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I. INTRODUCTION

Every modern public corporation has obligations of accountability and disclosure to the public and to its shareholders. These accepted duties of disclosure, however, become the source of conflicts when government agencies make unanticipated inquiries of accountants about otherwise private or background data concerning the corporations they audit. This is particularly true when a public corporation's duties of financial accountability, which stem chiefly from securities law requirements and fiduciary duties, evoke the Internal Revenue Service's interest in information that may reveal or be probative of the corporation's tax liability. Most corporate taxpayers and their accountants understand and accept—if only reluctantly—their obligations to provide the Internal Revenue Service (IRS or Service) with relevant documents generated during everyday business activity. More recently, however, the complexity of financial accountability requirements has prompted some corporations to ask their independent accountants to prepare a set of "sensitive"[1] papers for the audit of the corpora-

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1. The American Institute of Certified Public Accountants (AICPA) and the American Bar Association implicitly acknowledged the extent of this sensitivity when they formed advisory committees on the topics discussed in this Article to organize the resistance to the Government's attempts at obtaining these papers by summons. Moreover, at least one court has found the topic to be too controversial to decide on the facts presented. United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980). In the initial appeal to the First Circuit, the court dismissed the case as moot, since the workpapers had been produced. The case went to the court of appeals again, however, because the summons also called for testimony, which of course had not been "produced." The court stated,

tion's financial statements. These papers, which the accountants and their client corporations originally did not intend for revenue agents to examine, have attracted the Service's interest because of their potential impact on the corporation's tax liability.

A legal controversy has been emerging recently in a few reported cases over the Service's efforts to obtain by summons[2] accountants' "sensitive" papers. These documents include audit workplans, reports to management (dealing with internal accounting and management controls), and tax reserve papers (dealing with the corporate balance sheet's accrued reserve for contingent tax liabilities). The controversy concerns a small but influential group of clients—the very large public corporations—and the "Big Eight" of the accounting profession.[3] After examining the back-

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The importance of the interests of all concerned—taxpayers, accountants, and IRS—is clear. That a resolution sensitively reflecting the legitimate interests of all and faithful to applicable statutes would involve the most delicate and demanding analysis of facts, research and law, and reflection on policy is equally clear. Precisely because we view the issue of "relevance" as so significant, we find this case in a poor posture to serve as the matrix for a precedent. . . .

We therefore hold . . . that because of the production of the records to which any questioning would relate, any decision regarding the possible relevance of such questioning under 26 U.S.C. § 7602 would be premature.

623 F.2d at 729-30.

2. The summons power is codified in I.R.C. § 7602, which deals with the examination of books and witnesses and provides as follows:

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary 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 may deem proper, to appear before the Secretary 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.

3. The eight major accounting firms are as follows: Arthur Andersen & Co.; Arthur Young & Co.; Coopers & Lybrand; Deloitte, Haskins & Sells; Ernst & Whinney; Peat, Marwick, Mitchell & Co.; Price Waterhouse & Co.; and Touche Ross & Co. Each of the litigated cases in this field has involved at least one of these firms or a client thereof. Generally, however, the accountants have been the only ones who have evinced a truly adversarial attitude. In United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), for example, the taxpayer, Johns-Manville Corp., was not a party and did not seek to intervene. *Accord*, United States v. Price Waterhouse & Co., 515

ground of this controversy in more detail, this Article explores the IRS' efforts to resolve the dispute in its favor, the availability of the summons power to obtain sensitive accountant workpapers, the public policy controversy generated by the Service's efforts, and the course that the debate is likely to take on these issues in the future.[4]

II. BACKGROUND

When a corporation goes public, the law subjects it to a series of reporting and disclosure requirements in fulfillment of new obligations to its shareholders and the public. Many federal and state statutes and regulations that govern corporate existence in general, and public corporations in particular, require the engagement of independent accountants to perform annual audits of the corporation's books, records, and financial statements. Most prominent among these duties are securities law reporting requirements (Securities and Exchange Commission (SEC or Commission) regulations) and Generally Accepted Accounting Principles, which delimit the scope and depth of the accountants' audit. The Commission's Regulation S-X[5] specifies the uniform accounting rules for certain financial statements required to be filed under the Securi-

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F. Supp. 996 (N.D. Ill. 1981) (mem.). *Compare* United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980) *and* United States v. Riley Co., 45 A.F.T.R.2d 80-1164 (N.D. Ill. 1980) (mem.), *appeal dismissed,* No. 80-1124 (7th Cir. Sept. 16, 1980) *and* United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot,* 623 F.2d 720 (1st Cir.), *cert. denied,* 449 U.S. 1021 (1980), *aff'd as to second party,* 623 F.2d 725 (1st Cir. 1980) *with* United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill. 1978) (mem.) *and* United States v. Noall, 587 F.2d 123 (2d Cir. 1978), *cert. denied,* 441 U.S. 923 (1979).

4. A public corporation's engagement of independent accountants to fulfill auditing requirements often will generate tension between the reporting and disclosure obligations and the accountants' desire to keep secret the "private" papers that they prepare for their client. Furthermore, the Service's efforts to compel production of the engagement's results exacerbate this conflict, which is in part a result of the accountant's dual role as private counselor and public overseer. It is understandable, therefore, that the accounting profession would take such a keen interest in the outcome.

In United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.) Price Waterhouse responded to the Government's petition in part by filing eight affidavits, one each from the "Big Eight" accounting firms. These affidavits were aimed at convincing the court that the accountants' auditing standards would suffer if the court compelled production of the tax reserve memorandum that was summoned by the IRS. *Id.* at 1000 n.6. Significantly, the client-taxpayer did not ever seek to intervene and expressed no reluctance to have the IRS obtain a copy of the memorandum from Price Waterhouse, which was the Service's only source.

5. 17 C.F.R. § 210 (1980).

ties Act of 1933,[6] the Securities Exchange Act of 1934,[7] and the Investment Company Act of 1940.[8] Rule 3-16(o)[9] of the regulation requires disclosure in a corporation's income statement—or a note to it[10]—of the components of income tax expense, including taxes currently payable. The rule further provides that the corporation must detail the net effects of timing differences for items such as depreciation, warranty costs, operating losses, and net deferred investment tax credits. The financial statement or a note to it also must contain a provision concerning foreign taxes, in addition to a disclosure of the reasons for and amount of any cash outlay for income taxes due in succeeding years, if they will substantially exceed the current year's taxes. Finally, the rule requires a reconciliation of the reported tax expense with pretax income mutiplied by the applicable tax rate, and an explanation of any differences between the two figures.[11]

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6. 15 U.S.C. §§ 77a-77aa (1976).
7. 15 U.S.C. §§ 77b-77e, 77j, 77k, 77m, 77o, 77s, 78a-78o, 78o-3, 78p-78hh (1976).
8. 15 U.S.C. §§ 80a-1 to -52 (1976).
9. 17 C.F.R. § 210.3-16(o) (1980).
10. The following are examples of financial statement notes:

XEROX CORPORATION (DEC)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Subsequent Event—On February 12, 1979, the Company received an Internal Revenue Service notice proposing additional tax liability of $88 million for the years 1972 and 1973 which will be vigorously contested by the Company. The proposed adjustments relate principally to the timing of depreciation deductions for tax purposes. The IRS is proposing a longer life for the Company's copying and duplicating equipment than currently used for both tax and financial reporting purposes; however, this will not affect the way the Company currently depreciates copying and duplicating equipment in its financial statements. In the opinion of the Company, the final outcome will have no material impact on results of operations.

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CMI CORPORATION (DEC)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Note 9 (in part): Commitments and Contingent Liabilities—

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The Internal Revenue Service has completed its examination of the Company's income tax returns for the years 1972 through 1975 and advised the Company that additional income taxes of approximately $2,300,000 were due for those years, a major portion of which results from timing differences. The Company has contested the asserted deficiencies and has petitioned for a redetermination of the deficiencies before the United States Tax Court. In the opinion of management, the final additional tax will be substantially less than the amounts proposed. The Company believes that it has made adequate provision for final settlement of the proposed adjustments.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING TRENDS AND TECHNIQUES, 78, 113 (33d ed. 1979).

11. The Commission considered, but did not adopt, a more far-reaching amendment. *See* Keeshan & Craco, *Securities Law Considerations in the Auditor's Tax Accrual Review,*

The accounting profession's standard for the disclosure of material contingent items is contained in Financial Accounting Standards Board (FASB) No. 5, entitled "Accounting for Contingencies."[12] FASB No. 5 applies to several of the possible components of a corporation's reserve for contingent taxes, including timing differences,[13] permanent differences,[14] and other potential adjustments, all of which require judgments of inclusion or exclusion on the part of the accountant. Under this standard, any loss *must* be accrued by a charge to income if information available prior to the issuance of the financial statement indicates it is "probable"[15] that an asset has been impaired or a liability incurred as of the date of the financial statement, and that the amount can be reasonably estimated. If accrual is not appropriate, then the contingency must be disclosed if a loss is at least a "reasonable possibility."[16] The disclosure must reveal the nature of the contingency and estimate the range of the potential loss.[17] If a particular contingent item is of borderline materiality, the doctrine of conservative accounting[18] may require accrual or disclosure to avoid a potential liability for

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in IRS ACCESS TO ACCOUNTANTS' WORKPAPERS 15-18 (N.Y.L.J. Law Journal Seminars-Press 1980). The authors state that the proposed rule would have required reporting companies to reconcile the following two sets of figures: (a) Pretax income and income tax expense, both federal and foreign, and (b) taxable income and related income taxes that are anticipated to be reported on federal and foreign returns. This proposal might have required disclosure of tax accrual workpapers. *See* Securities Act Release No. 6178, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,424 (Jan. 15, 1980). The proposal, however, was strongly opposed and withdrawn. Securities Act Release No. 6233, 6 FED. SEC. L. REP. (CCH) ¶ 72,302 (Sept. 2, 1980).

12. FASB STATEMENT No. 5.

13. *See* notes 38-42 *infra* and accompanying text.

14. *See id.*

15. "Probable" is defined as follows: "The future event or events are likely to occur." FASB STATEMENT No. 5, ¶ 3(a).

16. "Reasonably possible" is defined as follows: "The chance of the future event or events occurring is more than remote but less than likely." *Id.* ¶ 3(b).

17. No disclosure is required, however, when a potential claimant has manifested no awareness of a claim "unless it is considered probable that the claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable." *Id.* ¶ 10.

18. Although the doctrine of conservative accounting has sometimes been oversimplified, in that it is said to require an overstatement of liabilities and an understatement of assets and net income, it is actually two principles intended to guide accountants' best estimates of a firm's actual financial situation. First, the doctrine forbids the anticipation of sales, revenues, or income. Recognition is permitted only on the consummation of sale and delivery. Second, estimates of all liabilities and losses, if known to have been incurred, should be recorded despite a lack of certainty about the exact amount. These principles reinforce the accountant's independent attempt to provide the most reasonable and accurate reflection of "potential losses in the realization of recorded assets and in the settlement of actual and contingent liabilities." R. WIXON, W. KELL & N. BEDFORD, ACCOUNTANTS HANDBOOK 1-22 (5th ed. 1970).

the accountants.

Under these guidelines and standards, the accountant must decide whether the contingent tax reserve and other accounts on the financial statement are reasonable and correct, as well as whether any error is sufficiently material[19] to require disclosure. To make these decisions, the accountants must evaluate the reasonableness and materiality of the tax reserve and other accounts from both an individual and collective viewpoint. The accountant then may be in a position to render the required formal opinion on the statement's adherence to Generally Accepted Accounting Principles (GAAP).

In addition to the public reporting that is required of the corporation, the accountants themselves are subject to personal liabilities, the range and frequency of which have been steadily increasing.[20] These liabilities can extend to criminal charges as well as civil actions for damages.[21] The threat of such sanctions creates a self-preservation motive that induces accountants to make thorough audits of their corporate clients. To fulfill all of their duties during and after the audit, accountants create at least three distinct sets of papers that are the subject of the emerging contro-

19. *See* Keeshan & Craco, *supra* note 11, at 22-24 (defining materiality).

20. *See, e.g.*, Gormley, *Accountants' Professional Liability—A Ten-Year Review*, 29 BUS. LAW. 1205 (1974); Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME LAW. 838 (1977).

21. Under I.R.C. § 7206(2) it is a felony to assist willfully in the preparation of a false or fraudulent return. *See, e.g.*, United States v. Egenberg, 441 F.2d 441 (2d Cir.), *cert. denied*, 404 U.S. 994 (1971); Newton v. United States, 162 F.2d 795 (4th Cir. 1947), *cert. denied*, 333 U.S. 848 (1948) (false or excessive deductions). *See generally* Annot., 43 A.L.R. Fed. 128 (1979). Accountants are also liable for ordinary negligence or fraud. *See* Annot., 46 A.L.R.3d 979 (1972). Moreover, they may be subject to censure or suspension from practice before the SEC for failure to follow Generally Accepted Accounting Principles (GAAP), Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979), and, under certain circumstances, may share the liability of their principals for rule 10b-5 violations. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967). The profession is also highly regulated by state law, and improprieties can result in the ultimate sanction of loss of license. *See* Annot., 70 A.L.R.2d 433 (1960) (collecting law and cases from twenty-one jurisdictions that regulate the accountancy profession). *See generally* Gormley, *supra* note 20; Mess, *supra* note 20. Finally, Treasury Department Circular No. 230, 31 C.F.R. § 10 (1980), is a comprehensive document that sets forth the Service's rules on who may practice before it, ethical duties required of enrolled agents, and the disciplinary proceedings for violation of its provisions. The authority to practice before the IRS is the bread and butter of many accountants, particularly members of the larger firms such as the "Big Eight." The Circular imposes general duties of disclosure, *id.* § 10.20, the duty to disclose errors or omissions, *id.* § 10.21, and a duty of diligence in ensuring the accuracy of a return. *Id.* § 10.22. Violation of any part of Circular 230 clearly could cause serious consequences for the accountant's practice.

versy: (1) The audit workplan,[22] (2) reports to management,[23] and (3) tax reserve files and memoranda. The last of these are also sometimes termed tax pool analysis files,[24] tax accrual workpapers and reports,[25] and tax contingency reserves or analyses.[26] A clear understanding of the contents of these papers is essential to any discussion of the legal issues that they have generated.

