

United States v Arthur Young & Co.: Judicial Death Knell for Auditors' Privilege and Suggested Congressional Resurrection

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UNITED STATES *v.* ARTHUR YOUNG & CO.: JUDICIAL
DEATH KNELL FOR AUDITORS' PRIVILEGE AND
SUGGESTED CONGRESSIONAL
RESURRECTION

The judicial controversy of whether the Internal Revenue Service (IRS) may gain access to an independent auditor's tax accrual workpapers¹ is over. In *United States v. Arthur Young & Co.*,² the United States Supreme Court unanimously held that the IRS may obtain an independent auditor's workpapers pursuant to its summons power under section 7602 of the Internal Revenue Code (Code).³ Although the Court's decision in *Arthur Young* ends judicial attempts to exempt these workpapers from section 7602,⁴ the battle is not over. The *Arthur Young* decision simply shifts the battleground

¹ Tax accrual workpapers also are known as tax pool workpapers, tax provision workpapers, and tax liability contingency analysis workpapers. This Note employs the term "tax accrual workpapers" for uniformity and convenience. See *infra* notes 32-35 and accompanying text (discussing tax accrual workpapers).

² 465 U.S. 805 (1984).

³ 26 U.S.C. § 7602 (1982). Section 7602 provides in relevant part:

For the purpose of ascertaining the correctness of any return, . . . determining the liability of any person for any internal revenue tax . . . the Secretary [of the Treasury Department] or his delegate is authorized—

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

26 U.S.C. § 7602(a) (1982). The summons power granted to the Secretary of the Treasury Department and delegated to the IRS is enforced pursuant to § 7604 of the Code. Section 7604 reads in relevant part:

If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, records, or other data.

26 U.S.C. § 7604(a) (1982).

⁴ See *United States v. Arthur Young*, 677 F.2d 211 (2d Cir. 1982), *aff'd in part, rev'd in part*, 465 U.S. 805 (1984); *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977). See also *infra* notes 36-59 and accompanying text.

from the courts to Congress. Congress now must decide whether public policy reasons justify the result in *Arthur Young*, or whether a statutory privilege for an independent auditor's tax accrual workpapers should be enacted.

This Note describes the judicial controversy over tax accrual workpapers that existed prior to *Arthur Young* and discusses the *Arthur Young* case, evaluating the Supreme Court's policy reasons against recognition of an auditor privilege for tax accrual workpapers. The Note argues that a legislatively created auditor privilege for tax accrual workpapers is justified because of its positive benefits to the public securities system and the federal taxing structure. The Note also proposes the substance of appropriate privilege legislation that Congress should enact.

I

THE AUDIT PROCESS

A. Audits and Auditors

In a typical audit engagement, an independent auditor examines, tests, and reviews the financial statements prepared by a company's management. This independent examination of a company's financial statements is an integral part of the protection accorded investors in the public securities markets. Publicly held corporations must file audited financial statements with the Securities and Exchange Commission (SEC) to register a new security issue,⁵ list a security on an exchange,⁶ solicit proxies,⁷ and comply with SEC annual financial reporting requirements.⁸ Investors may rely on audited financial statements when making investment decisions regarding securities of publicly held corporations. Furthermore, privately held companies often must submit to an annual audit to obtain credit from private lenders and capital from private investors, although such companies are not subject to the reporting requirements of the SEC.⁹

⁵ Securities Act of 1933, Schedule A (25)-(27), 15 U.S.C. § 77aa (1982).

⁶ Securities Exchange Act of 1934, § 12(b)(1)(J)-(L), 15 U.S.C. § 78 l(b)(1)(J)-(L) (1982).

⁷ Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n(a) (1982); Schedule 14A, Item 15, 17 C.F.R. § 240.14a-101 (1985).

⁸ Securities Act of 1934 § 13(a)(2), 13(b), 15 U.S.C. § 78m(a)(2) (1982); 17 C.F.R. § 249.310 (1985).

⁹ See, e.g., *In re Newton*, 718 F.2d 1015, 1017 n.2 (11th Cir. 1983) (bank required audited financial statements for credit), *cert. denied sub nom. Trio Mfg. Co. v. United States*, 466 U.S. 904 (1984). See generally A. ARENS & J. LOEBBECKE, *AUDITING: AN INTEGRATED APPROACH* 1-2 (2d ed. 1980) (audited financial statements provide necessary information to private decisionmaker because of frequent lack of adequate personal knowledge).

The SEC requires that an independent certified public accountant (CPA) or public accountant audit the financial statements of publicly held companies according to generally accepted auditing standards (GAAS).¹⁰ These standards also govern a CPA's conduct in auditing the financial statements of privately held companies.¹¹ The standards require an auditor to state whether the financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP).¹² The GAAP standard, used to measure financial presentations, is the aggregate of accounting conventions, rules, and procedures of currently accepted accounting practice.¹³ In short, an independent auditor examines the records of a company using GAAS to determine whether the company's financial statements are presented fairly in accordance with GAAP.

Generally, an auditor does not examine all transactions entered into by a company during the period under audit. According to GAAS, the "cost of audits should bear a reasonable relationship to the benefits expected to be derived."¹⁴ The primary method of providing adequate audit evidence at an acceptable cost is selective testing of transactions.¹⁵ Requiring an audit of all transactions would be economically infeasible.¹⁶

¹⁰ Regulation S-X, 17 C.F.R. § 210.2-02(b) (1984). GAAS represent the minimum professional standards for conducting an audit. 1 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS AU § 150.02 (1982) [hereinafter cited as PROFESSIONAL STANDARDS].

¹¹ 2 PROFESSIONAL STANDARDS, *supra* note 10, at ET § 202.01.

¹² 1 *id.* at AU § 410.01.

¹³ *Id.* at AU § 411.02. The Financial Accounting Standards Board (FASB), the accounting profession's current accounting standard-setting body, formulates GAAP by issuing pronouncements. See A. ARENS & J. LOEBBECKE, *supra* note 9, at 710, for a brief discussion of GAAP.

¹⁴ 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 327.11.

¹⁵ See A. ARENS & J. LOEBBECKE, *supra* note 9, at 324; 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 350.01.

¹⁶ See A. ARENS & J. LOEBBECKE, *supra* note 9, at 140. Because an independent auditor does not review every transaction during an audit, the auditor does not guarantee the accuracy of the financial statements. See *id.* at 110; see also *Rosenblum v. Adler*, 93 N.J. 324, 344, 461 A.2d 138, 148 (1983) (auditor is not required to examine every document; audit assurance has limits). Rather, an independent auditor usually attests only that he performed a GAAS audit and that the financial statements are presented fairly in accordance with GAAP. This type of audit opinion is known as an "unqualified opinion." 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 509.28. Based upon the audit findings, however, an auditor may be unable to issue an unqualified opinion because of problems in the financial statements. In these circumstances, an auditor will issue one of two other types of audit opinions or disclaim an opinion. An auditor may issue a "qualified opinion," stating that the financial statements are presented fairly in accordance with GAAP "except for" the effects of a material departure from GAAP or a change in accounting principles or reporting periods, or "subject to" the effects of significant uncertainties surrounding the financial statements. *Id.* at AU § 509.29. Alternatively, an independent auditor may issue an "adverse opinion," stating that the financial statements are not presented fairly in accordance with GAAP. *Id.* at AU § 509.41. Finally, if

The audit process itself represents a unique tripartite relationship among the auditor, the corporation, and third parties. Although the corporation pays for the audit, the auditor's opinion on the financial statements is designed to facilitate informed financial decisions by creditors and the investing public.¹⁷ To ensure the credibility of audit findings, an auditor must be a disinterested professional, maintaining both actual and apparent independence.¹⁸ An auditor preserves independence by maintaining a detached mental attitude and avoiding circumstances that the public "might believe likely to influence independence."¹⁹ Although the independence requirement is designed to prevent auditor bias or public perception of auditor bias in favor of the audited company, independence does not connote an adversarial relationship between an auditor and the company. Independence requires auditor impartiality and fairness to the company, the company's creditors, and the investing public.²⁰

B. Auditing Federal Income Taxes

An important part of the overall examination of a company's financial statements is the independent auditor's review of the company's accounting provision and liability for federal income taxes. Because an IRS audit may revise the amount of federal income tax a company owes for a year, an independent auditor must evaluate the financial statement presentation of taxes in light of those potential additional taxes.²¹ Thus, an independent auditor must identify and

an independent auditor's examination is so curtailed or limited that no basis for an opinion exists, a "disclaimer of opinion" is appropriate. *Id.* at AU § 509.45. A "disclaimer of opinion" is not an expression of an opinion.

¹⁷ *Arthur Young*, 465 U.S. at 817-18. See generally A. ARENS & J. LOEBBECKE, *supra* note 9, at 5 (auditor fulfills public role by being competent and independent).

¹⁸ 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 220.02-03.

¹⁹ *Id.* at AU § 220.03.

²⁰ *Id.* at AU § 220.02.

²¹ See FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS—CURRENT TEXT § C59, at 8301-8317 (1984) [hereinafter cited as FASB ACCOUNTING STANDARDS].

The potential liabilities of a company, such as additional income taxes, are loss contingencies. The accounting treatment of a loss contingency is dependent on how likely it is that a loss has been incurred and whether the amount of the loss can be reasonably estimated. Where the likelihood of a loss having been incurred is "probable" and the amount of the loss can be reasonably estimated, the loss should be reflected in the financial statements and perhaps disclosed in a note to the statements. *Id.* § C59.105-108, at 8302-8303. Where there is a "reasonable possibility" that a loss has been incurred, the loss contingency should be disclosed in a note to the financial statements. *Id.* § C59.109-110, at 8303. Where the likelihood of a loss having been incurred is less than reasonably possible, normally the financial statements may be silent regarding the loss contingency. See *id.* § C59.113, at 8304 (disclosure of remote loss contingencies recommended but not required).

evaluate items and transactions for which the company's tax treatment appears legally uncertain.

Generally, the examination of federal income taxes is more difficult than the audit of many other accounts and transactions because an independent auditor must deal with the uncertainty of potential additional liabilities.²² Once an independent auditor identifies items and transactions as areas of uncertainty or "gray areas," the auditor must predict the likelihood of the company's incurring additional taxes on such "gray areas."²³ Further, because these items and transactions may be scattered throughout the accounting records, an auditor must be concerned about whether all "gray areas" have been identified.²⁴ To satisfy this concern an auditor typically will perform certain independent procedures designed to identify "gray areas" and potential assessments of additional tax.²⁵ Although these independent procedures provide some assurance that all "gray areas" have been identified, GAAS strongly suggests that an auditor supplement these procedures with two other audit procedures: discussions with management and correspondence from the company's attorney.²⁶

Auditor discussions with management normally include inquiry about the company's procedures for identifying potential loss items. The auditor also elicits management's thoughts regarding the existence of items or transactions that may constitute "gray areas," and obtains a letter of representation from the company stating that all potential liabilities have been disclosed to the auditor.²⁷ Correspondence from the company's attorney usually entails securing a letter describing potential tax liabilities stemming from pending or threatened tax litigation, IRS tax assessments, or potential tax claims against the company from each of the company's outside counsel.²⁸ These discussions and letters typically allow an auditor to identify effectively "gray areas" and potential tax liabilities. Both

²² See A. ARENS & J. LOEBBECKE, *supra* note 9, at 666 ("[I]t is more difficult to discover unrecorded transactions or events than to properly verify recorded information.").

