Critical Support Elements**

Segregation, counsel control, and ongoing training are essential to uphold *Kovel* protection effectively.

## **Early Project Design**

Design the legal protection architecture from the very first day of the project to ensure compliance.

## **Documenting Privilege**

Contemporaneous evidence of legal purpose is valued by courts far more than after-the-fact affidavits.

# Speakers

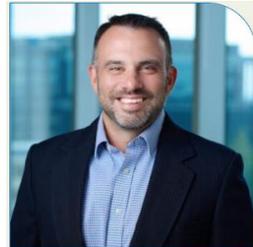


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