A. The Audit Workplan

The audit workplan is a "detailed master plan prepared by [the accounting firm] for and prior to its examination" of the client's financial statements.[27] The program consists of (1) a listing of procedures that the accountants intend to follow in examining the books and records, (2) records confirming that those procedures were followed, and (3) suggestions for future modification of the procedures.[28] The workplan is "the statement of the independent auditor's plan and program for the conduct of the audit . . . , the auditor's methodology, the guidelines as to which areas and which records of the client will and will not be examined."[29] The audit workplan tells the auditor, among other things, which of thousands of accounts to check, how thorough the test check should be, and whether and to what extent backup data, documents, or even client interviews should be secured. In other words, it is the accountant's "game plan."

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22. *See* United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980).

23. *See* United States v. Noall, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979); United States v. Riley Co., 45 A.F.T.R.2d 80-1164 (N.D. Ill. 1980) (mem.), *appeal dismissed*, No. 80-1124 (7th Cir. Sept. 16, 1980); United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill. 1978) (mem.).

24. *See* United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.).

25. *See* United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980); United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980).

26. *See In re* Grand Jury Subpoenas Duces Tecum, 483 F. Supp. 1085 (D. Minn.), *stay granted*, 483 F. Supp. 1091 (D. Minn. 1979).

27. United States v. Coopers & Lybrand, 413 F. Supp. 942, 945 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

28. *See* United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980).

29. *Id.* at 1157.

B. Reports to Management and Internal Audit Reports

The accountants prepare reports to management at the end of each audit. These reports evaluate whether the corporation's accounting systems, procedures, and controls are adequate and accurate.[30] For example, the corporation's accounts receivable department may have the authority to charge off debts without checking with the credit department. A report to management might expose this problem and suggest ways in which the corporation could improve its accounting system for bad debts. An inventories report to management might recite that the physical inventory is carelessly taken, that test counts are inaccurate, or that no documented procedure exists for an accurate physical count of inventory items.[31] Similarly, the report to management would provide possible methods to correct these weaknesses.

C. Tax Reserve Papers and Memoranda

The tax reserve papers[32] are by far the most controversial of the sensitive papers now being sought by the IRS through summonses. These papers typically contain a summary analysis of certain selected transactions, recorded in the corporation's general ledger, concerning the special reserve for contingent income taxes. The documents also usually include a computation of the tax provision and a memorandum discussing those items of income or expense for which the ultimate tax treatment is uncertain.[33]

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30. These reports, called internal audit reports if done by company personnel, summarize the work done in normal accounting workpapers. The Internal Revenue Audit Manual defines audit workpapers to include

> workpapers retained by the independent accountant as to the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to his/her examination. Workpapers may include work programs, analyses, memorandums, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. These workpapers provide an important support for the independent certified public accountant's opinion as to the fairness of the presentation of the financial statements, in conformity with generally accepted accounting principles and demonstrate compliance with the generally accepted auditing standards.

I INTERNAL REVENUE MANUAL—AUDIT (CCH) § 4024.2(2) (May 14, 1981) (citations omitted).

31. *See, e.g.*, United States v. Riley Co., 45 A.F.T.R.2d 80-1164 (N.D. Ill. 1980) (mem.), *appeal dismissed*, No. 80-1124 (7th Cir. Sept. 16, 1980).

32. Although this set of papers is known by a variety of terms—tax provision memoranda, tax accrual workpapers, tax contingency files, tax reserve memoranda, and tax pool analyses; *see* cases cited notes 24-26 *supra* and accompanying text—the shorthand "tax reserve" papers, files, or memoranda will be used for convenience in this discussion.

33. *Compare* United States v. Arthur Andersen & Co., 474 F. Supp. 322, 327 n.6 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*,

Reports to management and tax reserve files share some of the accountants' subjective judgments based on their experience, selected testing, and even client interviews. The accountants ordinarily do not prepare either set of files for the corporation's federal income tax return, but provide them to promote managerial efficiency and to justify the tax reserves. The two classes of papers differ in that the tax reserve files focus directly and exclusively on items having potential tax consequences. They also may contain more speculation and conjecture on legal and accounting theories than would reports to management.

The tax reserve, for example, may include an accrual for questionable inventory writedowns. The tax reserve files and memorandum would evaluate the accuracy of this reserve, the consequences of the differing legal and accounting theories that may affect the reserve's treatment, the best and worst outcomes for the corporation, and the effect of the disallowance of all or part of the reserve as a deduction. As the court stated in *United States v. Coopers & Lybrand*,[34] "Inherent in the . . . analysis is the clear recognition . . . that the tax treatment and projections . . . may be interpreted differently by the IRS."[35] Thus, the tax reserve file is likely to bring together most of the corporation's potential tax vulnerabilities and contain the thoughts, experiences, evaluations, and even educated speculations of the accountants. Indeed, one commentator—a former Commissioner of Internal Revenue—has labelled it as the "definitive roadmap to the soft spots in a tax return."[36]

The tax reserve file has four components of varying degrees of

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449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980), *with* United States v. Arthur Young & Co., 496 F. Supp. 1152, 1153 n.2 (S.D.N.Y. 1980). The Internal Revenue Audit Manual defines tax reconciliation workpapers to include "workpapers used in assembling and compiling financial data preparatory to placing it on a tax return. . . . They include information used to trace financial information to the tax return." I INTERNAL REVENUE MANUAL—AUDIT (CCH) § 4024.2(1) (May 14, 1981). Section 4024.2(3)(a) of the Manual incorporates the definition in footnote six of the district court opinion in *Arthur Andersen* into its definition of tax accrual workpapers.

34. 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

35. *Id.* at 945. Other examples of items that could appear in tax reserve memoranda are financial history; comparison of book and taxable income; prominent sales, gains, losses, and tax consequences; inventery and its aging controls; timing of recognition of sales of property (installment basis, capital or ordinary gain or loss); pension plans, stock options, deferred compensation, custemer debts. The file would reflect how these items are accounted for, their tax consequences, and possibly even the chances of an audit.

36. Caplin, *Should the Service Be Permitted To Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX. 194, 194 (1979).

"sensitivity."[37] The first and least controversial component is an analysis of actual but unpaid tax accruals in filed or soon to be filed returns. To prepare this analysis, the accountant mechanically computes or checks the reserve for unpaid, accrued, present, or future liabilities that are actually reported. In the second and third components, the accountant evaluates the reserve for timing differences and permanent differences in tax treatment of the various reserve items. Timing differences arise when revenues or expenses are recognized in one period for financial reporting purposes and in another for tax purposes. Examples of these differences are installment sales and advance rents or royalties.[38] The accountant in these transactions typically must ask the following questions: (1) Has a sufficient reserve been accrued for warranty claims, and, if so, for which taxable years?[39] (2) What factors and judgments went into the accrual? (3) What is the reserve for installment sales, which may be recognized for tax purposes in years after the year of actual sale?[40] Permanent differences, on the other hand, are tax items that have a permanent—as opposed to a deferred—effect. Examples of permanent differences are like-kind exchanges,[41] capital or ordinary treatment for gains,[42] tax-exempt income, and percentage depletion. The alleged sensitivity of the papers containing these two types of components stems from the accountant's familiarity not only with the nature and amount of the transaction, but also with the various legal and accounting theories that could affect that transaction's tax treatment.

The last component, which has the potential for the greatest controversy, is the accountant's analysis of the reserve for any other undisclosed potential adjustments. This component includes the identification of issues—whether or not reported, accounted for, or material—which the accountant believes, in light of his experience, that the IRS *may* raise on audit. These items, apparently bounded only by the breadth of the Internal Revenue Code of 1954 (Code) and the imagination of lawyers and accountants, include matters such as the Service's potential reallocation of income, the

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37. *See generally* Cohen, *Tax Aspects of Accountant's Tax Accrual Workpapers*, in IRS ACCESS TO ACCOUNTANTS' WORKPAPERS 35-55 (N.Y.L.J. Law Journal Seminars-Press 1980).

38. *Id. See also* APB OPINION No. 11, ¶ 15; 3 AICPA PROFESSIONAL STANDARD (CCH) §§ 4091.12, .14.

39. *See* 3 AICPA-PROFESSIONAL STANDARD (CCH) § 4091.14.

40. *Id.*

41. *See id.* § 4091.32; I.R.C. §§ 1245(b)(4), 1250(d)(4).

42. *See generally* I.R.C. § 1222; *see also* I.R.C. §§ 1201, 1253.

tax effects of pension plans, deferred compensation, and the like. The accountant often must question the client closely to discover these and other *potential* areas of adjustment. He must examine the return and related workpapers, discuss the facts, and evaluate potential theories of liability, the likelihood of discovery by the IRS, the potential tax consequences of this discovery, and the chances of success if an item is contested. The report, for example, might include the "worst case" scenarios that are mentioned in some of the litigation in this field.[43] In addition, the accountants often evaluate, among other things, the following issues: Whether the IRS may detect an arbitrary deduction, the corporation's exposure if it does, and what the taxpayer's position should be; whether, in an acquisition or sale, the parties have valued the assets properly, and the tax exposure if they have not; and whether inventory writedowns are arbitrary, and, if so, why and what the corporation's potential exposure might be. Thus, the accountant must ask questions in every area in which the complexities of tax law and accounting procedures expose the corporation to potential additional liability. In these situations the accountant's independence and conservatism often conflict with the client's desire to maximize the report of earnings. The accountant, however, must ask the questions and record the results; otherwise, he may be unable to conclude whether the tax reserve is adequate. One tax reserve memorandum, for example, contained the following statement:

> * * *[c]onsideration was being given by the audit staff to writing off in 1975 approximately $500,000, [in advertising receivables] of which $200,000 related to 1974 and $300,000 to 1975, although the client is confident that these amounts will be collected. A revenue agent could assert that a write-off is inappropriate and that the income and related receivable should not have been recorded in the earlier year. To the extent that any write-offs relate to receivables accrued in years closed by the statute of limitations, a disallowance in 1975 would have a permanent effect. In addition, this advertising income was included in the computation of the patronage refund in the year in which it was recorded. Accordingly, to the extent that income was recorded in years for which the statute of limitations is still open, a permanent difference may result since a portion of the patronage refund for that year would not be deductible for tax purposes.
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> [Taxpayer's] position on audit would be that the receivable represented their best estimate at the time and that any uncollectible portion is a current bad debt. The issue may not arise since [taxpayer's] method of writing off the receivable (i.e., by crediting to the receivable amounts which actually re-

43. *See, e.g.*, United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

present current income) will be somewhat difficult to detect.[44]

The depth of the accountant's inquiry, the give-and-take of client-accountant discussions, the continual testing and checking, and the critical perspective that these probes require, result in voluminous documents which reveal the financial and tax workings of the corporation. The IRS has been seeking precisely these types of data—if only infrequently.[45] These attempts at examination of documents are understandable when one considers their probative value. It is equally understandable, however, that the accountants, as well as occasionally their clients, are loathe to disclose them. The accountants in particular have expressed concern over this issue, since they typically have highlighted the questionable areas of the taxpayer's return and, unlike lawyers, cannot rely on a client privilege.[46]

Thus, the IRS has sought enforcement of summonses for "sensitive" accounting papers, and the accountants have resisted these efforts. Any successful resistance to compulsory process obviously must take the form of recognized defenses to the summons power. These defenses provide the framework of the accountants' opposition to summonses for tax reserve papers, reports to management, and audit workplans. They have developed in the case law and can be articulated as follows: (1) The data either are not relevant to the Service's investigation or are a mere convenience; (2) public policy considerations dictate that the data should be kept confidential; and (3) the papers are not "other data," which are subject to summons under section 7602 of the Code.[47] Part III of this Article explores the rationales underlying the accountants' defenses and concludes that the courts should find them unpersuasive.

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44. Government's Affidavit in Support of Motion for Summary Judgment Exhibit I, at 9-10, United States v. Price Waterhouse & Co., 515 F. Supp. 996 (S.D. Ill. 1981) (mem.).

45. The courts have decided fewer than ten reported cases in this field over the past six years. Moreover, the Service's own manual further restricts the extent to which, and the circumstances under which, agents should seek tax reserve papers. *See* note 49 *infra*.

46. *Compare* Upjohn Co. v. United States, 101 S. Ct. 677 (1981) *with* Couch v. United States, 409 U.S. 322 (1973) *and* United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980) *and* United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980). *See also* notes 104-15 *infra* and accompanying text. The protection of attorneys' material is derived from the work product doctrine enunciated in Hickman v. Taylor, 329 U.S. 495 (1947), as well as from the various protections provided for in rule 26 of the Federal Rules of Civil Procedure.

47. *See* notes 218-41 *infra*. and accompanying text.