²³ See FASB ACCOUNTING STANDARDS, *supra* note 21, § C59.144, at 8313.

²⁴ See 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 337.01 (GAAS guidance on identifying potential losses from litigation, claims, and assessments against company). See also A. ARENS & J. LOEBBECKE, *supra* note 9, at 666 ("[T]he primary objective at the initial stage of the tests [for loss contingencies] is to determine the *existence* of contingencies.") (emphasis in original).

²⁵ See A. ARENS & J. LOEBBECKE, *supra* note 9, at 666-67.

²⁶ 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 337.05, .09 (management is primary source of information regarding loss contingencies from litigation, claims, and assessments; correspondence from outside counsel is primary method of corroborating information provided by management).

²⁷ See *id.* at AU § 337.05.

²⁸ See *id.* at AU § 337.08-.09. For a general discussion of auditor contact with an

management and attorneys often are familiar with tax planning strategies and possible tax problems surrounding the company's financial transactions.²⁹

Although disclosure of tax information to an independent auditor may be detrimental ultimately to the company, GAAS requires that an auditor receive such disclosures to opine on the financial statements.³⁰ If management or outside counsel refuses to disclose tax information, the auditor may not issue an unqualified opinion on the financial statements.³¹ Consequently, an incentive is built into the audit process for management and outside counsel to provide an independent auditor with the information necessary to identify and evaluate all "gray areas" in a company's tax return.

C. Tax Accrual Workpapers

Tax accrual workpapers are the written documentation supporting an independent auditor's examination of a company's accounting provision and liability for income taxes in its financial statements. Although an independent auditor must document and support audit findings, GAAS does not prescribe the specific content of the tax accrual workpapers.³² Rather, the extent of documentation in these workpapers is left to the independent auditor's professional judgment.³³

In a typical audit engagement, tax accrual workpapers will contain most, if not all, of the evidence gathered by an independent auditor during the review of the client's tax liability. The workpapers usually delineate, in detail, the specific "gray areas" in a tax return. The auditor will construct and document a worst case

audited company's outside counsel, see A. ARENS & J. LOEBBECKE, *supra* note 9, at 666-71.

²⁹ Traditionally, an independent auditor would both audit the financial statements of a company and prepare that company's tax returns. Recently, however, companies have used their auditing firms less as their tax preparer or tax consultant. See, e.g., *United States v. Coopers & Lybrand*, 550 F.2d 615, 617 (10th Cir. 1977) (auditor was not preparer of tax returns). See also Schnee & Taylor, *Summonses of Accountants' Workpapers: The Fears Are Justified*, 43 OHIO CPA J. 115, 118 (1984) (recent survey of eight largest accounting firms indicates decline of tax planning services by independent auditors for their audit clients). In-house accountants and lawyers, and other accounting or law firms, now serve as substitutes. Consequently, an independent auditor may not have knowledge of a company's tax return information outside of the audit process. See Buchholz, *Tax Accrual File Controversy*, 40 INST. ON FED. TAX'N § 37.01, § 37.04, at 37-15 (1982). This structural change places more pressure on the audit process to provide an auditor with the necessary tax information to opine on financial statements.

³⁰ See 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU §§ 333.11, 337.13, 509.10-.12. For a brief discussion of audit report modifications because of limitations placed on an audit by management, see A. ARENS & J. LOEBBECKE, *supra* note 9, at 706-07.

³¹ 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 509.10-.12.

³² *Id.* at AU § 339.05.

³³ *Id.* at AU § 339.04-.05.

scenario for tax treatment of these areas to facilitate identification of the total potential additional tax liabilities for the company.³⁴ The tax accrual workpapers also may include the thoughts of management regarding tax items they might litigate, if necessary, and the dollar amounts at which they would compromise with the IRS.³⁵ Thus, tax accrual workpapers often will reveal the company's entire tax picture, including all sensitive "gray areas" and management strategies for dealing with the IRS.

II

HISTORICAL BACKGROUND OF AUDITORS' PRIVILEGE CONCERNING TAX ACCRUAL WORKPAPERS

For nearly a decade, courts and commentators have disagreed about whether the IRS should be able to gain access to an independent auditor's tax accrual workpapers.³⁶ Because of the sensitive information that tax accrual workpapers typically contain, they are of great interest to the IRS, corporate managers, and independent auditors. The IRS seeks access to tax accrual workpapers because they provide a detailed description of the "gray areas" on a company's tax return.³⁷ Quick identification of these areas and reliable information regarding a taxpayer's negotiating position are useful to the IRS. Corporate managers, on the other hand, wish to deny the IRS

³⁴ See *Arthur Young*, 465 U.S. at 812 ("auditor often engages in a 'worst-case' analysis"); Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 VA. TAX REV. 57, 61 (1982) (tax accrual workpapers contain "item-by-item evaluation of the taxpayer's potential exposure to additional tax liability"); Garbis & Rubin, *Implications of the Sup. Ct.'s Holding of No Accountant's Privilege in Arthur Young*, 60 J. TAX'N 342 (1984) ("auditor's 'worst case' analysis . . . documented fully in the tax accrual workpapers").

³⁵ See Garbis & Rubin, *supra* note 34, at 342 (tax accrual workpapers contain "potential litigation and settlement positions of the taxpayer"). See also Caplin, *supra* note 34, at 60 n.14 (tax accrual workpapers may include information regarding possible future settlements or litigation with IRS).

³⁶ Compare *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982) (access prohibited), *aff'd in part, rev'd in part*, 465 U.S. 805 (1984); *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977) (same); Caplin, *supra* note 34, at 83 (IRS access to tax accrual workpapers should be avoided except in extraordinary circumstances), with *In re Newton*, 718 F.2d 1015 (11th Cir. 1983) (access permitted), *cert. denied sub nom. Trio Mfg. Co. v. United States*, 466 U.S. 904 (1984); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass.) (same), *appeal dismissed as moot*, 612 F.2d 569 (1st Cir. 1979), *cert. denied*, 449 U.S. 1021 (1980); Nath, *Internal Revenue Service Summons for "Sensitive" Accountants' Papers*, 34 VAND. L. REV. 1561, 1622 (1981) (Disclosure of tax accrual workpapers is "not undesirable result" because taxpayer owes duty to pay all legally owed taxes.).

³⁷ See Brief for the United States at 25-27, *Arthur Young*, 465 U.S. 805 (1984) (primary purpose of the IRS's gaining access to tax accrual workpapers is to obtain a concise organization of relevant facts surrounding "gray area" items on tax returns). See also Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194, 199 (1979) (tax accrual workpapers provide "roadmap" to IRS regarding "gray areas" in tax return).

access to tax accrual workpapers because they believe that a fundamental unfairness results in their negotiations with the IRS.³⁸ Independent auditors fear that IRS access to tax accrual workpapers endangers the integrity of client-auditor communications and thereby threatens the audit process.³⁹ Auditors argue that an impaired audit process increases the risk that independent auditors may not detect materially misstated financial statements. Such statements would mislead investors and creditors, thus damaging the public securities and private capital markets.⁴⁰

Prior to *Arthur Young*,⁴¹ courts agreed on an overall test for allowing an IRS summons under section 7602, but disagreed about whether attempts to obtain tax accrual workpapers could meet the test.⁴² As formulated by the Supreme Court, the test has two separate parts. First, in *United States v. Powell*,⁴³ the Supreme Court held that an IRS summons will be enforced only if the IRS shows that its investigation has a legitimate purpose, that it has followed the procedural requirements of the Code, that it does not already have the information sought from the taxpayer or third party, and that "the inquiry may be relevant to the [legitimate] purpose."⁴⁴

Most litigation involving the *Powell* requirements focused on the last two items: duplicative information and relevancy. Taxpayers and independent auditors repeatedly attempted to deny the IRS access to tax accrual workpapers by asserting that the IRS was requesting duplicative information because the IRS already had in its possession the information contained in the workpapers. Courts uniformly rejected these contentions, finding either that the duplicative information limitation refers to documents, and not to the information contained within the documents, or that the limitation does not preclude the IRS from examining workpapers to check the

³⁸ See *Arthur Young*, 677 F.2d at 220 (IRS access to tax accrual workpapers "puts the taxpayer-corporation at a substantial disadvantage when it is audited."). See also Garbis & Rubin, *supra* note 34, at 342 (IRS access to tax accrual workpapers provides an "advantage [to the IRS] in the resolution of the issues raised in [an IRS] audit.").

³⁹ See Brief *Amici Curiae* of Arthur Andersen & Co., Alexander Grant & Co., Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat, Marwick, Mitchell & Co., Price Waterhouse & Co., Seidman & Seidman and Touche Ross & Co. in Support of Respondents at 6, *Arthur Young*, 465 U.S. 805 (1984) (IRS access to tax accrual workpapers "may lessen the candor with which the client communicates with the independent auditor and thus compromise the effectiveness of the audit function.").

⁴⁰ See *id.* at 6 n.3. See also Buchholz, *supra* note 29, § 37.06, at 37-20 ("A decline in quality auditing would erode the integrity of financial reporting and poorly serve investors.").

⁴¹ 465 U.S. 805 (1984).

⁴² See cases cited *supra* note 36.

⁴³ 379 U.S. 48 (1964).

⁴⁴ *Id.* at 57-58.

reliability of information already in its possession.⁴⁵

Challenges to IRS access based upon a lack of relevancy proved more troublesome for courts, and ultimately resulted in two different judicial readings of section 7602. In *United States v. Coopers & Lybrand*,⁴⁶ the Tenth Circuit held that tax accrual workpapers were not relevant under section 7602 where they were not prepared in connection with a tax return filing.⁴⁷ Because an auditor prepares tax accrual workpapers principally for an audit, and not for tax return preparation, the Tenth Circuit's narrow reading of relevancy effectively eliminated IRS access in most instances. No other court, however, followed the Tenth Circuit's reading of section 7602.⁴⁸ Rather, these courts construed relevancy very broadly, finding tax accrual workpapers relevant under section 7602 because they may highlight questionable positions taken on tax returns.⁴⁹

The Supreme Court noted a second set of limitations on the IRS summons power under section 7602 in *United States v. Euge*.⁵⁰ The *Euge* Court stated that the IRS must show that disclosure of the information sought is not forbidden by either a federal statute or "substantial countervailing policies."⁵¹ The Court did not define "substantial countervailing policies" beyond implying that it encompassed "traditional privileges and limitations."⁵²

Prior to *Euge*, lower courts had rejected an independent auditor workpaper privilege or work product exception to section 7602.⁵³ The Second Circuit, however, in *Arthur Young*, recognized a "work product privilege"⁵⁴ for the tax accrual workpapers of an independ-

⁴⁵ See, e.g., *United States v. Noall*, 587 F.2d 123, 125 n.2 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979); *United States v. Price Waterhouse & Co.*, 515 F. Supp. 996, 999 (N.D. Ill. 1981); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 330 (D. Mass.), appeal dismissed as moot, 612 F.2d 569 (1st Cir. 1979), cert. denied, 449 U.S. 1021 (1980).

⁴⁶ 550 F.2d 615 (10th Cir. 1977).

⁴⁷ *Id.* at 621. Cf. *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973) (corporate budgets not relevant to issue of liability for taxes).

⁴⁸ See, e.g., *In re Newton*, 718 F.2d 1015, 1018-20 (11th Cir. 1983) ("relevancy" extends beyond source documents for tax return to include any document that may be useful), cert. denied sub nom. *Trio Mfg. Co. v. United States*, 466 U.S. 904 (1984); *United States v. El Paso Co.*, 682 F.2d 530, 536-37 (5th Cir. 1982) (two to one decision) (same) (dictum), cert. denied, 466 U.S. 944 (1984); *United States v. Price Waterhouse & Co.*, 515 F. Supp. 996, 999-1000 (N.D. Ill. 1981) (same).

⁴⁹ See cases cited *supra* note 48.

⁵⁰ 444 U.S. 707 (1980).

⁵¹ *Id.* at 711.

⁵² *Id.* at 714 (tax summons remains "subject to the traditional privileges and limitations"). See *Upjohn Co. v. United States*, 449 U.S. 383, 398 (1981) (citing *Euge* for definition of "substantial countervailing policies").

⁵³ See, e.g., *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 327 (D. Mass.), appeal dismissed as moot, 612 F.2d 569 (1st Cir. 1979), cert. denied, 449 U.S. 1021 (1980); *United States v. Kelly*, 311 F. Supp. 1216, 1217 (E.D. Pa. 1969).

⁵⁴ The doctrines of privilege and work product are two separate legal concepts. A

ent auditor.⁵⁵ The court believed that such a privilege was necessary to protect the integrity of the public securities market.⁵⁶ Without the privilege, the court reasoned that a publicly held corporation faces a no-win situation: either the company discloses all sensitive tax information to its independent auditor, thereby prejudicing its negotiating position with the IRS in tax liability disputes, or it withholds information from its independent auditor, thus impairing the audit process and jeopardizing the reliability of the financial statements available to investors.⁵⁷ Other courts rejected this reasoning, finding that such fears were unwarranted or that the decision to accord a work product privilege was one for Congress, not the courts.⁵⁸

The Supreme Court granted certiorari in *United States v. Arthur Young & Co.*⁵⁹ to resolve the conflicts among the lower courts over the application of section 7602 to tax accrual workpapers.

III

UNITED STATES V. ARTHUR YOUNG & CO.

In 1971, Amerada Hess Corporation (Amerada Hess), a publicly held corporation, engaged Arthur Young & Co. (Arthur Young), a firm of certified public accountants, to perform annual audits of its financial statements. Pursuant to federal securities laws, Amerada Hess filed its financial statements, accompanied by Arthur Young's audit opinions, with the SEC.⁶⁰ In the course of examining

privilege is "an exception to the general liability of every person to give testimony upon all acts inquired of in a court of justice." J. WIGMORE, *EVIDENCE IN TRIALS AT COMMON LAW* § 2285, at 527 (1961). In short, a privilege is a testimonial right which allows parties in relationships such as attorney-client and husband-wife to avoid disclosing confidential communications in court. *See id.* § 2285, at 528, § 2321, at 629-30, § 2327, at 634-35. In contrast, the work product doctrine, a more recent invention, is not a per se testimonial right. Although designed partly to foster attorney-client communications, the work product doctrine protects directly the work produced by an attorney in preparation for litigation. *See* FED. R. CIV. P. 26(b)(3).

For clarity and uniformity, this Note employs the term "work product privilege" to identify the tax accrual workpaper exception created by the Second Circuit. This is the same term used by the Second Circuit. *Arthur Young*, 677 F.2d at 221.

⁵⁵ *Arthur Young*, 677 F.2d 211 (2d Cir. 1982).

⁵⁶ *Id.* at 219-21. *See infra* notes 69-78 and accompanying text.

⁵⁷ 677 F.2d at 220-21.

⁵⁸ *See, e.g., In re Newton*, 718 F.2d 1015, 1020-21 (11th Cir. 1983) (absent congressional action IRS access permissible), *cert. denied sub nom. Trio Mfg. Co. v. United States*, 466 U.S. 904 (1984); *United States v. El Paso Co.*, 682 F.2d 530, 544-45 (5th Cir. 1982) (fear of impaired audit process merely speculative; if problem exists, Congress is proper vehicle for change) (dictum), *cert. denied*, 466 U.S. 944 (1984).

⁵⁹ 459 U.S. 1199 (1983).

⁶⁰ For a description of filings with the SEC, see *supra* notes 5-8 and accompanying text. *See generally* L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 487-90 (1983) (description of annual, quarterly, and current reports required of publicly held companies

the financial statements of Amerada Hess, Arthur Young created and maintained tax accrual workpapers.

In 1976, publicity erupted over American companies' making questionable payments to foreign government officials.⁶¹ In response to this publicity, Amerada Hess created a special committee to investigate whether its employees had committed any such acts. The special committee engaged Arthur Young and a law firm as independent investigators. Although the special committee found only minor instances of wrongdoing, the IRS instituted a criminal probe of Amerada Hess's tax returns for the years 1972 through 1974. This criminal investigation, accompanied by a routine IRS civil audit already in progress, prompted the IRS to issue a summons to Arthur Young pursuant to section 7602. The IRS requested various documents, including Arthur Young's tax accrual workpapers for the years 1972 to 1974. Arthur Young refused to comply with the IRS summons.

At a proceeding to enforce the IRS summons, the federal district court found no federal statutory authority prohibiting disclosure of the requested documents and refused to create a privilege for independent auditors.⁶² The court found that the IRS had satisfied the *Powell* test for Arthur Young's audit workpapers, including its tax accrual workpapers, and accordingly, enforced that part of the summons.⁶³

On appeal, Arthur Young and Amerada Hess⁶⁴ sought to reverse the district court's holding regarding the tax accrual

under Securities Exchange Act of 1934). For discussion of audit opinions, see *supra* note 16.

⁶¹ See R. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS, CASES AND MATERIALS 514-15 (2d ed. 1981) (legacy of Watergate was disclosure by approximately 400 corporations of illegal domestic political campaign contributions and "commissions" or bribes to overseas officials).

In 1977, Congress enacted the Foreign Corrupt Practices Act of 1977, making it illegal for corporations or their employees to pay bribes to foreign officials or foreign political parties to gain business opportunities. Foreign Corrupt Practices Act of 1977, Pub. L. 95-213, 91 Stat. 1496 (codified at 15 U.S.C. § 78 dd-2 (1982)).

⁶² *Arthur Young*, 496 F. Supp. 1152, 1156-58 (S.D.N.Y. 1980).

⁶³ *Id.* at 1157-58.

The district court refused to enforce the IRS summons covering Arthur Young's audit program (a master document detailing audit procedures) and documents prepared by the special committee. The court found the audit program irrelevant under *Powell* and the special committee documents protected by the attorney work product doctrine. *Id.*

⁶⁴ The parties were joined by 11 amici curiae including the AICPA and the accounting firms of Arthur Andersen & Co., Alexander Grant & Co., Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Laventhol & Horwath, Peat, Marwick, Mitchell & Co., Price Waterhouse & Co., Seidman & Seidman, and Touche Ross & Co. With the exception of Laventhol & Horwath, these amici curiae, accompanied by The Committee on Corporate Law Departments of the Association of the Bar of the City of New York, the El Paso Company, the Chamber of Commerce of the United States, and the

workpapers on a number of grounds. In response to a challenge of "relevancy," the Second Circuit found that the tax accrual workpapers were relevant to a proper IRS investigation.⁶⁵ Rejecting the Tenth Circuit's reasoning in *Coopers & Lybrand*,⁶⁶ the court endorsed a broad reading of relevancy. Under section 7602, the court stated, relevance means whether the documents sought may "throw 'light upon' the correctness of the return."⁶⁷ The court concluded that an independent auditor's tax accrual workpapers would indeed illuminate a tax return.⁶⁸

The circuit court was more responsive to arguments based on fundamental unfairness and detriment to the public securities system. The court noted that the Securities Exchange Act of 1934⁶⁹ requires an annual audit of all publicly held corporations and that these audits are one of the key safeguards of the securities laws.⁷⁰ The court recognized that a free flow of information from a company to an independent auditor is necessary to protect the reliability of audit reports.⁷¹ This free flow of information becomes critical when an auditor deals with tax liabilities because an auditor must pinpoint and document all items of uncertainty.⁷² Given the sensitivity of such tax information, the court concluded that "a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed [to auditors] would be reachable [by the IRS] under § 7602."⁷³

The court stated that IRS access to tax accrual workpapers creates "a clash between two important congressional policies": enforcement of tax laws and protection of investors in the securities market.⁷⁴ The court balanced these interests and concluded that protection of investors generally prevails over tax enforcement with regard to tax accrual workpapers for publicly held corporations. The court reasoned that although a privilege for tax accrual workpapers may result in some loss of operational efficiency to the IRS, investors will avoid "the 'grave dangers of inaccuracy and un-

Tax Executive Institute, Inc., also filed amicus curiae briefs with the Supreme Court supporting the position of Arthur Young.

⁶⁵ *Arthur Young*, 677 F.2d at 218-19.

⁶⁶ 550 F.2d 615, 618-21 (10th Cir. 1977). See *supra* notes 46-47 and accompanying text.

⁶⁷ 677 F.2d at 219.

⁶⁸ *Id.*

⁶⁹ Securities Exchange Act of 1934, § 12(b)(1)(J)-(L), 15 U.S.C. § 78 l(b)(1)(J)-(L) (1982).

⁷⁰ 677 F.2d at 219. See *supra* notes 5-8 and accompanying text.

⁷¹ 677 F.2d at 219-20.

⁷² *Id.* at 220. For a description of the audit of federal income taxes, see *supra* notes 21-31 and accompanying text.