III. The Great Debate

A. *The "Relevance" Argument*

The IRS compels production of data through its summons power.[48] Thus, if the agent's request for the tax reserve file, reports to management, or the audit workplan is resisted during the course of an audit, he may issue a summons for them.[49] Should the summoned party fail to comply, the IRS may request the Justice Department to bring suit to enforce the summons.[50] The require-

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48. I.R.C. § 7602; *see* note 2 *supra.*

49. Prior to May 14, 1981, IRS guidelines, *see* I Internal Revenue Manual-Audit (CCH) § 4024 (June 8, 1976), restricted the issuance of summonses for tax accrual workpapers only in the sense that a prior report to the National Office of the IRS should be made in a "potentially sensitive situation." A Treasury Department information notice, however, provides that the examiner should "exhaust all efforts to obtain an explanation of the items in [the tax] reserve from the taxpayer's records and the responsible corporate executives with knowledge before seeking the information from independent accountants for the corporation." Internal Revenue Service, U.S. Dep't of the Treasury, Information Notice No. 80-7, Requests for Accountant's Workpapers 2 (1980). Moreover, "[t]he examiner's interest in the items is limited to identification of material undisclosed positions taken by the taxpayer on the return which the substantially completed examination has left unexplained, not opinions or evaluations concerning the items." *Id.*

More recently, Deputy Commissioner William E. Williams stated that the IRS is revising these Manual provisions "to make it absolutely clear that examiners are not to request tax accrual workpapers from the taxpayer or the accountant as a standard examination procedure." *Quoted in* BNA Daily Tax Report, March 16, 1981, at 1. The IRS published the revisions on May 14, 1981. Under new Manual section 4024.4, Guidelines for Requesting Audit or Tax Accrual Workpapers, the agent may examine such papers only in "unusual circumstances," only when factual data cannot be obtained from the taxpayer's records and not as a matter of standard examining procedure. The request must relate to an issue the agent has already spotted, and the request must be limited to those portions of the papers which bear on that issue. The agent must also first take all reasonable means, including the use of a summons, to secure the information from the taxpayer himself. I Internal Revenue Manual-Audit (CCH) § 4024.4 (May 14, 1981).

This revision does not apply to criminal investigations, however. The revision was brought to the attention of the district judge in United States v. Price Waterhouse, 515 F. Supp. 996 (N.D. Ill. 1981) (mem.) who did not address it in his opinion. The revision's transmittal letter specified that its provisions were not retroactive.

50. The summons is not self-executing. Upon a failure to comply, the Government must petition for enforcement in the federal district court where the summoned party resides or is found. I.R.C. § 7604(a). The summoned party or intervenor, *see* Donaldson v. United States, 400 U.S. 517 (1971); I.R.C. § 7609, then has the right to an adversary hearing, during which available defenses may he raised. Reisman v. Caplin, 375 U.S. 440, 445 (1964). The proceeding is a summary one, however, I.R.C. § 7609(h), and if the party opposing the summons neither places any of the petition's allegations in controversy nor comes forward with specific facts in support of a legally sufficient defense, no evidentiary hearing is required. United States v. Kis, 658 F.2d 526 (7th Cir. 1981); United States v. Freedom Church, 613 F.2d 316 (1st Cir. 1979); United States v. Genser, 602 F.2d 69 (3d Cir.), *cert. denied*, 444 U.S. 928 (1979); United States v. Morgan Guar. Trust Co., 572 F.2d 36 (2d Cir.), *cert. denied*, 439 U.S. 822 (1978).

ments for enforcement are four:[51] (1) The summons must be issued for a legitimate purpose; (2) the Service must show that the summoned data "may be relevant" to this purpose;[52] (3) the data sought must not already be in the Service's possession;[53] and (4) the required administrative steps must be followed.[54]

The relevance requirement is the standard upon which ac-

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51. The Supreme Court set forth these requirements in United States v. Powell, 379 U.S. 48 (1964). When the Service's Criminal Investigation Division conducts an investigation, there is arguably a fifth requirement to allege and prove that the IRS has not formally recommended prosecution of the taxpayer to the United States Department of Justice. United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978). *But see* United States v. Kis, 658 F.2d 526 (7th Cir. 1981).

52. The relevance requirement derives in part from the language of § 7602, which permits the summoning of documents that "may be relevant" to the investigation of a return or of tax liability. I.R.C. § 7602. It also derives from the series of cases that culminated in United States v. Powell, 379 U.S. 48 (1964), in which the Supreme Court articulated the general standards for the enforcement of administrative process. Under those cases, the subpoena or summons is to be enforced regardless of the lack of probable cause, but only if the inquiry is within the agency's power, the data sought are relevant to that inquiry, and the demand is not overbroad or burdensome. *Id.*; United States v. Morton Salt Co., 338 U.S. 632 (1950); Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186 (1946); Endicott Johnson Corp. v. Perkins, 317 U.S. 501 (1943); Wilson v. United States, 221 U.S. 361 (1911).

53. United States v. Lenon, 579 F.2d 420 (7th Cir. 1978); United States v. Garrett, 571 F.2d 1323 (5th Cir. 1978). Courts have literally construed the "in possession" requirement to encompass only the exact records summoned. Focusing on the term "information," which was loosely used in United States v. Powell, 379 U.S. 48, 58 (1964), some parties have argued that tax reserve data "information" is in the Service's "possession" because of the hundreds of thousands of documents already produced, the total access afforded IRS agents to the corporation's books and records, and the presumed ability of the agents to reproduce the accountant's work from the raw data. Courts in each case have flatly rejected this suggestion. *See* United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.); United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980); United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill. 1978) (mem.); United States v. Acker, 325 F. Supp. 857 (S.D.N.Y. 1971). In United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd* 550 F.2d 615 (10th Cir. 1977), the court rejected a liberal interpretation of the "possession" requirement. *Id.* at 949. Moreover, the Second Circuit has stated that the argument "borders on the frivolous." United States v. Noall, 587 F.2d 123, 125 n.2 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979). Even when data may *actually* be in the Service's files, but simply difficult to retrieve, the courts generally have held that the Service has proved lack of possession. *See* United States v. Kis, 658 F.2d 526 (7th Cir. 1981); United States v. Davis, 636 F.2d 1028 (5th Cir. 1981); United States v. First Nat'l State Bank, 616 F.2d 668 (3d Cir.), *cert. denied*, 447 U.S. 905 (1980). *But compare* United States v. Garrett, 571 F.2d 1323 (5th Cir. 1978) *with* United States v. Goldman, 637 F.2d 664 (9th Cir. 1980) *and* United States v. Pritchard, 438 F.2d 969 (5th Cir. 1971).

54. The Supreme Court in United States v. Powell, 379 U.S. 48 (1964), confined this requirement to a showing that a reopening letter had been issued under the provisions of I.R.C. § 7605(b). Nevertheless, the requirement has evolved into a more general standard, and the courts have indicated that minor discrepancies in the "administrative steps" do not void the summons. United States v. Davis, 636 F.2d 1028 (5th Cir. 1981); United States v. Bank of Moulton, 614 F.2d 1063 (5th Cir. 1980); United States v. Myslajek, 568 F.2d 55 (8th Cir. 1977).

countants most frequently rely in opposing summonses for tax reserve and other sensitive papers. Thus, in *United States v. Coopers & Lybrand*,[55] the first reported case in this area, the accountants successfully argued that enforcement of the summons should be denied because the tax reserve data were not "relevant" to the Service's investigation. Both the district court and the Tenth Circuit in *Coopers & Lybrand* refused to enforce a summons for tax reserve files that Coopers & Lybrand (the summoned party) had prepared in connection with an audit of its client, Johns-Manville Corporation. Each court strongly emphasized that Coopers & Lybrand did not prepare Johns-Manville's tax returns for the audited years, and that the audit program and resulting papers lacked a direct connection with the preparation or filing of those returns. Furthermore, the district court stressed, and the Government conceded, that the data did not relate to the specific matters under audit, but only in a general way to the return.[56] Since Coopers & Lybrand prepared the files for financial statement purposes and SEC requirements, and since they contained the "private thoughts and theories of the taxpayer,"[57] both courts reasoned that the files were too remote from the Service's inquiry. The courts also rejected the Government's suggestion that the files might be probative of corporate intent for purposes of the fraud[58] or negligence[59] penalties. Further, because Johns-Manville did not use the data to prepare the tax return under audit, the court reasoned that the files could not be relevant to potentially fraudnlent items on that return.[60]

1. Relevance in General

The relevance standard, as applied to summonses, derives from section 7602 of the Code,[61] which provides for summoning data that "may be relevant or material" to the Service's inquiry. In *United States v. Powell*[62] the Supreme Court held that the probable cause standard of the fourth amendment does not apply to the

55. 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).
56. *Id.*; United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.).
57. 413 F. Supp. at 950, 550 F.2d at 618.
58. *See* I.R.C. § 6653(b).
59. *See id.* § 6653(a).
60. 550 F.2d at 621.
61. I.R.C. § 7602.
62. 379 U.S. 48 (1964).

enforcement of an IRS summons; relevance to the investigation, together with satisfaction of the three other criteria for enforcement noted above, is sufficient. The Court in *Powell* did not elaborate on the relevance concept, except to imply that the standards applicable to other administrative agency process would be translatable to determining the scope of the summons power.[63] The *Powell* Court did make clear, however, that this power is to be liberally construed—much like the power of a grand jury, to which the summons power has often been analogized.[64]

Drawing an analogy to both the grand jury subpoena and that administrative process, and noting the strong congressional interest in vigorous enforcement of the revenue laws, courts since *Powell* have uniformly endorsed a low threshold for the relevance requirement. So long as the summoned data "might throw light upon"[65] the correctness of either a taxpayer's return or his tax liability, the data meet the "may be relevant" test.[66] Moreover, courts

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63. *See generally* Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186 (1946). Subpoenaed documents and testimony are relevant unless they are "plainly incompetent or irrelevant for any lawful purpose." Endicott Johnson Corp. v. Perkins, 317 U.S. 501, 509 (1943), *quoted in* SEC v. Wheeling-Pittsburgh Steel Corp., 482 F. Supp. 555, 562 (W.D. Pa. 1979), *vacated and remanded*, 648 F.2d 118 (3d Cir. 1981).

64. The Court stated, "While the power of the Commissioner of Internal Revenue derives from a different body of statutes, [than the administrative subpoena and grand jury subpoena powers] we do not think the analogies to other agency situations are without force when the scope of the Commissioner's power is called in question." 379 U.S. at 57 (footnotes omitted); *accord*, United States v. Bisceglia, 420 U.S. 141 (1975); United States v. Rosinsky, 547 F.2d 249 (4th Cir. 1977); United States v. Joyce, 498 F.2d 592 (7th Cir. 1974); United States v. Matras, 487 F.2d 1271 (8th Cir. 1973); United States v. Weingarden, 473 F.2d 454 (6th Cir. 1973); United States v. Egenberg, 443 F.2d 512 (3d Cir. 1971); United States v. McKay, 372 F.2d 174 (5th Cir. 1967); DeMasters v. Arend, 313 F.2d 79 (9th Cir. 1963); Foster v. United States, 265 F.2d 183 (2d Cir. 1959).

65. United States v. Harrington, 388 F.2d 520, 523 (2d Cir. 1968); United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.); United States v. Riley Co., 45 A.F.T.R.2d 80-1164 (N.D. Ill. 1980) (mem.), *appeal dismissed*, No. 80-1124 (7th Cir. Sept. 16, 1980); *accord*, United States v. Garden State Nat'l Bank, 607 F.2d 61 (3d Cir. 1979); United States v. Noall, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979); United States v. Rosinsky, 547 F.2d 249 (4th Cir. 1977); Foster v. United States, 265 F.2d 183 (2d Cir. 1959); Falsone v. United States, 205 F.2d 734 (5th Cir. 1953).

66. The notion appears in some cases that the standard of relevance may be higher for summonses issued to third parties because of the potential for damage to their privacy interests. *Compare* United States v. Harrington, 388 F.2d 520, 523 (2d Cir. 1968) ("This judicial protection . . . is particularly appropriate in matters where the demand for records is directed not to the taxpayer but to a third party who may have had some dealing with the person under investigation.") *with* United States v. Noall, 587 F.2d 123, 126 (2d Cir. 1978) ("The threshold [of relevance] is particularly low when, as here, the papers at issue are the taxpayer's own and there is no question of the invasion of the privacy of third persons against their will."), *cert. denied*, 441 U.S. 923 (1979). Although some courts have read *Harrington* as requiring a higher standard, *see* United States v. Arthur Young & Co., 496 F.

appear to be growing reluctant to substitute their oversight role for the acknowledged expertise of the IRS. If the minimal nexus exists between the summoned data and a section 7602 purpose, the courts rarely intrude further into the administrative process, in which the precise relevance is actually determined,[67] nor will they ordinarily conduct even an *in camera* examination of the data.[68] The Supreme Court in 1980 effectively endorsed this "hands-off" principle in *United States v. Euge*.[69]

Supp. 1152 (S.D.N.Y. 1980); United States v. Acker, 325 F. Supp. 857 (S.D.N.Y. 1971), the Second Circuit appears to have undercut its *Harrington* dictum in *Noall;* the low standard is "might throw light upon," and would be lower if the summons were to the taxpayer itself. United States v. Noall, 587 F.2d at 126. *Harrington,* however, cannot fairly be read to impose a higher standard of relevance for third party summonses. The court in *Harrington* evidenced its concern for third party privacy by formulating the "might throw light upon" standard in the first place; it did not suggest that any higher standard existed. In any event, the outside accountants who create tax reserve data cannot legitimately claim any higher standard, since their claim to privacy is attenuated at best. Couch v. United States, 409 U.S. 322 (1973). *See also* part III *infra.* Moreover, a higher standard than the marginal relevance than is now required may well be unworkable. To meet this standard, the IRS would have to show that it did not need the document—because it already had a good case—to demonstrate its right to have it produced. *See* United States v. Harrington, 388 F.2d 520 (2d Cir. 1968). In short, the IRS need not be required to demonstrate specific relevance in order to meet the *Powell* standard. *See* United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.).

67. As the court stated in *Price Waterhouse,* the Government need not demonstrate to the Court the specific relevance of data it has not seen on issues it has not spotted. United States v. Riley Co., 45 A.F.T.R.2d 80-1164, (N.D. Ill. 1980) (mem.), *appeal dismissed,* No. 80-1124 (7th Cir. Sept. 16, 1980); United States v. Acker, 325 F. Supp. 857 (S.D.N.Y. 1971). The Court in *Riley* stated that "the Service is expected to examine much irrelevant material in order to sift out the material that may be relevant to an investigation." 45 A.F.T.R.2d at 80-1165; *accord,* United States v. Noall, 587 F.2d 123 (2d Cir. 1978), *cert. denied,* 441 U.S. 923 (1979); United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill 1978) (mem.).