⁷³ 677 F.2d at 220 (footnote omitted).

⁷⁴ *Id.* at 219-20.

trustworthiness' ” in financial statements resulting from an impaired audit system.⁷⁵

Capitalizing on the second *Euge* limitation, “substantial countervailing policies,” the court then carved out an independent auditor work product privilege. The court held that in general the privilege precludes the IRS from gaining access to an independent auditor’s tax accrual workpapers created in an audit of a publicly held corporation.⁷⁶ The court, however, added that it would permit access to these workpapers in two situations: where the IRS alleges fraud by the corporate taxpayer or where the IRS shows a true need for the workpapers, such as where corporate records have been destroyed.⁷⁷ Because the IRS had not alleged fraud against Amerada Hess and could not show a true need for the workpapers, the Second Circuit denied access to Arthur Young’s tax accrual workpapers.⁷⁸ Faced with this adverse ruling the government petitioned for and received review of the case in the United States Supreme Court on a writ of certiorari.⁷⁹

The Supreme Court affirmed the Second Circuit’s holding that the tax accrual workpapers were relevant under the *Powell* standard but reversed the lower court’s finding that a work product privilege precluded IRS access to the workpapers.⁸⁰ The Court endorsed the broad reach of IRS summonses under section 7602, stating that “Congress has endowed the IRS with expansive information-gathering authority; § 7602 is the centerpiece of that congressional design.”⁸¹ Noting the clear language of section 7602, the Court quickly disposed of the relevancy argument. The use of the language “may be relevant,” rather than “is relevant,” in section 7602 “reflects Congress’ express intention to allow the IRS to obtain items of even *potential* relevance.”⁸² The court concluded that “tax accrual workpapers . . . are . . . highly relevant to legitimate IRS inquiry” because such workpapers illuminate questionable positions taken on tax returns.⁸³

The Court next considered whether “substantial countervailing policies” necessitated the judicial creation of a privilege for an independent auditor’s tax accrual workpapers. The Court noted that

⁷⁵ *Id.* at 221 (quoting *Hickman v. Taylor*, 329 U.S. 495 (1947)).

⁷⁶ *Id.* at 221. The circuit court did not address the issue of whether such a work product privilege would extend to audits of privately held companies. For discussion of this issue, see *infra* notes 167-72 and accompanying text.

⁷⁷ 677 F.2d at 221 & n.10.

⁷⁸ *Id.* at 221.

⁷⁹ 459 U.S. 1199 (1983).

⁸⁰ 465 U.S. 805, 821 (1984).

⁸¹ *Id.* at 816.

⁸² *Id.* at 814 (emphasis in original).

⁸³ *Id.* at 815.

the Second Circuit's work product privilege actually resembled an accountant-client testimonial privilege because the purpose of the exception was to protect client-auditor communications.⁸⁴ Such a testimonial privilege, the Court stated, does not exist in federal law. In *Couch v. United States*,⁸⁵ the Court had rejected a federal accountant-client testimonial privilege. To the extent that the circuit court's privilege was nontestimonial, reflecting a work product doctrine origin, the Court found the relationship between the Second Circuit's privilege and the work product doctrine unpersuasive. The Court reasoned that the work product doctrine's protection of an attorney's work product is premised on the role of an attorney as a "client's confidential advisor and advocate . . . whose duty it is to present the client's case in the most favorable possible light."⁸⁶ In contrast, the Court stated, an independent auditor has an overriding public responsibility, extending to the creditors and stockholders of the corporation and to the investing public.⁸⁷ This public responsibility requires an independent auditor to perform an audit with complete mental independence from the audited company.⁸⁸ The Court concluded that to protect an independent auditor's tax accrual workpapers "would be to ignore the significance of the [auditor's] role as a disinterested analyst charged with public obligations."⁸⁹

The Court emphasized that the language of section 7602 clearly reflects the purpose and intent of Congress. "[T]he . . . language of § 7602 reflects . . . a congressional policy choice *in favor of disclosure* of all information relevant to a legitimate IRS inquiry."⁹⁰ Given the clear language and intent of Congress in section 7602, the Court stated that "[w]hile § 7602 is 'subject to the traditional privileges and limitations,'" courts should be circumspect in creating new privileges that would limit IRS power under section 7602.⁹¹ The Court concluded that "[i]f the broad latitude granted to the IRS by § 7602 is to be circumscribed, that is a choice for Congress, and not this Court, to make."⁹²

The Supreme Court supported its refusal to grant a privilege for an independent auditor's tax accrual workpapers with three pub-

⁸⁴ *Id.* at 817-18; see *supra* note 54 for a comparison of privileges and the work product doctrine.

⁸⁵ 409 U.S. 322 (1973).

⁸⁶ 465 U.S. at 817.

⁸⁷ *Id.*

⁸⁸ *Id.* For a description of the independence requirement for auditors in audit engagements, see *supra* notes 17-20 and accompanying text.

⁸⁹ 465 U.S. at 818.

⁹⁰ *Id.* at 816 (emphasis in original).

⁹¹ *Id.* (quoting *United States v. Euge*, 444 U.S. 707, 714 (1980)).

⁹² *Id.* at 816-17 (citation omitted).

lic policy arguments: self-verification of the audit process, appearance of auditor independence, and fundamental fairness. First, the Court stated that the lack of an auditor privilege will not harm the public securities market because the audit process is self-verifying.⁹³ Faced with independent auditors' insistence on disclosure of all information regarding taxes, executives of publicly held corporations "would not risk a qualified evaluation of [the company's] financial posture to afford cover for questionable positions reflected in a prior tax return."⁹⁴ Second, the Court perceived that an auditor privilege would impair the audit process by creating an impression that the auditor was an advocate of the company.⁹⁵ The Court stated that "[i]ndeed, rather than protecting the investing public . . . insulation of tax accrual workpapers from disclosure might well undermine the public's confidence in the independent auditing process."⁹⁶ Third, the Court rejected the assertion that fundamental fairness required a privilege for tax accrual workpapers.⁹⁷ The Court noted that other parties, such as the SEC and private litigants, may obtain tax accrual workpapers. Reasoning that if a private litigant in securities litigation may obtain these workpapers when little or no public interest is involved, the court stated that "no sound reason exists" for not allowing the IRS access to the same workpapers when the public interest of revenue collection is implicated.⁹⁸ Moreover, the Court added, the IRS had announced a policy of self-restraint in requesting tax accrual workpapers.⁹⁹ This self-restraint, the Court concluded, "further refutes respondents' fairness argument and reflects an administrative flexibility that reinforces our decision not to reduce irrevocably the § 7602 summons power."¹⁰⁰

IV

POLICY REASONS FOR AND AGAINST AN AUDITOR PRIVILEGE REGARDING TAX ACCRUAL WORKPAPERS

The Supreme Court's holding in *Arthur Young* reflects the Court's reluctance to limit IRS power under section 7602 absent a

⁹³ *Id.* at 818-19.

⁹⁴ *Id.* (footnote omitted); see *supra* notes 30-31 and accompanying text (discussing the theoretical self-verification of audits of federal income taxes).

⁹⁵ 465 U.S. at 819-20 n.15.

⁹⁶ *Id.*

⁹⁷ *Id.* at 820-21.

⁹⁸ *Id.* at 820.

⁹⁹ *Id.* at 820-21. For a description of the IRS policy of self-restraint, see *infra* notes 134-39 and accompanying text.

¹⁰⁰ 465 U.S. at 821.

clear expression of congressional intent. The Court's policy justifications for rejecting an auditor privilege, however, are unpersuasive. Closely examined, policy concerns lead to the opposite conclusion that some form of privilege should be accorded an independent auditor's tax accrual workpapers.

A. The Self-Verifying Audit Process

The *Arthur Young* Court stated that the danger of diminished auditor-client communication resulting in the absence of an auditor privilege would be offset by the self-verifying nature of the audit process. The Court noted that if corporate officials withhold information necessary for an auditor to examine tax expense and liability accounts adequately, the auditor will not issue an unqualified audit opinion on the financial statements.¹⁰¹ The absence of an unqualified opinion immediately warns creditors and investors that some material problems may exist in the financial statements.¹⁰² Furthermore, the SEC will not accept a qualified opinion or disclaimer of opinion if it results from a limitation placed on the audit by corporate management.¹⁰³ Accordingly, the Court concluded that "[r]esponsible corporate management would not risk a qualified evaluation" by withholding information from an independent auditor regarding tax items.¹⁰⁴

In theory, the Court is correct to conclude that the audit process is self-verifying and that responsible management will not risk receiving a detrimental audit opinion by withholding sensitive tax information from its independent auditor. In practice, however, the Court's analysis is unpersuasive for two reasons. First, the Court assumed that the *quality* of client-auditor communications would not diminish because of IRS access to tax accrual workpapers. Second, the Court further assumed that if the quality of communications did diminish, an auditor would be able to recognize this occurrence. If these two assumptions prove untrue, the public securities system may suffer damage because of an increased risk that investors will receive materially misstated financial statements.

The Second Circuit as well as numerous commentators have expressed concern that the quality of client-auditor communications will be impaired once the IRS begins to request tax accrual workpapers.¹⁰⁵ Because tax accrual workpapers identify all "gray-

¹⁰¹ *Id.* at 818.

¹⁰² See A. ARENS & J. LOEBBECKE, *supra* note 9, at 701.

¹⁰³ See L. LOSS, *supra* note 60, at 1267; Buchholz & Moraglio, *IRS Access to Auditors' Work Papers: The Supreme Court Decision—A Measured Response is Called For*, J. ACCT., Sept. 1984, at 91, 96.

¹⁰⁴ *Arthur Young*, 465 U.S. at 819.

¹⁰⁵ See, e.g., *Arthur Young*, 677 F.2d at 220 (prudent management may not be "per-

areas" in a corporation's tax return and emphasize the weak points of tax positions, corporate managers and their advisers will fear that IRS access may become a "self-fulfilling prophecy" in IRS audits.¹⁰⁶ To avoid this adverse result, corporate managers and their advisers may become less willing to disclose tax information to an independent auditor than they would be otherwise.¹⁰⁷ If management or their advisers become guarded with information about tax items, an independent auditor, recognizing this occurrence, will issue a qualified opinion or disclaim an opinion on the affected financial statements.¹⁰⁸ The auditor's reaction to diminished communications is the essence of the self-verification rationale advanced by the Supreme Court.