68. *Compare* United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill 1978) (mem.) *with* United States v. Noall, 587 F.2d 123 (2d Cir. 1978), *cert. denied,* 441 U.S. 923 (1979), United States v. Riley Co., 45 A.F.T.R.2d 80-1164 (N.D. Ill. 1980) (mem.), *appeal dismissed,* No. 80-1124 (7th Cir. Sept. 16, 1980) *and* United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980). At least one court has ascribed to the *agent's* judgment the determination whether sufficient indication of relevance exists for judicial purposes. *See, e.g.,* United States v. Arthur Andersen & Co., 474 F. Supp. 322, 329-30 (D. Mass. 1979), *appeal of one party dismissed as moot,* 623 F.2d 720 (1st Cir.), *cert. denied,* 449 U.S. 1021 (1980), *aff'd as to second party,* 623 F.2d 725 (1st Cir. 1980) ("I find that the collective familiarity of the agents involved in the joint investigation as to Good Hope records will suffice to establish a 'realistic expectation' of relevancy.") While such a concept probably goes beyond the holding in *Powell,* the court's deference to the administrative process and the agents' expertise is entirely appropriate, particularly in view of recent precedent in the Supreme Court. *See* United States v. Euge, 444 U.S. 707 (1980).

69. 444 U.S. 707, 711 (1980). The Court stated,

> Further, this Court has consistently construed congressional intent to require that if the summons authority claimed is necessary for the effective performance of congressionally imposed responsibilities to enforce the tax code, that authority should be up-

Considering this trend in the courts, it is difficult to justify the *Coopers & Lybrand* test for relevance, which requires that the accountants must have compiled the summoned data for use in, or at least in the preparation of, the taxpayer's return.[70] Section 7602 itself provides for the summoning of data that "may be relevant" to aid in "making a return where none has been made," as well as in "determining the liability of any person for any internal revenue tax."[71] Thus, neither the statute nor logic requires that data must be used to prepare, or be associated with the preparation of, a tax return in order to be relevant to that return or to a taxpayer's correct liability. Extended to its logical conclusion, the *Coopers & Lybrand*'s standard would permit a taxpayer who kept one true and one false set of books to prevent enforcement of a summons for the true set; he would simply argue that he did not use the summoned (true) set to prepare his (possibly false) return. Common sense dictates that papers—regardless of when or for what purpose they were created—which evaluate financial data that the taxpayer has included on his tax return, or which are probative of his tax liability, would also help an auditor evaluate the statements reported on the return. For these reasons, courts since *Coopers & Lybrand* have uniformly rejected that decision's rationale in favor of a broader concept of relevance.[72]

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held absent express statutory prohibition or substantial countervailing policies. The authority claimed here is necessary for the effective exercise of the Service's enforcement responsibilities; it is entirely consistent with the statutory language; and it is not in derogation of any constitutional rights or countervailing policies enunciated by Congress.

Id.

70. *See also* United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill. 1978) (mem.).

71. I.R.C. § 7602.

72. *See* note 68 *supra* and cases cited therein. In the most recent case, the court in *Price Waterhouse* flatly rejected the accountants' contention that a tax reserve memorandum was not relevant where the issues the memorandum discussed had not yet been detected by the examining agent. The court stated,

> Moreover, under [Price Waterhouse's] theory, the task of deciding what issues have been identified by the IRS would fall upon the summoned party, thus allowing that party to control the scope of the audit. This result can hardly be deemed acceptable and certainly was not the intent of Congress in drafting the broad authorizing language found in section 7602. *See United States v. Riley Co.*, 45 AFTR 2d 80-1164, 80-1 USTC Section 9157 (N.D. Ill. 1980); *United States v. Acker*, 325 F. Supp. 857 (S.D.N.Y. 1975). Finally, respondents' argument . . . would permit the taxpayer to withhold relevant information unless the IRS stated the magic words identifying the issue. This, however, would misconstrue the purpose of the summons procedure, which is to determine the truthful scope of the taxpayer's liability, rather than to engage in a sophisticated game of hide and seek.

2. Relevance of Tax Reserve Files, Reports to Management, and Audit Workplans

Tax reserve files and reports to management, if available to the IRS, may affect a taxpayer's exposure to audit adjustments in several ways.[73] If, for example, the taxpayer improperly prices goods sold to affiliates, the IRS may reallocate income to the taxpayer under section 482,[74] with tbe attendant tax consequences.[75] Similarly, a report to management that is critical of a corporation's accounts receivable treatment, intercompany accounting practices, or inventory statistics, for example, could cause an IRS agent to pursue those leads to important tax return items, possibly with unpleasant tax consequences for the corporation.[76]

The analysis, opinion, and speculation aspects of tax reserve

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United States v. Price Waterhouse & Co., 515 F. Supp. 996, 999-1000 (N.D. Ill. 1981) (mem.).

73. It is somewhat inconsistent for the accounting profession to argue that the data are irrelevant while litigating so vigorously over their production. Indeed, the intensity of opposition is more likely a true indicator of relevance. As the court noted in United States v. Noall, 587 F.2d 123 (2d Cir. 1978), *cert. denied,* 441 U.S. 923 (1979), the taxpayer's own statements showed that the internal audit reports were the taxpayer's internal auditors' analyses of the books and records of various corporate divisions and related corporations and were part of the taxpayer's program to monitor and supervise the accounting, financial planning and established operational plans and procedures of those divisions and corporations. The taxpayer had attempted with these reports to ensure uniform bookkeeping practices and compliance with management directives and internal control and operational procedures. Even though the documents may have contained hearsay, rumors, and opinions, the court stated that the taxpayer's own description of the utilization of the reports demonstrated their relevance. The Service was interested in discovering whether the tax returns reflected the taxpayer's true income picture, not simply whether the accountants correctly prepared them from the books of account. *Accord,* United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot,* 623 F.2d 720 (1st Cir.), *cert. denied,* 449 U.S. 1021 (1980), *aff'd as to second party,* 623 F.2d 725 (1st Cir. 1980).

74. I.R.C. § 482.

75. Conversely, the reserve could confirm the agent's confidence in the return as filed; such confirmation is one of the functions of an audit.

76. This discussion implicitly assumes a concept of relevance that applies to *leads* to evidence—in addition to direct-impact data—and to areas of a tax return that had not yet come under audit. It is a common practice in tax investigations to trace data through several stages and ultimately arrive at a previously unsuspected item of liability. *Accord,* Reporters Comm. v. American Tel. & Tel. Co., 593 F.2d 1030 (D.C. Cir. 1978) (telephone records are useful leads), *cert. denied,* 440 U.S. 949 (1979); United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot,* 623 F.2d 720 (1st Cir.), *cert. denied,* 449 U.S. 1021 (1980), *aff'd as to second party,* 623 F.2d 725 (1st Cir. 1980); *In re* D.I. Operating Co., 14 A.F.T.R.2d 5879 (D. Nev. 1964) (temporary, disposable cards kept as convenient records of daily transactions); *see* United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill. 1978) (mem.) (audit reports relevant because they give agents the chance to investigate areas in which current information is lacking).

files and reports to management can also affect the outcome of an audit. First, the agent often looks to the opinion in the documents to gauge the accountants' degree of confidence in the tax reserve, as well as to spot potentially weak areas that deserve further scrutiny. A typical reserve file might contain the statement, "In our opinion, the corporation's reserve for contingencies resulting from foreign operations is inadequate because the IRS might assign to the domestic return some additional items of foreign income." This statement, though nonfactual and perhaps even speculative, lets the agent know that the taxpayer's allocation of income between domestic and foreign corporations may be questionable. It at least indicates to the agent that the accountants themselves doubt the reliability of the corporation's tax judgments. These realizations certainly would "throw light" upon either the correctness of the return or the taxpayer's correct liabilities. In *United States v. Price Waterhouse & Co.*,[77] for example, the record contains a tax reserve memorandum that pointed out several hundred thousand dollars in potentially taxable items and indicated how the IRS could detect these items in the books.[78] Similarly, a report to management might expose weaknesses in the corporation's controls over assets, which in turn might lead an agent to question the accuracy of the assets reported on the tax return. The importance of such statements to an effective tax audit is clear.

Concerning the audit workplan, the courts in *Coopers & Lybrand* and *United States v. Arthur Young & Co.*[79] denied enforcement of summonses for audit workplans on the ground that they were not records of actual transactions, but were mere "projections."[80] Respondents successfully argued that the Service's interest lay exclusively in actual transactions, since only actual transactions can affect corporate tax liability. In other words, the

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77. 515 F. Supp. 996 (N.D. Ill. 1981) (mem.).

78. With respect to the relevancy of these documents the *Price Waterhouse* court noted that

> every court that has considered the question has held that the IRS has the right to review documents containing opinions, regardless of whether the government already has documents that contain the factual bases for those opinions. . . .
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> . . . .
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> . . . [S]uch opinions are very likely to be relevant to the issue of tax liability.

United States v. Price Waterhouse & Co., 515 F. Supp. 996, 999 (N.D. Ill. 1981) (mem.).

79. 550 F.2d 615 (10th Cir. 1977); 496 F. Supp. 1152 (S.D.N.Y. 1980).

80. *But see* United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980). In *Arthur Andersen* the court compelled production of the audit workplan.

accounting firms contended that the Service's interest lay in what actually occurred, not in what the accountants thought or planned to audit. Nevertheless, the audit workplans may be relevant to an IRS examination with or without the later audit workpapers or final tax reserve files. A "battle plan" obviously helps the analyst discern what occurred or failed to occur in the "battle" itself. Thus, in nonfraud investigations the agent wants to know what areas the accountant intended to review and to check so that he can compare them to what was eventually examined. He then can focus on potential problem areas if, for instance, the actual investigation was much less comprehensive than the original plan; conversely, he can satisfy himself that the accountant audited the item properly, and that he need pursue the matter no further.[81]

3. Relevance in Fraud Investigations

In IRS investigations that the Criminal Investigation Division conducts,[82] when the potential for assertion of criminal fraud exists, an extra dimension is added. In *United States v. Arthur Andersen & Co.*,[83] a case that dealt with a special agent's summons for tax reserve data, the district court first rejected the accountants' contention that they should be accorded an accountant-client privilege. It then held that the tax reserve files would likely shed

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81. *See* United States v. Davey, 543 F.2d 996, 1000 (2d Cir. 1976) (Summoned computer tapes "would incidentally insure greater accuracy and a substantial saving in auditing time by enabling the IRS, through use of the taxpayer's own medium, to trace transactions from the original documents to the tax returns.").

82. The Criminal Investigation Division investigates allegations of criminal violations of the tax laws, whereas the Examination Division is concerned solely with civil matters—including, however, civil fraud, negligence, and other penalties. The functions of the two divisions, however, are closely related, and the Supreme Court has construed their duties to be "inherently intertwined." United States v. LaSalle Nat'l Bank, 437 U.S. 298, 309 (1978); Donaldson v. United States, 400 U.S. 517 (1971). *See also* United States v. Garden State Nat'l Bank, 607 F.2d 61 (3d Cir. 1979); United States v. Crespo, 281 F. Supp. 928 (D. Md. 1968).

83. 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980). In a companion case, United States v. Arthur Andersen & Co., 43 A.F.T.R.2d 79-1161 (2d Cir. 1979) (per curiam), the court rejected the appeal of the intervening taxpayer, Good Hope Industries, since the respondent in that case had already produced the summoned data. The court similarly disposed of the contention which the individuals under investigation—the Stanleys, Good Hope's officers and owners—advanced, namely, that the summoned data did not pertain to their particular liabilities. Since one portion of the document, an outline of a corporate meeting, did pertain to the individuals, the Second Circuit ordered production of the remaining portions, since they "possibly" could throw light on the individual's liability. Thus, the court rejected the notion of "bifurcated" or "selective" relevance.

light on the taxpayer's correct liabilities and affect the outcome of the fraud issue. The files, therefore, were relevant, since Arthur Andersen had applied the procedures and systems of analysis directly to the actual transactions reported on the return.[84]

Two elements generally comprise the proof of tax fraud: A false return or false statement and fraudulent intent.[85] The requisite fraudulent intent derives from many sources, including—and often—the taxpayer himself. In the alternative, the accountant may conclude after analyzing the taxpayer's papers and returns that the failure to include an item of income, or its inclusion against the accountant's advice, is erroneous, negligent, or fraudulent.[86] The accountant also may find that the taxpayer's treatment of some accounts is absolutely contrary to the law or normal accounting procedures; the client is then on unequivocal notice of potentially fraudulent conduct. The accountant's duties of analysis, conclusion, and notice assist the agent in establishing a negligence or fraud case. It is precisely this type of data that may find its way into tax reserve files or reports to management. Thus, the same files that can assist in establishing an understatement or a false return may also provide evidence of—or at least lead to—a finding of fraudulent intent. Since the fraud penalties are a potential com-

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84. 474 F. Supp. at 326-31. The court's reasoning in *Andersen* is not readily apparent. If the court meant that any affected transaction would increase the 50% fraud penalty on that particular transaction and other underpayments, then the statement resembles a truism; the fraud penalty is thereby relegated to the status of a mere mathematical calculation. On the other hand, the court may have meant that the tax reserve data, when analyzed together with the actual transactions, would be probative on corporate intent. *Accord, In re* Grand Jury Subpoena Duces Tecum, 483 F. Supp. 1085 (D. Minn.), *stay granted,* 483 F. Supp. 1091 (D. Minn. 1979).

85. *See generally* United States v. Pomponio, 429 U.S. 10 (1976); Sansone v. United States, 380 U.S. 343 (1965); Spies v. United States, 317 U.S. 492 (1943).

86. In the district court's decision in United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), the court rejected the Government's contention that the audit program was relevant because it would show which transactions the accountants had in fact audited, which could in turn reveal the corporation's intent. The court reasoned that the Government's purpose was beyond the reach of I.R.C. § 7602, since it failed to fall within one of the four purposes enumerated in that section for the issuance of a summons. If the court's reasoning ever had any precedential foundation, *see* Donaldson v. United States, 400 U.S. 517 (1971), the Supreme Court in United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978), undercut that foundation when it restated the law that IRS investigations normally promote the dual goals of discovering both civil and criminal liability, and that a summons may issue to discover criminal fraud.