In order for self-verification to work, however, an auditor must recognize the diminished communication by management or their advisers. Auditor recognition of impaired communications may be difficult for two reasons. First, the diminished communications rarely will be an outright withholding of information by management or outside counsel. Rather, the impairment will manifest itself as a general reluctance to volunteer information or to speak freely.¹⁰⁹ Second, because the audit of income taxes involves assess-

factly candid" with auditor if IRS can reach such communications); Brief of American Institute of Certified Public Accountants as *Amicus Curiae* at 29, *Arthur Young*, 465 U.S. 805 (1984) (depth and quality of communications from corporations and their tax advisers to auditors will suffer if the IRS gains access to tax accrual workpapers). See also Caplin, *supra* note 34, at 81-82 ("[c]andid communication between accountant and client is at stake" if IRS obtains tax accrual workpapers); M. SALTZMAN, *IRS PRACTICE AND PROCEDURE* ¶ 8.06[3][b], at 8-37 (1981) (management and its advisers may not communicate openly with auditors because tax accrual workpapers indicate all possible weaknesses in tax return). *But see* Nath, *supra* note 36, at 1592-93 (SEC reporting requirements will counter management's inclination to withhold sensitive tax information from auditors).

¹⁰⁶ M. SALTZMAN, *supra* note 105, ¶ 8.06[3][b], at 8-37 ("Production of [tax accrual] workpapers creates the obvious hazard that the amount reserved in the exercise of the auditor's conservative judgment will become a self-fulfilling prophecy by way of the revenue agent's adjustment. Clients and their advisers might not communicate openly with auditors if tax adjustments will be the result.")

¹⁰⁷ One *amicus curiae* in *Arthur Young* expressed the probable reaction of corporate managers and their advisers if the IRS obtains tax accrual workpapers:

If a person feels secure that his statement will be held in confidence, he will speak much more expansively and fully than he would otherwise. An audit client or [that client's] attorney who is concerned that the client's confidence to his auditor will be scrutinized by the IRS will be much more guarded with his information than otherwise, and the auditor will learn much less.

Brief *Amicus Curiae* of The Committee on Corporate Law Departments of the Association of the Bar of the City of New York at 7, *Arthur Young*, 465 U.S. 805 (1984).

¹⁰⁸ See *supra* notes 30-31 and accompanying text.

¹⁰⁹ See Brief *Amicus Curiae* of The Committee on Corporate Law Departments of the Association of the Bar of the City of New York at 7, *Arthur Young*, 465 U.S. 805 ("audit client . . . will be much more guarded with his information than otherwise"); M. SALTZ-

ing *potential* liabilities, an auditor does not have a complete independent source of information from which to judge the completeness or degree of detail of client disclosures.¹¹⁰ Moreover, an auditor cannot rely completely on other audit procedures to determine whether a client has disclosed all "gray-areas" and potential tax liabilities. These procedures test only certain parts of the company's books and records where an auditor believes potential tax liabilities may exist.¹¹¹ Although these procedures provide some audit evidence regarding the existence of "gray areas," they are not comprehensive.¹¹²

Presently, it is uncertain whether a denial of privilege for tax accrual workpapers actually will reduce auditor-client communication and impair the flow of reliable information to public investors. Denial of a privilege, however, does raise the possibility of such damage.¹¹³ A grant of a privilege for tax accrual workpapers, on the

MAN, *supra* note 105, ¶ 8.06[3][b], at 8-37 ("Clients and their advisers might not communicate openly with auditors . . .").

The problem of client reluctance to volunteer information is compounded by the historical friction between independent auditors, on one side, and attorneys, on the other side. Attorneys often are reluctant to disclose information to an independent auditor because they fear that disclosure will bring about the losses they desire to avoid. See AMERICAN BAR ASSOCIATION, STATEMENT OF POLICY REGARDING LAWYERS' RESPONSES TO AUDITORS' REQUESTS FOR INFORMATION (preamble) (Dec. 1975), *reprinted in* 1 PROFESSIONAL STANDARDS, *supra* note 10, (Exhibit II) at AU § 337C (critical of attorney disclosures to auditor because such disclosures "might become public and precipitate a loss to or possible liability of the [company] that might otherwise never materialize") [hereinafter cited as LAWYERS' RESPONSES]; A. ARENS & J. LOEBBECKE, *supra* note 9, at 668 (reluctance of attorneys to disclose information to auditor because "inclusion of the information in a footnote [to the financial statements] could actually cause the lawsuit [an attorney desires to avoid]"). Attorneys express further reluctance to disclose information to an independent auditor because they believe disclosure may be "destructive of free and open communication and early consultation between lawyer and client." LAWYERS' RESPONSES (preamble), *supra*.

¹¹⁰ See *supra* notes 21-23 and accompanying text. See also Note, *Creation of an Accountant Work-Product Privilege for Tax Accrual Workpapers*. United States v. Arthur Young & Co., 68 MARQ. L. REV. 155, 171 (1984) ("an auditor who does not know [that certain tax loss contingencies] exist cannot know [that such] information is missing").

¹¹¹ See *supra* notes 25-26 and accompanying text.

¹¹² See *supra* notes 22-26 and accompanying text.

¹¹³ Whether audit clients and their attorneys become more guarded with information regarding "gray area" tax positions in the absence of an auditor privilege is a question that will be answered over time. Assuming that the Supreme Court is correct in concluding that IRS access to tax accrual workpapers ultimately will not affect the quality of financial reporting in the public securities system, this still does not prove that a privilege should not be accorded for the other policy reasons set forth in this Note. The self-verification argument, if valid, does not prove that a privilege would damage the audit process; it simply negates the assertion that the absence of a privilege for tax accrual workpapers will damage the audit process and, in turn, the public securities system. In such circumstances, the public policy factor of protection of the public securities system becomes neutral in the determination of whether to accord a privilege for tax accrual workpapers.

One other possible private sector response to *Arthur Young* is that auditors may

other hand, will remove this risk of damage because management and counsel communications to an auditor will be insulated from the IRS, thereby fostering an environment conducive to full and free communication.

B. Auditor Independence

The Court noted in *Arthur Young* that “insulation of tax accrual workpapers from disclosure [to the IRS] might well undermine the public’s confidence in the independent auditing process” because a privilege may affect adversely the public’s perception of an auditor’s independence.¹¹⁴ The Court speculated that a privilege would create the appearance of an auditor as an advocate of the company. This appearance, the Court concluded, would destroy the public perception of auditor impartiality and thereby threaten the “value of the audit function itself.”¹¹⁵

The Court is correct to identify the potential for the appearance of impaired auditor independence if the public views an auditor as an advocate of the company. The purpose of a privilege for tax accrual workpapers, however, should reduce the risk of public misperception. The purpose of the privilege is to remove the unfairness resulting from IRS access to these workpapers and thereby protect the reliability of information available to public investors.¹¹⁶ As this Note will discuss subsequently, removal of this unfairness by granting a privilege will also help preserve the self-assessed taxing structure and avoid increased tax litigation by corporate taxpayers.¹¹⁷ Although a privilege for tax accrual workpapers will benefit corporations by protecting their negotiating and litigating positions in tax disputes, the public perception of auditor independence should remain unchanged. The public should view the privilege as a protection designed to serve noncorporate public goals and not as a tool implemented by auditors and companies to advance corporate interests.

Further, twenty states have enacted some form of statutory protection for confidential communications in accountant-client rela-

avoid detailing everything in the tax accrual workpapers. Auditors may evaluate the capacity of company tax personnel, review “gray areas” using company documentation, and place only a general memorandum in the workpapers. Although this approach eliminates the “roadmap” effect of the tax accrual workpapers, it raises questions of impaired auditor independence. The public may view such adjustment of tax accrual workpaper content as a subterfuge, giving rise to at least the appearance of diminished independence. See generally *supra* notes 17-20 and accompanying text.

¹¹⁴ 465 U.S. at 819-20 n.15.

¹¹⁵ *Id.*

¹¹⁶ See *supra* notes 101-12 and accompanying text. But see *supra* note 113.

¹¹⁷ See *infra* notes 140-56 & 157-62 and accompanying text.

tions which include audits.¹¹⁸ One state, Illinois, employs broad statutory language that protects all communications originating during the professional relationship of an accountant and client.¹¹⁹ The remaining nineteen state statutes protect accountant-client communications but include one or more exceptions that, for example, require disclosure in criminal or bankruptcy proceedings or when commanded by a court subpoena.¹²⁰ Although these provisions vary in scope and degree of protection, they indicate that protection of accountant-client communications at the state level apparently has not impaired public perception of auditor independence.

The Supreme Court believed that a privilege for tax accrual workpapers might impair public confidence in the audit process by creating an impression of an auditor as an advocate of the company. Denial of a privilege for tax accrual workpapers, however, may impair public confidence in the audit process by creating an impression that the auditor is an adversary of the company. According to GAAS, "independence does not imply the attitude of a prosecutor, but rather a judicial impartiality."¹²¹ An independent auditor should be an impartial professional, neither favoring nor disfavoring the company.¹²² Allowing IRS access to tax accrual workpapers may create a public perception of an auditor as a supplemental en-

¹¹⁸ The 20 states that have enacted some form of statutory protection for confidential communications between accountant and client are: Arizona, Florida, Georgia, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Missouri, Montana, Nevada, New Mexico, Pennsylvania, Rhode Island, Tennessee, Vermont, and Washington. See generally Note, *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. CORP. L. 349, 368-72 (1977) (survey of state testimonial privileges for accountant-client relationship in mid-1970s).

¹¹⁹ Act of July 22, 1943, Laws 1943, § 27, ILL. ANN. STAT. ch. 111, § 5533 (Smith-Hurd 1978) ("A public accountant shall not be required by any court to divulge information or evidence which has been obtained by him in his confidential capacity as a public accountant.").

¹²⁰ See, e.g., ARIZ. REV. STAT. ANN. § 32-749 (West Supp. 1985) (protection of accountant-client communications except in criminal and bankruptcy proceedings or where court subpoena commands disclosure); GA. CODE ANN. § 84-220(b) (Supp. 1982) (protection of accountant-client communications except, for example, where dispute over accounting services, or where peer review by other accountants or professional organizations); MD. CTS. & JUD. PROC. CODE ANN. § 9-110 (1984) (protection of accountant-client communications except in criminal and bankruptcy proceedings); MICH. COMP. LAWS ANN. § 339.713 (West Supp. 1985) (protection of accountant-client communications except, for example, where waived by client, or where part of defense in court action or administrative hearing); PA. STAT. ANN. tit. 63, § 9.11a (Purdon Supp. 1985) (protection of accountant-client communications except for disclosures in court, accountant disciplinary action, or legal actions against accountant regarding professional services).

¹²¹ 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 220.02; see *supra* notes 17-20 and accompanying text.