Moreover, if the court in *Coopers & Lybrand* was implying that the audit program *would* be relevant if the investigation graduated to the fraud level, then its reasoning offends the *Powell* doctrine that no probable cause to suspect fraud—or to suspect even a civil violation—need be shown to inquire about or summon data.

ponent of every tax investigation,[87] the tax reserve files and reports to management are highly relevant to these inquiries.

Concerning the audit workplan, a special agent in a fraud investigation wants to know whether and why the accountants did or did not pursue their intention to audit particular accounts. This knowledge can aid the agent in forming a conclusion on the issue of fraudulent intent. The presence of the accountants' resulting reports—with background papers or files—should not preclude the IRS from obtaining the audit workplan if the applicable standard is "might throw light"; the inquiry is not whether the plan is *less* relevant than the resulting report or files, but whether the workplan by itself might throw light on the accuracy of the return.

4. The "Convenience" Limitation on Relevance

Despite the considerations discussed thus far, some courts have drawn the line of relevance at the point of "mere convenience." That is, these courts have held that data which merely make life more convenient for the IRS are not thereby relevant. This argument derives from the Tenth Circuit's decision in *United States v. Matras,*[88] which a few reported cases have cited approvingly, but without careful analysis.[89] In *Matras* the IRS summoned the corporate taxpayer to produce its company-wide budgets for the audited year. The district court[90] denied enforcement and reasoned that only actual transactions, not proposed budgets, could have tax consequences. The court of appeals[91] agreed noting that the taxpayer had made available all other records bearing on actual transactions, and that the Government could not sustain its

87. United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978).

88. 487 F.2d 1271 (8th Cir. 1973).

89. United States v. Coopers & Lybrand, 550 F.2d 615 (10th Cir. 1977). *Contra,* United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot,* 623 F.2d 720 (1st Cir.), *cert. denied,* 449 U.S. 1021 (1980), *aff'd as to second party,* 623 F.2d 725 (1st Cir. 1980); *In re* Grand Jury Subpoena Duces Tecum, 483 F. Supp. 1085, 1089 (D. Minn. 1979), *stay granted,* 483 F. Supp. 1091 (D. Minn. 1979); *In re* Co-Build Cos., 41 A.F.T.R.2d 78-308 (E.D. Pa. 1977). These three courts generally distinguished *Matras,* rather than disapproved it, on the ground that whereas the court in *Matras* had dealt with projections, their cases dealt with actual transactions. The distinction, however, is not logically supportable. The tax reserve cases enforced in full summonses or subpoenas for tax reserve papers that appeared, in part, to be projections of future tax liabilities based upon past conduct. The type of projections of future deductible expenses—or budgets—in *Matras* are not different in kind from the tax reserve files' projection of future nondeductible expenses, which relate to inventory, bad debts, and the like.

90. 31 A.F.T.R.2d 73-725 (D. Neb. 1972).

91. 487 F.2d 1271 (8th Cir. 1973).

burden to show relevance by alleging a general need for a "roadmap." The court concluded that the term "relevance" encompassed more than "convenience."[92] Despite the limited nature of the holding in *Matras*,[93] other courts have applied the concept to deny enforcement of summonses for audit workplans,[94] but not for tax reserve files, even though the latter also contain a "roadmap" of potential future liabilities for which reserves must be accrued.

The validity of the convenience argument almost always will be a matter of degree. Thus, it is surely more "convenient" for the IRS to summon accountants' audit workpapers to retrace and check the calculations and tests than it is for the agents themselves to perform the same tasks from the original books of entry. Nevertheless, the courts have upheld the enforcement of summonses for

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92. *Id.* at 1275.

93. The court made clear how limited its holding was when it stated,

> As the court observed in the *Harrington* case, *supra*, the question whether materials sought by summons may be relevant does not always lend itself easily to solution. Based on the rationale of the authorities cited herein, we recognize that given the proper factual setting a court could find that budgets are potentially relevant to a tax investigation. Obviously, that issue must be determined on an ad hoc basis. Certainly, a taxpayer should not erect roadblocks for the purpose of frustrating or preventing the IRS from a full-scale inquiry of the liability of the taxpayer. By the same token, the government should not, for the mere sake of its convenience, impose unnecessary burdens on a taxpayer in conducting an audit or investigation for tax liability, particularly where, as here, there is no indication of a purpose to escape any tax liability. The term "relevant" connotes and encompasses more than "convenience." Consequently, we are not persuaded to fault the district judge for concluding that the government failed to sustain its burden of proof by alleging a general need for a "road map." If we were to accede to the government's view, it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation, and thus, according to the government, be deemed relevant to the tax investigation.

Id. at 1274-75. Thus, the court was prepared to draw a line—under the particular facts in *Matras*—at budget requests because it saw no other stopping point. Of course, the point of burdensomeness or overbreadth can always be a line of demarcation, United States v. Powell, 379 U.S. 48 (1964), but short of this liberally construed boundary, courts have not seen fit to restrict the summons—even for massive numbers of documents—as long as the relevance standard is met. United States v. Giordano, 419 F. 2d 564 (8th Cir. 1969) (summons for all corporate taxpayer's internal reports was not overbroad; IRS has been "licensed to fish"), *cert. denied*, 397 U.S. 1037 (1970); United States v. First Pa. Bank, 453 F. Supp. 457 (E.D. Pa. 1978) (summons for "all records in the bank's possession or under its control relating to" the taxpayer held not overbroad); United States v. Ruggeiro, 300 F. Supp. 968 (C.D. Cal. 1969), *aff'd*, 425 F.2d 1069 (9th Cir. 1970), *cert. denied*, 401 U.S. 922 (1971) (summons for "all financial and business transactions" for investigated years, requiring 607 truckloads of documents, held not overbroad).

94. United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980); United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

such records with near unanimity.[95] Moreover, the term "convenience" begins to lose meaning in large-case audits.[96] The record in *Coopers & Lybrand,* for example, contains references to Johns-Manville's 3,000 company computer programs, 90,000 separate accounts, and 200,000 invoices per month.[97] Although the large staff available to Coopers & Lybrand might be able to test check accurately a relatively large number of items or accounts, IRS resources available for a similar effort pale in comparison. It is, quite simply, impossible—from a resources perspective—for the IRS, or perhaps for anyone else, to perform a complete audit of any major corporation. For this reason, disclosure of the product of the auditors and accountants who have already gone through the corporate books is a necessity rather than a convenience. When weaknesses or potential extra liabilities exist, tax reserve and management report data can lead the agent directly or indirectly to them. Without this groundwork, the laws of probability and the agent's past experience might be all that govern the chances of discovering potential adjustments. Moreover, it is a common practice for agents to *rely* on company auditors' work to complete their examination; the two "antagonists" often work in tandem. If the company auditor appears to have exercised reasonable thoroughness, the agent frequently accepts the results on their face. Thus, our entire system of corporate taxation and tax auditing is predicated upon the premise that the Government can—and must—rely, in large part, upon the integrity and work product of the taxpayers' internal auditors and outside accountants. This notion of reliance—as opposed to gamesmanship—partly underlay the Second Circuit's decision in *United States v. Davey.*[98] In *Davey* the court upheld a

95. *See, e.g.,* Couch v. United States, 409 U.S. 322 (1973); Falsone v. United States, 205 F.2d 734 (5th Cir.), *cert. denied,* 346 U.S. 864 (1953); United States v. Hankins, 424 F. Supp. 606 (N.D. Miss. 1976), *aff'd in part, rev'd in part, dismissed in part,* 565 F.2d 1344 (5th Cir. 1978), *cert. denied,* 440 U.S. 909 (1979), *add'l contempt order reversed,* 624 F.2d 649 (5th Cir. 1980). *But see* United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980) (denying enforcement, without apparent explanation, of a summons for "audit workpapers"; the final enforcement order, however, did not withhold these workpapers).

96. Large-case audits fall under the "Coordinated Examination Program" (CEP). These cases are so designated according to several criteria, including gross assets and gross receipts. The ranges for gross assets are from "up to $500 million" to "over $10 billion." The gross receipts category ranges from "up to $1 billion" to "over $5 billion." INTERNAL REVENUE MANUAL—AUDIT § 42(11)(o).

97. Brief for Appellees at 10, United States v. Coopers & Lybrand, 550 F.2d 615 (10th Cir. 1977).

98. 543 F.2d 996 (2d Cir. 1976).

summons for Continental Insurance Company's computer tape recordations of hundreds of thousands of transactions. In rejecting the company's suggestion that production of the tapes would be a mere convenience, the court first noted that if the subject matter of the records was not *otherwise* relevant, mere convenience would not make it so. The *Davey* court held that the test for relevance is not whether the tapes would be a convenience to the IRS, but whether the data would throw light upon the correctness of the taxpayer's returns. If they did this, the records would be subject to production even though they were also a convenience to the IRS. Significantly, the court also noted that the tapes "would incidentally insure greater accuracy and a substantial saving in auditing time by enabling the IRS, through use of the taxpayer's own record medium, to trace transactions from the original documents to the tax returns."[99]

The court's rationale in *Davey* is at odds with the reasoning in *Matras*. *Davey* would measure relevance by focusing upon that term's traditional test, namely the "might throw light" standard; that the data might make the Service's task more convenient is salutary, even praiseworthy, rather than suspect. The *Matras* court, on the other hand, views the situation from a gamesmanship perspective: even though data could throw light on the correctness of the return, if the Service's task is simply made more convenient, the burden on the taxpayer justifies refusing to compel production.

The *Davey* approach more nearly comports with the realities of auditing large—or even medium-sized—corporations. The approach is also consistent with the law's general principle that barriers to the truth are not favored,[100] as well as with the high national priority given to the collection of revenue.[101] Moreover, under the present case law, it is difficult to justify a convenience limitation on relevance beyond the outside limit of burdensomeness. The Supreme Court placed no such limitation on relevance when it formulated the standard in *Powell*. It did, however, discuss the outer limits of the summons power in terms of "burdensomeness," "harassment," "collateral purpose," and "bad faith."[102] Most cases

99. *Id.* at 1000.

100. McMann v. SEC, 87 F.2d 377, 378 (2d Cir. 1937) ("The suppression of truth is a grievous necessity at best, more especially when as here the inquiry concerns the public interest; it can be justified at all only when the opposed private interest is supreme."); 8 J. WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW (McNaughton rev. 1961) § 2192.

101. Bull v. United States, 295 U.S. 247 (1935).

102. United States v. Powell, 379 U.S. 48, 58 (1964).

since *Powell* that have considered the relevance of various data likewise have held them relevant under the "might throw light" standard, even though the data coincidentally made the Service's task more convenient.[103] The notion of convenience as a limitation on the summons power, therefore, lacks precedential and logical force, and the courts should not adopt it.

B. Policy Considerations

The second major source of defenses to IRS summonses for accountants' papers is nonstatutory public policy arguments, which accountants and their clients claim justify the confidentiality of tax reserve and management report data. The inhibitory effect on accountant-client relations that a breach of confidentiality might produce, the alleged deleterious effect on the independent audit process, and the potential problems of reduced compliance with other legal disclosure requirements, are all asserted to justify nondisclosure from a policy perspective.[104]

An understanding of the dimensions of this position must begin with the Supreme Court's decision in *Couch v. United States*.[105] In *Couch* an IRS agent summoned a taxpayer's accountant to produce both the taxpayer's records and the accountant's workpapers that were pertinent to the Service's investigation. The summoned data were ordinary workpapers, not tax reserve files or reports to management. The accountant refused to produce the documents, and the Government petitioned for enforcement. Couch, the intervening taxpayer, argued that enforcement should be denied because of an accountant-client privilege recognized under state law. The Supreme Court rejected this argument, noting that no federal law sanctioned an accountant's privilege and

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103. *See, e.g.*, United States v. First Nat'l State Bank, 616 F.2d 668 (3d Cir.), *cert. denied*, 447 U.S. 905 (1980); United States v. Shlom, 420 F.2d 263 (2d Cir. 1969) (corporate records and journals), *cert. denied*, 397 U.S. 1074 (1970); United States v. Rizzo, 45 A.F.T.R.2d 80-1479 (S.D. Fla. 1980) (temporary patient account cards). *Compare* United States v. Richards, 631 F.2d 341 (4th Cir. 1980) (eleven question "slush fund" questionnaire to corporations modified) *with* United States v. Wyatt, 637 F.2d 293 (5th Cir. 1981) (enforcing summons for eleven questions).

104. United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980). *See also* Barnes, *IRS Access to Accountants' Workpapers: The Coopers & Lybrand Case*, 7 TAX ADV. 44 (1976); Hansen & Lees, *IRS Examination of Accountants' Workpapers*, J. ACCOUNTANCY, Apr. 1977, at 60; Horvitz & Hainkel, *The IRS Summons Power and Its Effect on the Independent Auditor*, 4 J. ACCOUNTING, AUDITING AND FINANCE 114 (1980).

105. 409 U.S. 322 (1973).

that no federal cases had recognized a state law privilege. The Court went further, however, and declared that "there [is no] justification for such a privilege where records relevant to income tax returns are involved in a criminal investigation or prosecution."[106] The *Couch* Court gave three reasons for its refusal to recognize a federal accountant-client privilege. First, the taxpayer can have little expectation of privacy when he surrenders records to an accountant, since he knows in advance that mandatory disclosure of "much of the information therein" is required in an income tax return.[107] Second, the data to he disclosed are largely in the accountant's, not the taxpayer's, discretion. Last, an accountant himself risks prosecution if he knowingly assists in the preparation of a false return.[108] Thus, the Court reasoned, the accountant's need for self-protection often requires that the right to disclose information upon demand be vested in him rather than the client. The Court rejected the concept of a legitimate expectation of privacy on the ground that expectations and obligations of mandatory disclosure prompted the creation of the papers in the first instance, and that the accountant himself also labored under independent legal obligations, which required him to disclose certain information.[109]

Couch effectively preempted any suggestion that an accountant-client privilege exempts tax reserve files from disclosure to the IRS.[110] Since *Couch,* therefore, the accounting profession has attempted to argue for recognition of a quasi- or limited privilege, although it has not phrased its arguments in these terms. Instead, accountants have argued that disclosure—or the threat of disclosure—would chill the client's candor with its internal auditors and

106. *Id.* at 335.