¹²² 1 PROFESSIONAL STANDARDS, *supra* note 10, at AU § 220.02.

forcement arm of the IRS because access forces the auditor to disclose information detrimental to the company.¹²³ The change in an auditor's role from impartial professional to company adversary may damage public confidence in the audit process. If an auditor appears to be an adversary of the company, the public may question the credibility of audit findings.¹²⁴

C. Fundamental Fairness

The Supreme Court rejected the assertion by Arthur Young and Amerada Hess that fundamental fairness required creation of a privilege for tax accrual workpapers.¹²⁵ The parties had argued that allowing the IRS access to tax accrual workpapers is unfair because it provides the IRS with a complete preview of a corporate taxpayer's position in negotiating and litigating tax disputes.¹²⁶ The Court cited the access to tax accrual workpapers by others and the IRS policy of self-restraint in rejecting the fundamental fairness argument. On balance, neither of these reasons offsets the unfairness resulting from IRS access to tax accrual workpapers. In fact, the Court did not adequately consider the ramifications of the fundamental unfairness of IRS access. If left unabated, this unfairness may erode public confidence in the fairness of federal taxing and have a detrimental effect on the self-assessed taxing structure.¹²⁷

¹²³ See Caplin, *supra* note 37, at 199-200. Cf. SEC v. Arthur Young & Co., 590 F.2d 785, 788 (9th Cir. 1979) (SEC cannot conscript auditors to do agency task).

¹²⁴ See *supra* notes 17-20 and accompanying text. Critics of the accounting profession question whether the major accounting firms are independent of their audit clients. Much criticism centers on the "other services," such as tax and management consulting, that these accounting firms often perform for their major audit clients. Critics charge that auditors' financial ties to their clients through these "other services" impair the independence of auditors.

A prominent critic of the accounting profession, Professor Abraham Briloff, summed up the criticism aptly:

The owner of a closely held enterprise was desirous of going public. . . .

. . . .
 . . . As the partner of each [major accounting] firm was interviewed, he was asked, "What does 2 plus 2 equal?" Each of the respondents replied "Four, of course"—that is, all but the one from the lucky [firm that got the audit engagement]. His answer, after some serious reflection, was, "What number did you have in mind?"

A. BRILLOFF, UNACCOUNTABLE ACCOUNTING 1-2 (1972).

Despite criticism of the accounting profession, the profession continues, by federal design, to play a prominent role in the public securities system. See *supra* notes 5-8 and accompanying text.

¹²⁵ *Arthur Young*, 465 U.S. at 820.

¹²⁶ *Id.*

¹²⁷ See *infra* notes 140-56 and accompanying text.

1. *The Supreme Court's Reasons for Finding No Fundamental Unfairness*

a. *Access to Tax Accrual Workpapers by Others.* The Supreme Court justified its finding that no fundamental unfairness results from IRS access to tax accrual workpapers by noting that other parties may obtain these same workpapers in nontax settings.¹²⁸ The Court observed that the SEC or private litigants may obtain tax accrual workpapers in securities litigation and concluded that if private litigants may obtain workpapers when no public interest is implicated, "no sound reason exists for conferring lesser authority upon the IRS" when the public interest in effective revenue collection is present.¹²⁹

The Court's comparative analysis of IRS and private litigant access to tax accrual workpapers appears to follow a "lesser presumes the greater" reasoning, stating that because the less important access by private litigants is allowed, the more important access by the IRS should be allowed. The Court correctly identified revenue collection as a significant public interest. Revenue collection, however, is only one of several public interests implicated by a decision to grant or deny a privilege for tax accrual workpapers. For example, a grant of privilege for tax accrual workpapers would protect the public securities system,¹³⁰ preserve the self-assessed federal taxing structure,¹³¹ and avoid increased tax litigation by corporate taxpayers.¹³²

A balancing of the competing interests is more appropriate than the Court's reasoning because a balancing test permits the decisionmaker to identify and consider all the competing interests of society before determining whether to grant or deny a privilege.¹³³ The Supreme Court's "lesser presumes the greater" reasoning fails to account for all valid public interests. As this Note will

¹²⁸ *Arthur Young*, 465 U.S. at 820.

¹²⁹ *Id.*

¹³⁰ See *supra* notes 101-12 and accompanying text. But see *supra* note 113. If the Supreme Court's conclusion that the audit process is self-verifying is correct and no harm will result to the audit process because of IRS access to tax accrual workpapers, the public policy factor of protection of the public securities system becomes neutral in determining whether to accord a privilege for tax accrual workpapers.

¹³¹ See *infra* notes 140-56 and accompanying text.

¹³² See *infra* notes 157-62 and accompanying text.

¹³³ See J. WIGMORE, *supra* note 54, § 5285, at 527 (recognition of privilege contingent on conclusion that injury caused to confidential relationship by denial of privilege outweighs benefits derived by denial of privilege). See also Note, *A Balancing Approach to the Discoverability of Accountant's Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185 (1982) (use of balancing approach in determining whether IRS should be able to access tax accrual workpapers). But see Nath, *supra* note 36, at 1590 n.118 (balancing test tends to prolong litigation because experts have to form opinion on general issue and specific case).

show, a proper balancing of all competing public interests indicates that some form of privilege should be accorded to an independent auditor's tax accrual workpapers.

b. *IRS Self-Restraint*. The Supreme Court noted that IRS self-restraint in requesting tax accrual workpapers is an alternative to a formal judicial or statutory privilege. The IRS presently has institutional guidelines providing that IRS agents should request an independent auditor's tax accrual workpapers only in "unusual circumstances."¹³⁴ The Internal Revenue Manual defines "unusual circumstances" as those situations where an agent believes a tax item to be material and the agent cannot obtain sufficient information regarding that item from the taxpayer's records or the independent auditor's nontax audit workpapers.¹³⁵ The Manual also provides that an agent must seek prior approval of a summons for tax accrual workpapers from the Chief of the Examinations Division of the IRS.¹³⁶

The IRS "unusual circumstances" guidelines for requesting tax accrual workpapers are a reasonable *administrative* response to the controversy surrounding these workpapers. The guidelines, however, are not an adequate alternative to a formal privilege. First, the guidelines are not legally enforceable against the IRS. Courts consistently refuse to hold the IRS bound by its announced policies, reasoning that IRS policies are administrative in nature and do not create any taxpayer rights.¹³⁷ Furthermore, IRS adherence to the guidelines is questionable. The IRS reaffirmed its intent to follow the "unusual circumstances" guidelines eight days after the Supreme Court announced its decision in *Arthur Young*,¹³⁸ but a study conducted in 1984 showed a significant increase in IRS requests for tax accrual workpapers.¹³⁹ Although this study is only

¹³⁴ 1 INTERNAL REVENUE MANUAL-AUDIT (CCH) § 4024.4, at 7019-3 (May 14, 1981).

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *See, e.g.,* United States v. Caceres, 440 U.S. 741, 751-55 (1978) (IRS failure to follow its internal guidelines does not invalidate agency action per se); United States v. Price Waterhouse & Co., 515 F. Supp. 996, 999 (N.D. Ill. 1981) (failure to follow internal guidelines does not preclude IRS action); *see also* Garbis & Rubin, *supra* note 34, at 345 ("[E]ven in a case in which the particular summons may be issued contrary to the stated policy [of the IRS], . . . the documents will be subject to production.") (footnote omitted).

¹³⁸ Internal Revenue News Release 84-85, STAND. FED. TAX REP. (CCH) ¶ 54,994 (Mar. 28, 1984).

¹³⁹ Schnee & Taylor, *supra* note 29, at 117. The 1984 study showed "a 28% increase [during the past three-year period] over the [previous] three-year period for the [eight largest accounting firms] and an 81% increase for the [remaining accounting firms surveyed]." *Id.* The two three-year time periods compared approximate roughly the time periods immediately prior and subsequent to the issuance of the "unusual circumstances" guidelines in 1981. *Id.* *But see* Buchholz & Moraglio, *supra* note 103, at 92-93

one attempt to assess the trend of IRS requests for tax accrual workpapers, it does suggest that reliance on IRS self-restraint as a substitute for an auditor privilege may be illusory.

2. *Fundamental Unfairness and Its Effect on the Self-Assessed Federal Taxing Structure*

Since its inception, the federal taxing system has relied upon the related concepts of voluntary compliance and self-assessment of tax liability. Taxpayers determine the amount of tax owed and file their tax returns.¹⁴⁰ Voluntary compliance and self-assessment permit the federal government to place the responsibilities of assessing, reporting, and paying federal income taxes on taxpayers, thus avoiding the cost of having government agents determine the tax liability for every individual, corporation, trust, and estate in the United States.¹⁴¹

Although taxpayers have a legal duty to self-assess taxes and voluntarily comply with the tax laws, they have no legal duty to pay the government more money than the law requires.¹⁴² Accordingly, taxpayers reasonably seek to reduce their tax liabilities to the legal minimum. Furthermore, taxpayers expect to be treated in a fair manner when they have reasonable tax disputes with the IRS.¹⁴³ A taxpayer faces a significant disadvantage when the IRS is equipped with workpapers pinpointing "gray areas" in a tax return and exposing the taxpayer's negotiating and litigating positions on such items.¹⁴⁴ Instead of both the taxpayer and the IRS relying on their own research, experience, and ingenuity when resolving a reasonable tax dispute, the IRS has the benefit of most, if not all, of the

(IRS appears to be following its guidelines regarding requests for tax accrual workpapers).

¹⁴⁰ See generally J. SCHNEPPER, *INSIDE IRS 61-85* (1978) (discussion of history of federal income tax in United States).

¹⁴¹ For the year ended September 30, 1980, the IRS examined only 2.02% of all tax returns filed. 1980 COMM'R INT. REV. ANN. REP., Table 8, at 66 [hereinafter cited as 1980 ANN. REP.]. If the IRS had to determine and assess taxes for 100% of the population, IRS costs would increase substantially.

¹⁴² In 1947, Judge Learned Hand remarked: "[T]here is nothing sinister in so arranging one's affairs as to keep taxes as low as possible . . . for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting). Cf. Address by Roscoe L. Egger, Jr., Commissioner of Internal Revenue (Mar. 1983), *reprinted in A REPORT OF THE AMERICAN BAR ASSOCIATION SECTION ON TAXATION—INVITATIONAL CONFERENCE ON INCOME TAX COMPLIANCE 13* (1983) [hereinafter cited as ABA CONFERENCE ON INCOME TAX COMPLIANCE] (adversarial relationship between taxpayers and government is at times proper to maintain balanced tax system).

¹⁴³ See Buchholz & Moraglio, *supra* note 103, at 93 (best policy for resolving reasonable tax disputes between taxpayers and IRS is respect and fairness by both sides).