107. *Id.*

108. Accountants' exposure to civil and criminal liability for preparing a false return is independent of the fraud or nonfraud classification of an IRS investigation. That the Intelligence Division was investigating Mrs. Couch for fraud, therefore, was not a consideration in the Supreme Court's holding.

109. 409 U.S. at 335 (1973). *See also* Smith v. Maryland, 442 U.S. 735 (1979) (no legitimate expectation of privacy in telephone numbers dialed from home phone); United States v. Miller, 425 U.S. 435 (1976) (no legitimate expectation of privacy in bank records); California Bankers Ass'n v. Schultz, 416 U.S. 21 (1974); Katz v. United States, 389 U.S. 347, 360-62 (1967) (Harlan, J., concurring) (legitimate expectation of privacy in a public telephone booth).

110. Lower courts that have faced the issue since *Couch* have rejected the notion of a privilege. United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980); *In re* Grand Jury Subpoena Duces Tecum, 483 F. Supp. 1085 (D. Minn.), *stay granted,* 483 F. Supp. 1091 (D. Minn. 1979); United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot,* 623 F.2d 720 (1st Cir.), *cert. denied,* 449 U.S. 1021 (1980), *aff'd as to second party,* 623 F.2d 725 (1st Cir. 1980).

outside accountants,[111] which would undermine the independence of the audit process and the purity and quality of the accountants' oversight role.[112] The profession has argued that this deleterious effect in turn contravenes public policies, which favor complete candor and are evident in the securities laws and fiduciary principles. Furthermore, accountants have contended that the potential exists for the improper or compelled disclosure of the data once it is in the hands of the IRS, particularly through vehicles such as Freedom of Information Act (FOIA) suits.[113] Finally, the accounting profession has contended that the special features of the accountant-client relationship,[114] at least when the parties are dealing with tax reserve data, create a justifiable expectation of confidentiality that should be honored against the summons.[115]

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111. Several accounting firms have made this argument, and the courts have rejected it. United States v. Noall, 587 F.2d 123 (2d Cir. 1978) (Congress decided the policy issue in favor of disclosure to the IRS hy enacting I.R.C. § 7602), *cert. denied*, 441 U.S. 923 (1979); United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980) (independence might be undermined, but defendant still has neither a privilege nor any legitimate expectation of privacy); United States v. Arthur Andersen & Co., 472 F. Supp. 322 (D. Mass. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980) (defense to proffered argument would carve out one class from I.R.C. § 7602, which invites a liberal construction); United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill. 1978) (mem.) (taxpayer declaring report to be private does not ipso facto make it so). Even in United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), the argument received little discussion. *See also* Barnes, *supra* note 104; Caplin, *supra* note 36; Caplin, *IRS Toughens its Stance on Summoning Accountants' Tax Accrual Workpapers*, 53 J. TAX. 130 (1980); Horvitz & Hainkel, *supra* note 104.

112. Barnes, *supra* note 104 ("basic integrity" of the audit process is at stake). *But see* 57 MINN. L. REV. 807 (1973) (self-evaluative reports will be generated anyway, since they are a condition of some federal contracts).

113. 5 U.S.C. § 552 (1976). *See* subpart B(2) *infra*.

114. *See* Ritholz, *The Representatives' Responsibility in Fraud and Penalty Cases*, 51 TAXES 852 (1973). Ritholz states in a related context,

> Tbe relationship between accountant and client is unique. . . . In contrast to the relationship between attorney and client, the contacts and, therefore, the exchange of information and confidences between accountant and client are frequent and regular . . . . The subject matter of this intercourse varies widely over the fields of taxation, finances, provision for capital, conduct of business, management of office, sales, production staff, etc., preparation of financial statements for nontax purposes, relationships with lending and other institutions . . . .

Id.

115. The courts traditionally have not entertained considerations of accountants' policy interests as defenses to the summons power. The Supreme Court in *Powell* and *Couch* at least implicitly refused to do so. Thus, once the four requirements of *Powell* are satisfied, the general rule is to view the summons as enforceable unless a substantial material issue of fact is presented in support of a legally sufficient defense. *Accord*, United States v. Price Waterhouse & Co., 515 F. Supp. 996, 1000 (N.D. Ill. 1981) (mem.) ("[T]he Court is not unmindful of the policy arguments asserted by the respondents. However, the narrow ques-

1. Threat to Candor Between Accountant and Client

The accountants' policy arguments merit attention, if for no other reason but that a sound rational basis should support the invasion of a professional's work product. The consideration of conflicting policy principles implies that a balancing of interests must be struck, even if, as Judge Friendly concluded in *United States v. Noall*,[116] one eventually concludes that Congress in section 7602 has already struck such a balance.[117] The balancing approach[118] would entail weighing the interests of the taxpayer and the accountant, which were discussed above, against those favoring enforcement of the summons.

The accountants' major policy position is that compelled production of tax reserve files and reports to management would erode the candor of communications between client and independent auditor,[119] undermine the independent audit process, and de-

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tion presently before the Court does not require that those policy concerns be addressed herein."). *See* United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978); United States v. Freedom Church, 613 F.2d 316 (1st Cir. 1979); United States v. Genser III, 602 F.2d 69 (3d Cir.), *cert. denied*, 444 U.S. 928 (1979); United States v. McGuirt, 588 F.2d 419 (4th Cir. 1978), *cert. denied*, 444 U.S. 827 (1979); United States v. Morgan Guar. Trust Co., 572 F.2d 36 (2d Cir.), *cert. denied*, 439 U.S. 822 (1978). Policy arguments, and sometimes even privilege arguments do not form a part of the legal analysis of § 7602. *See, e.g.*, United States v. Schoenheinz, 548 F.2d 1389 (9th Cir. 1977) (no stenographer-employer privilege); United States v. Brown, 536 F.2d 117 (6th Cir. 1976) (no marital privilege); United States v. Prevatt, 526 F.2d 400 (5th Cir. 1976) (no banker-depositor privilege); United States v. Luther, 481 F.2d 429 (9th Cir. 1973) (no priest-penitent privilege); Angiulo v. Mullins, 338 F.2d 820 (1st Cir. 1964) (no trustee-principal privilege); *In re* Albert Lindley Lee Memorial Hosp., 209 F.2d 122 (2d Cir. 1953) (no physician-patient privilege). *Contra*, Upjohn Co. v. United States, 449 U.S. 383 (1981). The Second Circuit in *Noall* addressed the argument that policy should be considered and firmly rejected it. 587 F.2d 123, 126 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979). The court stated, "With respect to enforcement of the tax laws, Congress itself has decided the policy issue, and it is not for the courts to challenge that determination. In this, as in many other procedural questions, the collection of the revenue stands apart." *Id. But see* note 1 *supra*.

116. 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

117. *Id.* at 126.

118. A balancing approach, however, would tend to prolong litigation, since experts would have to adduce opinions on the relevant factors, both in general and in relation to the particular case. This prolongation conflicts with the established judicial and congressional policy favoring summary adjudication of summons enforcement matters. United States v. Kis, 658 F.2d. 526 (7th Cir. 1981); *see* United States v. Hodgson, 492 F.2d 1175 (10th Cir. 1974); United States v. Davey, 426 F.2d 842 (2d Cir. 1970); I.R.C. § 7609(h)(2). *But see* I.R.C. § 7609(e). Section 7609(e) provides for suspension of the statutes of limitations in certain summons enforcement cases.

119. The appellant in *Couch* made much the same argument in her brief to the Supreme Court. She argued that if the taxpayer knows his fifth amendment rights are unprotected when he gives papers to an accountant, his incentive to cooperate will be reduced. Couch v. United States, 409 U.S. 322, 333 (1973).

crease the client's efforts to ensure the integrity of its records, operational procedures, and compliance with other laws. As the Supreme Court suggested in *Hickman v. Taylor*,[120] the conclusion is not irrational that under *some*, albeit narrow, conditions, a professional advisor might have an incentive not to create discoverable work product if he knows that another party will attempt to obtain it. To apply this suggestion to accountants' workpapers, however, assumes that other law or principles do not compel the creation and revelation of tax reserve data. This assumption is at variance with the accountants' own strongly asserted position, raised in most recent cases in this field,[121] that the tax reserve data and reports to management do *not* arise in response to the client's tax return and preparation needs, a stance that the Government has not opposed. On the contrary, the requirements of the securities laws,[122] federal statutory reporting requirements,[123] and obligations and liability on the part of the accountants themselves[124] mandate the creation of tax reserve data and the audit requirements of corporations.[125]

The Supreme Court traditionally has viewed this "chilling" argument with skepticism. Its precursor appeared in *Couch*, in which the taxpayer argued in her brief that if she gave her tax-related documents to her accountant, and if those documents thereby lost whatever fifth amendment protection they might have had, the taxpayer would have no incentive to make records accessible. Although it only obliquely addressed the argument in its decision, the Court implicitly rejected the "chilling" argument and held that the taxpayer had no fifth amendment privilege in the papers once she had surrendered them.[126] Thus, the Court appeared to disregard whatever policy implications inhered in the taxpayer's argu-

120. 329 U.S. 495 (1947).

121. *See* notes 1 & 3 *supra*.

122. *See* notes 5-11 *supra* and accompanying text.

123. *See id.*; 17 C.F.R. §§ 210.5-02, .6-03 (1981).

124. *See* note 21 *supra*.

125. Ironically, the accountants use the existence of these myriad requirements to bolster their second argument that to comply with the law, confidentiality is expected and justified. It is somewhat inconsistent for the accountant to urge, on the one hand, that he needs and expects confidentiality to fulfill his role in fostering compliance with the law, and for him to argue, on the other hand, that the accounting work he wishes to do is not truly required. The appellant made the very same argument—that the difficulties and time constraints encountered in the preparation of a tax return require specialized help—in her brief to the Supreme Court in *Couch*, yet the Court rejected any notion that meeting these requirements would result in the forfeiture of any constitutional rights. 409 U.S. at 333.

126. *Id.* at 334-35.

ment. In a similar case, the Court in *St. Regis Paper Co. v. United States*[127] upheld a Federal Trade Commission (FTC or Commission) subpoena that required St. Regis to supply to the FTC a copy of a report which St. Regis had filed with the Census Bureau. St. Regis argued that since the purpose of the census statute was to encourage the free and full submission of statistical data, the Court should hold that a confidential relationship exists and honor it. The Court's response, however, was unequivocal: "Ours is the duty to avoid a construction that would suppress otherwise competent evidence unless the statute, strictly construed, requires such a result."[128] St. Regis' argument is not materially different from the one that other litigants have made about many reporting or disclosure statutes: to encourage the candor that the particular statute requires, courts should bar other interested agencies[129] from requesting the results. The more the law imposes public reporting obligations upon corporations, however, the less likely this "chilling" possibility becomes. Moreover, *St. Regis Paper Co.* appears to resolve the competing policies in favor of disclosure, even though the Supreme Court assumed that the undesirable chilling effect would in fact occur.[130]

From the Service's perspective, the salient feature of this regulatory and agency reporting process is its *alienation* from the corporation's duty to prepare a tax return. The accountant needs to inquire into obvious and hidden contingencies on the financial statements for independent, and compelling, reasons. The businessman, on the other hand, has a conflicting incentive to construe potential contingencies narrowly and present a more favorable financial statement. The independent accountant therefore, is required by law, regulations, and professional standards[131] to perform his analyses in accordance with the principles of conservatism and independence, as well as to *create* a set of papers that identify and discuss many potential tax liabilities. Whether the candor of clients will be inhibited despite these mandates because of the superimposed threat of a summons depends very much on the facts of the individual case.

A corporation that maintains a policy of silence in response to

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127. 368 U.S. 208 (1961).

128. *Id.* at 218. *See also* United States v. Euge, 444 U.S. 707, 711 (1980).

129. By extension, this argument also applies to any other *private* party, whose interests would not be as immediate or overriding as an agency's.

130. 368 U.S. at 216-20.

131. *See* notes 5-26 *supra* and accompanying text.

inquiries from its accountant—because it fears that the results will be subject to a summons—runs a substantial risk that the accountant will issue a qualified opinion or scope limitation on the financial statement.[132] The SEC, however, is not likely to accept the accountant's reservations; if the qualified opinion or scope limitation is revealed in a public document such as a 10-K report, the corporation faces a sea of potential troubles or sanctions, including delisting, investigations, and shareholder suits, all of which must be weighed against the cost of potential additional tax liabilities. A publicly-held corporation whose stock is likely to be traded on a national exchange, and who is threatened with an "unclean" opinion, probably would prefer to submit to a complete IRS investigation. This course is the path of least resistance. The board of directors of a public corporation is unlikely to be willing to inform its shareholders and the SEC that it withheld vital data or instructed its accountants not to perform their usual, thorough review because the board thought the IRS might one day summon the results.[133] A firm of certified public accountants is also unlikely to aid in this effort, since the accountants themselves face potential exposure to a variety of civil or criminal sanctions should they fail to discharge their professional obligations in the proper manner.

To give the IRS access to sensitive accountants' papers is consistent with the policy considerations that are the foundation of the revenue laws. The audit process ostensibly is a self-critical search for the truth, which is analogous to the due diligence process in public offerings. Public corporations owe equal obligations of disclosure and candor to their investors, the public, and the IRS alike. In addition, the Code's reporting requirements are not subordinate to the disclosure requirements of the securities or other laws. Indeed, either the SEC or the IRS probably could use their rulemaking powers to compel the creation and reporting of tax reserve data or questionable items.[134] It is not unreasonable,

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132. In early 1981, the American Institute of Certified Public Accountants' Auditing Standards Board issued an auditing interpretation on the subject of qualified opinions, *see* AICPA STATEMENT ON AUDITING STANDARDS No. 31, entitled *Evidential Matter*. This statement put the profession on notice that auditors are obligated, when free access to records is impaired, to consider a modification—or even a disclaimer—of the opinion letter. *Id.* ¶ 22.

133. *See In re* Grand Jury Investigation, 599 F.2d 1224, 1237 (3d Cir. 1979) ("We do not doubt that the ability to conduct a confidential investigation would make 'compliance with the complex laws governing corporate activity' more palatable . . . ; we do doubt, however, that a corporation would risk civil or criminal liability under those complex laws by foregoing introspection.") (citations omitted).

134. *See* notes 160 & 268 *infra*.

therefore, to require the disclosure of all potential items of adjustment, so that the IRS can examine them openly and decide upon their merits. If a corporation's auditors have discovered an obvious item of adjustment, the policy of self-reporting dictates that it *should* be reported and taxed. If, on the other hand, an item is questionable, a compromise may be appropriate. Arguable tax consequences should be resolved by negotiation, compromise, or litigation, not by concealment. Moreover, society generally has significant interest in the IRS' auditing major corporations closely and accurately, with full disclosure a beneficial, not detrimental, means to this end.[135] The Supreme Court phrased this truth-finding public policy in these terms:

> [P]ersons summoned as witnesses by competent authority have certain minimum duties and obligations which are necessary concessions to the public interest in the orderly operation of legislative and judicial machinery. A subpoena has never been treated as an invitation to a game of hare and hounds, in which the witness must testify only if cornered at the end of the chase. If that were the case, then, indeed, the great power of testimonial compulsion, so necessary to the effective functioning of courts and legislatures, would be a nullity. We have often iterated the importance of this public duty, which every person within the jurisdiction of the Government is bound to perform when properly summoned.
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> Certain exemptions from attending or, having attended, giving testimony are recognized by all courts. But every such exemption is grounded in a substantial individual interest which has been found, through centuries of experience, to outweigh the public interest in the search for truth. Dean Wigmore stated the proposition thus: "For more than three centuries it has now been recognized as a fundamental maxim that the public . . . has a right to every man's evidence. When we come to examine the various claims of exemption, we start with the primary assumption that there is a general duty to give what testimony one is capable of giving, and that any exemptions which may exist are distinctly exceptional, being so many derogations from a positive general rule."[136]

To assign any special significance to the papers at issue in the reported cases in this area is a product of narrow vision. While the documents may be sensitive to the accounting profession, they are

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135. *See generally* United States v. Bryan, 339 U.S. 323, 331 (1950).

136. *Id.* (citations omitted). The "chilling" argument is made in the name of the public, but in fact it is an attempt to hide from the public view some private and parochial concerns, namely, extra taxes owed. Coming from corporations and accountants whose enclaves in the Internal Revenue Code—special deductions and credits, for example—are firmly fixed, this argument should be viewed with skepticism. Moreover, the public has a very positive and beneficial interest in complete disclosure of tax-relevant facts, if for no other reason than that this policy should apply with particular vigor to public corporations, which are endowed with fewer rights than individuals. The benefits of these tax data seeing the blue sky of daylight might well "warm," rather than chill, these corporations into fuller compliance with the tax laws.

still auditors' work that other auditors—who happen to work for a governmental auditing agency—are seeking for the purpose of finding the truth. Indeed, it is not unheard of for IRS agents and accounting firms' auditors to have had experience in each other's offices.[137] Were one auditing firm to succeed another as a corporation's independent auditor, it would probably be unthinkable to either firm—or to the client—that these papers would be withheld from the successor auditors.

What occurs when the IRS summons a taxpayer's or a third party's documents is merely a variation of a more general fact of corporate life. Every day a corporation creates business documents that contain facts, projections, speculation, hearsay, and other assorted data. The corporation's minutes, for example, may encapsulate the debate over a potential acquisition, or may recite the "private" thoughts of the board of directors about the proper method of dealing with a large securities liability. Theoretical, speculative data with tax, securities, environmental, antitrust, and other nontax implications are generated daily for normal corporate purposes. It is axiomatic that data generated for one purpose may be obtained for another, regardless of whether it is by the IRS, another government agency, or even private litigants. In this sense, tax reserve data and reports to management are no different from other accounting or corporate data. The notion that a government agency may compel their production, therefore, is not an unreasonable proposition. Indeed, it may well promote the independent goals of truth-finding and compliance with all laws—including the revenue laws.

2. Danger of Outside Disclosure

The second major policy position which the accounting profession has taken is that tax reserve data and reports to management might be disclosed to other parties after they are produced to the IRS—either by negligent IRS personnel or through some compulsory process such as a FOIA suit.[138] This disclosure would impair the integrity of the accountants' independent audit function. In addition, the accountants argue that their clients will be able to obtain advance knowledge of the audit plan and prepare their

137. *See* United States v. Riley Co., 45 A.F.T.R. 80-1164 (N.D. Ill. 1980) (mem.) (the IRS' expert witness had once worked for Arthur Andersen & Co., and while he was there, he had written portions of some reports to management that the IRS later sought by a summons), *appeal dismissed,* No. 80-1124 (7th Cir. Sept. 16, 1980).

138. 5 U.S.C. § 552 (1976).

records accordingly.[139]

These arguments have some logical force. Since they are independent, a corporation's certified public accountants fulfill a quasi-adversarial role when they audit the client who pays them. Their goal is to be detached and objective. If a client knows in advance the areas on which the accountant intends to concentrate, he might be able to prepare accordingly and present a deceptive picture of the corporation's finances.[140]

Nevertheless, the likelihood that this possibility will ever become a reality is remote. The IRS operates under strict statutory requirements of nondisclosure,[141] and civil and criminal penalties attach to an improper disclosure of "tax return or return information."[142] These requirements and potential sanctions create an in-

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139. *See* United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.); United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

140. This argument assumes that the client will be dishonest in dealings with the accountant. Regardless of the accuracy of this assumption, that the accountants would even make the argument is in itself noteworthy.

141. I.R.C. §§ 6103, 7213, 7217. Enacted as part of the Tax Reform Act of 1976, § 6103 is a complete reversal of prior law, under which tax returns and related data were deemed public information. *See* I.R.C. § 6103.

142. Section 6103(b) defines these terms as follows:

> (1) RETURN.—The term "return" means any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for or permitted under, the provisions of this title which is filed with the Secretary by, on behalf of, or with respect to any person, and any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed.
>
> (2) RETURN INFORMATION.—The term "return information" means—
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> (A) a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense, and
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> (B) any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110,
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> but such term does not include data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.
>
> (3) TAXPAYER RETURN INFORMATION.—The term "taxpayer return information" means return information as defined in paragraph (2) which is filed with, or furnished to, the Secretary by or on behalf of the taxpayer to whom such return information relates.

I.R.C. § 6103(b). These definitions essentially are very broad; they cover virtually anything

centive to IRS agents not to make improper disclosures. Moreover, it is not appropriate to assume that these disclosures would take place; the evidence indicates that the IRS takes seriously its legal obligation to guard against the improper disclosure of tax data covered by nondisclosure statutes.[143]

The argument that accountants' papers obtained by the IRS are subject to FOIA depends upon a liberal construction of that act and two basic assumptions. First, one must assume that a taxpayer, the taxpayer's competitor, or some other interested nontaxpayer would pursue a FOIA request to litigation and a judgment. A corporate rival or shareholder may have such an incentive, but a taxpayer likely would not. It would be disingenuous for a taxpayer to litigate successfully a FOIA claim for tax reserve data and then claim in a later suit that the IRS should be denied access to such information in the future because the audit process had been undermined. Moreover, under FOIA, a nontaxpayer may not obtain a taxpayer's data.[144]

Second, one must assume that FOIA would permit disclosure of tax reserve data in the Service's possession. The Act provides a disclosure exemption, which is subject to certain conditions, for information that another statute specifically immunizes from disclosure.[145] The trend of decisions now is to deny disclosure of data—even to the taxpayers themselves—when the Secretary determines pursuant to section 6103(e)(6) of the Internal Revenue Code that disclosure would "seriously impair" federal tax administration.[146] In *Zale Corp. v. United States Internal Revenue Service*,[147] for example, the district court held that section 6103(e)(6) is a specific exemption that Congress had contemplated when it enacted FOIA, and that material which is not obtainable under

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that is brought to the attention of IRS personnel. Clearly, tax reserve data and reports to management fall into this category.

143. United States v. Chemical Bank, 593 F.2d 451 (2d Cir. 1979) (the court will presume that the IRS adheres to the strictures of I.R.C. § 6103). *See also* United States v. Michigan Bell Tel. Co., 415 F.2d 1284 (6th Cir. 1969) (a presumption of regularity and integrity attends IRS investigations). Section 6103 states that, except for the narrowly defined exceptions in § 6103(d) and § 6103(f)-(o), only the taxpayer himself, his designee, or a closely related person with a "material interest" may see a taxpayer's return. I.R.C. § 6103(c), (e). Return information is not open even to these persons unless the Secretary of the Treasury "determines that such disclosure would not seriously impair federal tax administration." I.R.C. § 6103(c).

144. 5 U.S.C. § 552(b)(3) (1976); I.R.C. § 6103(a).

145. 5 U.S.C. § 552(b)(3) (1976).

146. I.R.C. § 6103(e)(6).

147. 481 F. Supp. 486 (D.D.C. 1979).

section 6103, therefore, cannot be obtained under FOIA. The determination in *Zale* is entirely appropriate for those examinations that are still in progress, as well as for those that already are completed, if disclosure might affect future audits.[148] The latter of these two situations is precisely what the accounting profession contends are the circumstances in tax reserve cases.

The FOIA exemption, contained in section 552(b)(4) of U.S.C. Title 5, generally forbids disclosure of either matters that are trade secrets or financial information obtained from another party which is privileged or confidential.[149] The claims made in *Arthur Andersen, Arthur Young,* and *Coopers & Lybrand* that tax reserve data and reports to management are confidential would appear to satisfy the exemption's confidentiality requirement.[150] The term "confidential" has been interpreted to mean "customarily not . . . released to the public by the person from whom it was obtained."[151] This test, at least initially, is an objective one; it is subjective only to the extent that the court considers the legislative purpose of FOIA.[152] That purpose supports a finding of confidentiality if disclosure would have the effect of impairing the government's ability to obtain the necessary information in the future, or if it would cause substantial harm to the competitive position of the person from whom the data were obtained.[153] The accountants in fact have tried to persuade courts with variations of both of these propositions in the tax reserve cases.[154]

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148. For the most part, courts have followed *Zale. See, e.g.,* Breuhaus v. Internal Revenue Service, 609 F.2d 80 (2d Cir. 1979); Chamberlain v. Kurtz, 589 F.2d 827, 838 n.33 (5th Cir. 1979); Cal-Am Corp. v. Internal Revenue Service, 45 A.F.T.R.2d 80-1576 (C.D. Cal. 1980); Wolfe v. Internal Revenue Service, 45 A.F.T.R.2d 80-1565 (D. Colo. 1980); Kanter v. Internal Revenue Service, 496 F. Supp. 1004 (N.D. Ill. 1980); Schottenstein v. Commissioner, 39 A.F.T.R.2d 77-786 (S.D. Fla. 1977).

149. Freedom of Information Act, 5 U.S.C. § 552(b)(4) (1976).

150. The information clearly appears to be "commercial or financial" in nature within the meaning of the FOIA. *Id.*

151. National Parks and Conservation Ass'n v. Morton, 498 F.2d 765, 766 (D.C. Cir. 1974) (quoting S. REP. No. 813, 89th Cong., 1st Sess. 9 (1965)).

152. *Id.* at 766-77; *accord,* Board of Trade v. Commodity Futures Trading Comm'n, 627 F.2d 392 (D.C. Cir. 1980); *see* H. REP. No. 1497, 89th Cong., 2d Sess. 10 (1966); S. REP. No. 813, 89th Cong., 1st Sess. 9 (1965); *cf.* Murphy v. Department of Army, 613 F.2d 1151 (D.C. Cir. 1979) (exemption five of FOIA must be considered in light of congressional intent).

153. National Parks and Conservation Ass'n v. Morton, 498 F.2d 765, 770 (D.C. Cir. 1974).

154. *See, e.g.,* United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.); United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd,* 550 F.2d 615 (10th Cir. 1977).

In sum, a nontaxpayer cannot obtain data through a FOIA suit, and a taxpayer is not likely to try; if a taxpayer did try, however, the exemptions contained in sections 552(b)(3) and (b)(4) of the Act, read together with section 6103 of the Internal Revenue Code, suggest that the attempt would not be successful. Thus, the policy concerns of the profession about the leakage of produced data and restricted communication which accountants claim justify nondisclosure, are lacking in substance. The independent audit process, even if it is somewhat chilled by the threat of disclosure, will continue to an extent that is acceptable to various regulatory agencies and the corporation's stockholders. Finally, other federal statutes do not imperil data's secrecy once it is turned over to the Service.

3. Expectation of Confidentiality

The accounting profession's third major policy argument is that courts should recognize an expectation of confidentiality and privacy between accountant and client[155] because of their special relationship and the intimate financial knowledge that the latter routinely makes available to the former.[156] The decision in *Powell*, however, preempted any suggestion that the summons power is subject to the fourth amendment probable cause requirement,[157] and *Couch* rejected the concept of an accountant-client privilege.[158] The accountants' argument, therefore, can only be valid as a balancing of policy considerations that does not rely—at least explicitly—upon the fourth amendment's "zone of privacy" concept.[159]

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155. *See* cases cited notes 1 & 3 *supra*. The accountants in United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), pressed this argument strongly before the district court.

156. *See generally* Ritholz, *supra* note 114.

157. *See* notes 62-66 *supra* and accompanying text.