¹⁴⁴ See *supra* note 38 and accompanying text.

taxpayer's work through access to tax accrual workpapers. This imbalance of information is "fundamentally and inherently unfair"¹⁴⁵ given the traditionally accepted formulation of taxes as "enforced exactions, not voluntary contributions."¹⁴⁶

Erosion of taxpayer confidence in the fairness of the federal taxing system may jeopardize federal revenue collections. To function properly, the self-assessed taxing system requires that the IRS maintain public confidence in the fairness of federal taxing.¹⁴⁷ Former Commissioner of Internal Revenue Mortimer Caplin noted that "the Service must treat taxpayers in a fair, evenhanded manner, and demonstrate to the public that it is doing so."¹⁴⁸ Mr. Caplin concluded that the IRS should rethink its position on access to tax accrual workpapers to remove the possibility that the public and tax practitioners may perceive IRS access to workpapers as an unfair government advantage.¹⁴⁹ Other commentators have echoed this concern about the potential threat to the self-assessed taxing structure, noting the "Orwellian specter" of the IRS, a governmental agency, "intruding into the thought processes" of taxpayers and their advisers.¹⁵⁰

An impaired self-assessment system creates the risk of losing federal tax revenues because of taxpayer noncompliance with the tax laws.¹⁵¹ This risk could carry a high price in lost revenues given

¹⁴⁵ Brief *Amicus Curiae* of The Committee on Corporate Law Departments of the Association of the Bar of the City of New York at 4, *Arthur Young*, 465 U.S. 805 (1984). See also Note, *supra* note 133, at 207 (IRS access to tax accrual workpapers is unfair because it effectively requires the taxpayer to "prepare the IRS's case").

¹⁴⁶ *Commissioner v. Newman*, 159 F.2d 848, 851 (2d Cir. 1947) (Hand, J., dissenting).

¹⁴⁷ See U.S. DEP'T OF TREASURY, TREASURY REPORT ON TAX SIMPLIFICATION AND REFORM 9 (Nov. 1984) ("Taxpayer morale ultimately depends . . . on the belief that taxes are fair. If the basis for this belief comes under suspicion, voluntary compliance with the tax laws is jeopardized."). See also Caplin, *supra* note 34, at 82-83 (public confidence in fairness of taxing system is vital to present taxing structure); Buchholz & Moraglio, *supra* note 103, at 93 (self-assessed taxing structure depends on taxpayer honesty which is fostered by fairness and respect for taxpayers).

¹⁴⁸ Caplin, *supra* note 34, at 82.

¹⁴⁹ *Id.* at 82-83. Cf. Witte & Woodbury, *What We Know About The Factors Affecting Compliance With The Tax Laws*, in ABA CONFERENCE ON INCOME TAX COMPLIANCE, *supra* note 142, at 139 ("studies indicate that [tax] compliance is higher among those who believe . . . that the laws are administered equitably").

¹⁵⁰ Buchholz & Moraglio, *supra* note 103, at 93. See also Note, *supra* note 133, at 207 (IRS access to tax accrual workpapers threatens self-assessed taxing system because of inherent unfairness of such access).

¹⁵¹ See Jackson, *Stemming Income Tax Evasion—The Hole in the Dike is Widening*, J. ACCT., Jan. 1985, at 76, 76-77 (discussing magnitude of federal revenue loss from overall non-compliance within current taxing system; citing IRS study for estimate that government did not collect \$95.2 billion in 1981 because of problems in current taxing system). See also Henry, *Noncompliance with U.S. Tax Law—Evidence on Income Tax Compliance*, in ABA CONFERENCE ON INCOME TAX COMPLIANCE, *supra* note 142, at 15-111 (survey and analysis

the potential widespread effect of IRS access to tax accrual workpapers on business taxpayers. In 1980, the IRS received 2,061,672 corporate tax returns.¹⁵² All of these corporations are either actual or potential audit clients because of their frequent need for an audit to obtain credit.¹⁵³ Similarly, many unincorporated businesses are also either actual or potential audit clients because often they too must submit to an audit to acquire needed capital.¹⁵⁴ Moreover, in a recent study of taxpayer noncompliance with the tax laws, the IRS attributed approximately thirty-three percent of the total \$95.2 billion in uncollected taxes in 1981 (\$32 billion) to corporate and noncorporate businesses.¹⁵⁵ If IRS access to tax accrual workpapers spurs a widespread loss of public confidence in the fairness of federal taxing, the overall tax compliance rate, currently estimated at about eighty-five percent,¹⁵⁶ may drop even further. The potential loss of tax revenue resulting from increased noncompliance with the tax laws may diminish or outweigh any gain the IRS may derive from the use of tax accrual workpapers in individual cases.

D. Increased Tax Litigation

The potential for increased tax litigation, a policy factor not addressed by the Supreme Court in *Arthur Young*, also should be considered in determining whether to accord a privilege to tax accrual workpapers. Allowing the IRS access to tax accrual workpapers may lead to an increase in tax litigation by corporate taxpayers.

As indicated previously, the self-assessed federal income tax system requires taxpayers or their advisers to determine what the tax law prescribes regarding tax treatment of various financial trans-

of various studies regarding taxpayer noncompliance leads to rough consensus that taxpayers did not report \$100 billion of taxable income in 1976).

Of course, the IRS could increase its enforcement efforts to counter a drop in voluntary compliance by taxpayers. Such increased efforts, however, would be costly, considering that in the year ended September 30, 1980, for example, the IRS audited less than 7% of all corporate tax returns and only approximately 2% of all individual tax returns filed. 1980 ANN. REP., *supra* note 141, Table 8, at 66-67.

¹⁵² See 1980 ANN. REP., *supra* note 141, Table 7, at 64.

¹⁵³ Statistics are not maintained on the total number of companies audited each year by independent auditors. At a minimum, however, the 10,717 companies currently required to file audited financial statements with the SEC will be affected by *Arthur Young*. Telephone interview with Joseph Meiburger, Staff of the Securities and Exchange Commission (Feb. 11, 1985) (citing SEC, DIRECTORY OF COMPANIES REQUIRED TO FILE ANNUAL REPORTS WITH THE SECURITIES AND EXCHANGE COMMISSION (Introduction) (July 1984)).

¹⁵⁴ See *supra* note 9 and accompanying text.

¹⁵⁵ See Jackson, *supra* note 151, at 78 (derived from breakdown of IRS estimate of lost income tax revenue in 1981).

¹⁵⁶ *Id.* at 77.

actions. As all taxpayers can attest, the Code is complex.¹⁵⁷ This complexity arises, in part, because the Code employs a generalized approach and contains provisions intended to apply to millions of taxpayers.¹⁵⁸ Given that the Code is not always clear, reasonable people, in good faith, may differ as to the tax treatment of a particular financial item or transaction.¹⁵⁹ These differences between the IRS and taxpayers are frequently settled through negotiation. For example, in the year ended September 30, 1980, the IRS and taxpayers settled 41,963 or approximately 84% of the 49,971 federal tax cases closed.¹⁶⁰ The Second Circuit noted in *Arthur Young* that the IRS-taxpayer negotiation and settlement process "strike[s] an appropriate balance between collecting revenue and conserving judicial resources."¹⁶¹

IRS access to an independent auditor's tax accrual workpapers may encourage taxpayers to by-pass the negotiating process because of the IRS's superior bargaining position. With access to tax accrual workpapers, the IRS knows exactly where a corporate taxpayer expects or hopes to compromise on an asserted tax deficiency. The IRS may use this information as a starting point in negotiations, thus attempting to force a compromise at a higher amount of tax than would have been attempted without such information.¹⁶² As a result, corporate taxpayers may become more litigious in reasonable

¹⁵⁷ See J. SCHNEPPER, *supra* note 140, at 13-15 (tax code is complex for all persons who deal with it, evidenced by "average 75 percent error rate on tax returns filed by paid preparers" in nationwide sample audits by IRS).

¹⁵⁸ For the year ended September 30, 1980, the IRS received and processed a total of 96,409,932 tax returns, consisting of 90,727,115 individual tax returns, 2,061,672 corporate tax returns, 1,820,708 fiduciary (trust and estate) tax returns, and 1,800,437 other types of tax returns. 1980 ANN. REP., *supra* note 141, Table 8, at 66-67.

¹⁵⁹ *Arthur Young*, 677 F.2d at 220. See also M. SALTZMAN, *supra* note 105, ¶ 9.01-.11, at 9-1 to 9-59 (detailed discussion of appeals process for tax disputes with IRS); M. GARBIS & S. STRUNTZ, TAX PROCEDURE AND TAX FRAUD 25-30 (1982) (ethics of tax practice require that tax preparer have only "reasonable support" for client's position for items in tax return) (excerpting Corneel, *Ethics Guidelines for Tax Practice*, 28 TAX L. REV. 1 (1972)).

¹⁶⁰ 1980 ANN. REP., *supra* note 141, Tables 15-16, at 74. In the year ended September 30, 1980, the IRS Examinations Division examined 2,179,297 tax returns. Of this total, the IRS settled 1,997,302 or 90% by agreement with the taxpayer, taxpayer payment, or taxpayer default. *Id.* Table 12, at 72.

This high rate of settlement of tax disputes by the IRS and taxpayers has been a consistent feature of the federal taxing structure. See, e.g., E. GRISWOLD & M. GRAETZ, FEDERAL INCOME TAXATION 1063-65 (1976) (in 10 year period 1963-1973, IRS and taxpayers settled 97% of all tax disputes; in 1973, IRS and taxpayers settled 54,351 cases while federal judiciary decided 1,738 tax cases) (citing 1973 COMM'R INT. REV. ANN. REP.).

¹⁶¹ *Arthur Young*, 677 F.2d at 220.

¹⁶² See generally C. KARRASS, THE NEGOTIATING GAME 61 (1970) ("The more a negotiator knows about an opponent's objectives and bargaining position the stronger he is."); H. COHEN, YOU CAN NEGOTIATE ANYTHING 101-13 (1980) (information is power; knowing wants, limits, and priorities of other side provides decisive advantage).

tax disputes because the increased cost of compromise may outweigh the cost of litigating, and possibly winning, such tax disputes.

IRS access to tax accrual workpapers may result in increased revenue collection and improved IRS efficiency by facilitating quick identification of "gray areas" and relevant facts surrounding tax disputes. If corporate taxpayers become more litigious in tax disputes, however, the positive benefits may be outweighed or reduced by the increased cost of litigating a greater number of tax cases. Consequently, although the United States treasury may benefit from IRS access to tax accrual workpapers, the magnitude of the benefit, if any, is subject to question because of possible increased government litigation costs.

In sum, some type of privilege protection should be accorded to tax accrual workpapers because the public policy benefits of granting a privilege outweigh the costs of denying the IRS access to the workpapers. Because the Supreme Court has ruled against such a privilege, only the legislature can take corrective action. The Supreme Court itself stated in *Arthur Young* that "[t]his kind of policy choice is best left to the Legislative Branch."¹⁶³ Congress should respond to this challenge and provide protection for tax accrual workpapers.

V

AUDITOR PRIVILEGE LEGISLATION

Once Congress accepts the need for an auditor privilege, it must determine the appropriate scope of the privilege. The starting point for determining the scope of a privilege is the guideline that a privilege should be no greater or less than that which is necessary and warranted by policy interests.¹⁶⁴ Three principal questions arise in applying this guideline to an auditor privilege: what is to be

¹⁶³ *Arthur Young*, 465 U.S. at 821.

¹⁶⁴ See J. WIGMORE, *supra* note 54, § 2285, at 527 (One of four conditions precedent to recognition of privilege is that "[t]he injury that would incur to the [confidential] relation by the disclosure of the communication must be greater than the benefit thereby gained [by disclosure of the communication].") (emphasis in original; footnote omitted).

The common law recognized the need to balance the public interests implicated when determining the scope of a privilege, as evidenced by the limitations placed on the traditional privileges for attorney-client and husband-wife confidential communications. For example, the attorney-client privilege does not extend to communications before or after the professional relationship, *id.* § 2304, at 586, communications not relevant to legal advice, *id.* § 2310, at 598-99, or generally to acts or facts not subject to express communications, *id.* § 2306, at 590-91. Exceptions to the husband-wife privilege include cases involving certain injuries inflicted by one spouse on the other spouse, a wife's correspondence with her husband in cases of criminal conversation, criminal actions for family desertion, and civil suits for nonsupport. *Id.* § 2338, at 665-66.

protected, who is to be protected, and when such protection should be extended.

The first question refers to what specific documents the privilege should cover. Most privilege advocates agree that only an independent auditor's tax accrual workpapers deserve protection.¹⁶⁵ Expanding the privilege to include an auditor's other documentation is unnecessary because disclosure of other documentation to the IRS does not expose sensitive tax information, the impetus underlying creation of the privilege. Furthermore, the *Powell* standard of relevancy, which limits the IRS summons power to include only relevant documents, will continue to provide adequate protection for an auditor's other documents.¹⁶⁶

The second question concerns whether the privilege should apply only to audits of publicly held companies or to audits of privately held companies as well. In *Arthur Young*, the Second Circuit directed its "work product privilege" to audits of publicly held companies, focusing on the need to protect the public securities markets.¹⁶⁷ Under this approach, protection of tax accrual workpapers of private companies would be unnecessary because these companies may not access the public capital markets.

Although private companies do not participate in the public securities system, these companies do affect the public because they obtain credit and capital from private lenders and investors.¹⁶⁸ These lenders and investors often require an audit of a private company by an independent auditor before lending or investing finan-

¹⁶⁵ See, e.g., Caplin, *supra* note 37, at 199 (distinction between tax accrual workpapers and corporate records). See also Note, *An Appraisal of Arthur Young: A Valuable Privilege for Accountants*, 48 ALB. L. REV. 109, 145 (1983).

¹⁶⁶ See *supra* note 63 and accompanying text.

¹⁶⁷ See *supra* notes 69-78 and accompanying text. The Second Circuit did not address whether a privilege should protect tax accrual workpapers in an audit of a private company because Amerada Hess was a publicly held corporation. Given the circuit court's focus on protecting the public securities system, a factor not present in private company audits, protection of tax accrual workpapers in private company audits would require the court to adopt a more expansive view of the purpose underlying a privilege for tax accrual workpapers than it expressed in *Arthur Young*.

¹⁶⁸ Private lending institutions lend depositors' funds to businesses and other loan applicants. If those loans become uncollectible, depositors may not suffer directly because of federal insurance, but others are deprived of funds which could have been employed productively. Further, the public may invest or lend financial resources directly to private companies. If these investments or loans fail, not only do those members of the public suffer, but, again, others are deprived of resources which could have been employed productively. See A. ARENS & J. LOEBBECKE, *supra* note 9, at 1 ("Unreliable information can cause inefficient use of resources to the detriment of society and to the decision makers themselves."). But see Note, *supra* note 165, at 141-42 (less need for privilege for small business corporations because lenders and investors are "more closely associated" with such entities).

cial resources.¹⁶⁹ Absent a privilege for tax accrual workpapers in private company audits, users of private company financial statements may suffer the same harm as investors in the public securities markets. IRS access to tax accrual workpapers in private company audits may inhibit managers in their communications with independent auditors. In short, IRS access to tax accrual workpapers in either public or private company audits threatens the audit process and increases the risk that materially misstated financial statements reach investors.¹⁷⁰

Moreover, the other policy reasons underlying recognition of a privilege (preventing an appearance of impaired auditor independence, avoiding increased tax litigation, and protecting the self-assessed federal taxing structure) apply equally to public and private company audits. The factors that give rise to these public policy concerns are present in both types of audits. For example, IRS access to tax accrual workpapers in an audit of either a public or private company may affect the credibility of audit findings because the public may perceive the auditor as an adversary of the company rather than as a disinterested professional. The possibilities of increased tax litigation and damage to the self-assessed federal taxing structure also apply to private companies, perhaps with even greater emphasis than public companies, given the large number of private companies.¹⁷¹ Because audits of public and private companies implicate the same policy concerns, a legislatively created privilege should include private company audits as well as audits of public companies.¹⁷²

The third question, concerning when the privilege should be

¹⁶⁹ See *supra* note 9 and accompanying text.

¹⁷⁰ See Stanger, *Auditors' Tax Accrual Work Papers—A New Work Product Privilege*, 5 CORP. L. REV. 374, 377-78 (1982) (“[T]he [privilege] rationale can be extended to the auditor’s attest function . . . for the protection of lenders who also rely on financial statements of the [private] borrower in making their lending decisions.”).

A private company may engage an accountant to perform a “review” or “compilation” of financial statements as a substitute for an audit conducted in accordance with GAAS. “Reviews” and “compilations” are special accounting services, costing less than an audit, that provide less assurance that the financial statements are presented fairly in accordance with GAAP. See 1 PROFESSIONAL STANDARDS, *supra* note 10, at AR §§ 100-9300. This Note does not address whether privilege protection should extend to any tax accrual workpapers prepared by an accountant in connection with these special services.

¹⁷¹ See *supra* notes 151-62 and accompanying text.

¹⁷² Coverage of both public and private companies is consistent with a recent legislative bill, H.R. 5431, 98th Cong., 2d Sess. (1984), introduced in the House of Representatives. Representative Ron Paul introduced H.R. 5431 on April 11, 1984, proposing to amend § 7602 by adding the following new subsection:

(d) CERTAIN TAX WORKPAPERS OF INDEPENDENT AUDITORS MAY NOT BE SUMMONED, ETC. - Nothing in this title shall be construed to authorize-

(1) a summons to be issued under this title for the production of workpapers prepared by an independent auditor with respect to the ade-

extended, addresses whether the IRS should be barred from accessing tax accrual workpapers in all circumstances, and, if not, under what circumstances IRS access should be permitted. A flat ban on IRS access would provide an easy standard for courts and the greatest protection of workpapers, but it also would preclude IRS access when extenuating circumstances make such access necessary. For example, where a natural or man-made disaster destroys corporate records, IRS access to tax accrual workpapers should be allowed because the workpapers will constitute the only source of information regarding the tax return.¹⁷³ Similarly, where the IRS shows a prima facie case of tax fraud, tax accrual workpapers may be a necessary source of information. Fraud requires proof of fraudulent intent, and corporate documents may not contain enough information to prove that intent.¹⁷⁴

A legislative presumption of no IRS access to tax accrual workpapers, rebuttable by the IRS upon a showing of "true hardship and need," would accommodate both the general need for protection of tax accrual workpapers and instances of specific need by the IRS to gain access to the workpapers.¹⁷⁵ A presumption of no IRS access would protect tax accrual workpapers by shifting the burden of proof to the IRS to show "true hardship and need." The privilege legislation may include as illustrations of "true hardship and need" the instances of corporate records destruction and prima facie cases of tax fraud. The legislation, however, should not contain a narrow definition of "true hardship and need" nor an exclusive listing of what circumstances will satisfy this standard. A narrow definition or listing would preclude the possibility of recognizing other instances of legitimate IRS need for tax accrual workpapers. Flexibility is desirable because it will allow courts to

quacy and reasonableness of a taxpayer's reserve for contingent tax liabilities, or

(2) the taking of testimony with respect to such workpapers.

H.R. 5431, 98th Cong., 2d Sess. (1984).

H.R. 5431 was referred to the House Committee on Ways and Means, but the Committee did not undertake any action regarding the bill. Not enacted as law at the time of adjournment of the 98th Congress, H.R. 5431 is no longer a viable bill. Furthermore, because Rep. Paul was not reelected to the House in 1984, the prospects for reintroduction of H.R. 5431 or introduction of other similar legislation regarding tax accrual workpapers are questionable.

¹⁷³ See Caplin, *supra* note 37, at 199.

¹⁷⁴ The Second Circuit recognized an exception to its auditor privilege for cases involving taxpayer fraud. See *supra* note 77 and accompanying text.

¹⁷⁵ The Second Circuit also endorsed limiting the privilege for tax accrual workpapers by allowing IRS access where the IRS meets a threshold of need. See *Arthur Young*, 677 F.2d at 221 ("sufficient showing of need" by IRS for access to tax accrual workpapers). See also Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 *FORDHAM L. REV.* 468, 488 (1982) (endorsement of "sufficient showing of need" as threshold for IRS access to tax accrual workpapers).

mold the privilege to reflect basic changes in public needs and accommodate new circumstances in relations among corporate taxpayers, independent auditors, and the IRS.¹⁷⁶

CONCLUSION

United States v. Arthur Young & Co. ended the judicial controversy over whether the IRS may obtain an independent auditor's tax accrual workpapers under section 7602 of the Internal Revenue Code. The Supreme Court refused to establish an auditor privilege, granting the IRS unlimited access to the workpapers. Congress should respond to the *Arthur Young* decision and create a statutory privilege for tax accrual workpapers because public policy reasons support such a privilege.

The grant of a privilege for tax accrual workpapers will protect investors and creditors from materially misstated financial statements, maintain the appearance of auditor independence, preserve the self-assessed federal taxing structure, and avoid increased corporate tax litigation. These benefits outweigh any increase in revenue collection or improvement of IRS efficiency that denial of a privilege may provide.

A legislatively created privilege for an independent auditor's tax accrual workpapers should cover workpapers prepared in an audit of either a public or private company. Both types of audits implicate the policy concerns that require the creation of a privilege. The legislative protection should encompass a presumption of no IRS access to tax accrual workpapers, rebuttable by the IRS upon a showing of "true hardship and need." A rebuttable presumption satisfies the general need for tax accrual workpaper protection, but still provides courts with the flexibility to modify the privilege as public needs change regarding these seemingly uninteresting yet highly explosive workpapers.

Scot L. Kline

¹⁷⁶ Cf. *In re LTV Sec. Litig.*, 89 F.R.D. 595, 621 (N.D. Tex. 1981) (changing societal relationships require periodic review of need for and extent of attorney-client privilege).