158. *See* notes 105-10 *supra* and accompanying text.

159. *See, e.g.*, Katz v. United States, 389 U.S. 347 (1967). *See also* Griswold v. Connecticut, 381 U.S. 479, 484 (1965) ("Specific guarantees in the Bill of Rights have penumbras, formed by emanations from those guarantees that help give them life and substance.").

Nevertheless, the accountants' objective clearly is the recognition of what amounts to an accountant-client privilege by some other name. Some suggestion can be found in the cases that their goal is a variation on the work product doctrine that is less than a privilege, but which only a showing of substantial need—such as the likely presence of fraud—can overcome. Why fraudulent acts, whether they are civil or criminal, should rank above the collection of revenue in the hierarchy of "need" is not clear. Moreover, the Supreme Court has recognized the "inherently intertwined" nature of the dual purposes of I.R.C. § 7602, which are to discover civil as well as criminal liability. United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978). The Court in *LaSalle* made no distinction between these "normally

Couch also vitiated any argument that clients or accountants are reasonably entitled to a *subjective* expectation of confidentiality, at least concerning the usual type of accounting records. Moreover, the SEC can require the generation and disclosure of tax reserve data,[160] which further vitiates any subjective expectation of confidentiality argument. Whether policy considerations justify a finding of an *objective* privacy expectation, however, is both one of the foremost issues in this area and a somewhat more complex question.

The tax reserve and reports to management cases decided thus far, however, have rejected this proposition. In *Arthur Young,* for example, the court specifically noted the absence of an accountant-client privilege.[161] Although the client may surrender potential tax reserve data with the expectation that the data will remain confidential, this expectation is not legitimate vis-a-vis the IRS, which any client knows can always compel the production of both data that underlie the tax returns and specific payments that the taxpayer made. This compelled production may occur regardless of whether the data is in fact reflected on the return.[162] Moreover, the court in *Arthur Andersen* saw no difference between the objective expectation of confidentiality argument and the accountant-client privilege concept that the Court in *Couch* rejected.[163] Finally, the district court case of *Price Waterhouse,* in which Gulf Oil Corporation, the audited taxpayer, attempted to intervene and oppose an

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inseparable" goals, nor have other courts since *LaSalle. See, e.g.,* United States v. Garden State Nat'l Bank, 607 F.2d 61 (3d Cir. 1979).

160. Regulation S-X, "Form and Content of and Requirements for Financial Statements, Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Investment Company Act of 1940, and Energy Policy and Conservation Act of 1975," generally describes the categories of financial reporting the SEC requires pursuant to its rule-making powers. 17 C.F.R. § 210.1-01 (1981).

161. United States v. Arthur Young & Co., 496 F. Supp. 1152, 1157 (S.D.N.Y. 1980).

162. *See, e.g.,* Couch v. United States, 409 U.S. 322 (1973). A line of authority, which is similar to *Couch*'s holding that accountants have no justifiable expectation of privacy in accounting records, stands for the proposition that the filing of a tax return is a waiver of the attorney-client privilege concerning both the disclosed items and other information that is reasonably related thereto. *See, e.g.,* United States v. Cote, 456 F.2d 142 (8th Cir. 1972); United States v. Merrell, 303 F. Supp. 490 (N.D.N.Y. 1969). *But see* Colten v. United States, 306 F.2d 633 (2d Cir. 1962), *cert. denied,* 371 U.S. 951 (1963). The cases appear to be in accord with the notion that if data is found as a fact to have heen prepared with the intention—or even the possibility—that it will be disclosed in some form, a person cannot reasonably expect it to be confidential when the IRS subsequently makes a demand for disclosure.

163. United States v. Arthur Andersen & Co., 474 F. Supp. 322, 326-27 (D. Mass. 1979), *appeal of one party dismissed as moot,* 623 F.2d 720 (1st Cir.), *cert. denied,* 449 U.S. 1021 (1980), *aff'd as to second party,* 623 F.2d 725 (1st Cir. 1980).

IRS summons to the respondent accounting firm for tax reserve data, is another example of the courts' unwillingness to accept the newest confidentiality proposition.[164] In denying intervention, the court reasoned that Gulf had no recognizable legitimate expectation of privacy that would permit intervention, since it had forfeited all confidentiality when it turned its own material over to the accountants.[165]

The unifying, albeit unarticulated, theme in all these cases is that certified public accountants—particularly accountants for large, publicly held corporations—have a quasi-public stature and function that is inconsistent with claims of secrecy in accountant-client relations. While these corporations' financial affairs may be kept secret from the world at large, this privacy must give way to the demands of revenue collection or other public reporting obligations.

Accountants traditionally have assumed this quasi-public, independent role, and assumed it proudly. Thus, accountants do not perform audits for the corporate leadership alone. The shareholders, for example, have a legitimate, protectable interest in strict corporate financial accountability.[166] Customers also occasionally may impose audit accountability on a corporation through their responses in the marketplace or in private suits.[167] In addition, agencies such as the SEC impose a myriad of financial accounting requirements for the protection of investors. Indeed, the rules of both the SEC and the American Institute of Certified Public Accountants (AICPA) require public disclosure of material financial events and subsequent qualifications of an audited financial statement.[168] Thus, the transactions that are explored in tax reserve

164. United States v. Price Waterhouse & Co., 37 A.F.T.R.2d 76-1005 (W.D. Pa. 1975).

165. *Id.* at 76-1006. *See also In re* Co-Build Cos., 41 A.F.T.R.2d 78-308 (E.D. Pa. 1977).

166. *See* Guthrie v. Harkness, 199 U.S. 148 (1905); State *ex rel.* Dixon v. Missouri-Kansas Pipe Line Co., 42 Del. 423, 36 A.2d 29 (1944). *See generally,* Annot., 22 A.L.R. 24 (1923). These interests are based upon the principles that as the owners, the shareholders have a right to know their corporation's affairs, and that the officers and directors have a corresponding fiduciary and agency obligation to keep the shareholders informed. *See also* Apple v. Careerco, Inc., 82 Misc. 2d 468, 370 N.Y.S.2d 289 (1974) (shareholder entitled to see corporate financial statements); Lake v. Buckeye Steel Castings Co., 2 Ohio St. 2d 101, 206 N.E.2d 566 (1965).

167. *See* National Bank v. Western Pac. R.R. Co., 157 Cal. 573, 108 P. 676 (1910). *See generally* Annot., 149 A.L.R. 787 (1944) (trust fund theory of liability).

168. The Securities Exchange Act of 1934, 15 U.S.C. § 78m(a) (1976), requires corporations subject to the registration requirements of the Securities Act of 1933 to submit to the SEC periodic reports that disclose such information as the Commission may require. *See* 17 C.F.R. § 240.12b-20 (1980). Form 8-K is used for current reports, 17 C.F.R. §

data and reports to management quite conceivably could find their way into these publicly required statements.[169]

The tax laws and their interpretations impose further record-keeping requirements on businesses. Section 6001 of the Code, for example, provides that every taxpayer must keep such records and render such reports as will clearly reflect his income.[170] The applicable Treasury Regulations (Regulations) require that these records be made available to the IRS at reasonable times.[171] Moreover, the Code and Regulations abound with similar reporting and disclosure requirements whose nature and complexity implicitly contemplate the assistance of accountants.[172] The accounting profession itself has adopted rules that stress the auditor's independent and quasi-public "watchdog" role.[173] Thus, the litigating stance taken by the accountants—that some type of privilege should be recognized in order to keep sacrosanct the auditor's independence and the profession's methods, results, and secrets—is inconsistent with its generally accepted role as something much more than the mere tool of its client. Furthermore, the Supreme Court's denial of an accountant privilege in *Couch* can in part be attributed to a recognition of these aspects of the accountant's role and stature. The privacy notions that accompany financial transactions thus have only limited application, since virtually all financial transactions carry potential tax consequences, and since the client engages the accountant with either actual or constructive knowledge of the latter's quasi-public function.[174]

In addition, the accountant faces a potential threat of personal

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240.13a-11 (1980), and annual reports are made on Form 10-K, 17 C.F.R. § 249.310 (1980). The AICPA has also promulgated rules on this subject. *See* FASB STATEMENT No. 5.

169. If, for example, the corporation either had maintained significant "off-the-book" funds or had deducted foreign bribes, kickbacks, and the like, these transactions might require both disclosure in a 10-K report, *see* Upjohn Co. v. United States, 449 U.S. 383 (1981), and the accrual of extra amounts for the contingent tax exposure incurred.

170. I.R.C. § 6001.

171. Treas. Reg. § 1.6001-1(e) (1978); Treas. Reg. § 31.6001-1(d) (1960); Treas. Reg. § 53.6001-1(c) (1975); Treas. Reg. § 55.6601-1(c) (1981).

172. *See* I.R.C. §§ 6011, 6012, 6013, 6015, 6017, 6031, 6032, 6033, 6034, 6035, 6037, 6038, 6039, 6041, 6060 and Treasury Regulations thereunder.

173. The accountant, for example, may have duties to alert his client about potential problems, to correct or disclose errors, or to impose restrictions or qualifications on his opinion letter. *See* 31 C.F.R. §§ 10.21, .22, .51 (1980). The AICPA's canons of ethics are also explicit on these points. 2 AICPA PROFESSIONAL STANDARDS (CCH) ET § 54.

174. Not surprisingly, the courts have been reluctant to decide favorably upon the certified public accountants' assertions of privacy interests, since the Supreme Court has held that their clients themselves—the major publicly held corporations—have assumed a quasi-public status. *See* notes 166-67 & 191-99 *infra* and accompanying text.

liability for failure to adhere to his public responsibilities. An accountant cannot be asked to keep confidential, in the name of professionalism, the very information that will protect him against a charge that strikes at the heart of his professional reputation. In 1973 the Supreme Court in *Couch* referred to the accountants' realistic fear of prosecution for preparing a false return.[175] This threat has increased exponentially in recent years in the face of a long list of potential civil and criminal liabilities.[176] The Supreme Court's belief in *Couch* that personal exposure to liability detracts from the accountant's expectation of privacy[177] thus has become particularly relevant. Therefore, corporate public disclosure responsibilities, which are fulfilled by accountants whose exposure has vastly increased, argue even more strongly for the nonrecognition of an accountant's expectation of confidentiality in tax reserve and management report files.

Unquestionably, a tension exists in the accounting profession between its duty to the client and its quasi-public function. Nevertheless, the policy considerations that an expectation of confidentiality would further do not command a great deal of logical or experiential force. On the other hand, several considerations favor disclosure.

4. Prodisclosure Policies

The policy considerations favoring the Service's position directly contravene the accountants' arguments against disclosure. These policies stem from a tension between two inconsistent premises: While the Supreme Court has stated that the collection of the revenue is the "life-blood of government,"[178] the primary—and occasionally exclusive—source of tax data is the often reluctant taxpayer himself.[179] In addition, a third proposition must be considered, namely, that the assessment and collection of revenue are usually accomplished at the administrative level.

(a) Administrative Agency Policies in General

Administrative agency investigations in general—and IRS audits in particular—proceed under a set of rules and a code of val-

175. Couch v. United States, 409 U.S. 322 (1973).

176. *See* note 21 *supra* and accompanying text.

177. Couch v. United States, 409 U.S. 322 (1973).

178. Bull v. United States, 295 U.S. 247, 259 (1935).

179. *See* United States v. Brown, 349 F. Supp. 420 (N.D. Ill. 1972), *aff'd as modified*, 478 F.2d 1038 (7th Cir. 1973).

ues materially different from those operating in civil or criminal litigation. For example, no complaint, answer, indictment, or discovery is necessary in an administrative investigation. An audit or investigation may begin through a routine tax return check, an information item, a computer run, or an informant's tip. Because the probe is inquisitorial rather than accusatorial, the investigation is broad in scope, with the issues sometimes only vaguely defined. Disputes over discoverability and admissibility that are so common in litigation are inappropriate and do not often arise.[180] Moreover, in IRS and other agency investigations, the taxpayer or other subject of scrutiny is usually in control of the facts.[181]

Because of these differences from formal civil litigation, in which equal opportunity for both parties is paramount, Congress has structured,[182] and the courts have endorsed,[183] an *asymmetry* of interests in IRS and other agency inquiries. As the Supreme Court stated in *Powell*, the audit, revenue, or special agent may investigate a taxpayer because the law is violated, or merely because he wants assurance that it is not.[184] Moreover, the Service may inquire into any matter that might affect either the amount of a taxpayer's liability or the correctness of his tax return—limited only by a few constitutional and other broadly construed statutory

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180. As the court stated in *In re* Albert Lindley Lee Memorial Hosp., 209 F.2d 122 (2d Cir. 1953), *cert. denied*, 347 U.S. 960 (1954):

> Such investigatory inquiry by a Government agent is not a judicial proceeding. . . . Even administrative agencies like the Federal Trade Commission, the Labor Board and the Interstate Commerce Commission have never been restricted by the rigid rules of evidence applicable in courts of law. . . . [T]here is even less reason to restrict the revenue agent's inquiry by technical rules of evidence.

Id. at 123 (footnote and citations omitted).

181. United States v. Brown, 349 F. Supp. 420 (N.D. Ill. 1972), *aff'd as modified*, 478 F.2d 1038 (7th Cir. 1973).

182. *See* Federal Trade Commission Act, 15 U.S.C. § 46 (1976); National Labor Relations Act, 29 U.S.C. § 161 (1976); Civil Rights Act of 1964, 42 U.S.C. § 2000e-8 (1976).

183. *See* United States v. Morton Salt Co., 338 U.S. 632 (1950); FTC v. Cement Inst., 333 U.S. 683 (1948); Consolidated Edison Co. v. NLRB, 305 U.S. 197 (1938); ICC v. Baird, 194 U.S. 25 (1904); EEOC v. University of N.M., Albuquerque, 504 F.2d 1296 (10th Cir. 1974) (only limitation on Commission's power under 42 U.S.C. § 2000e-8(a) (1964), is whether data sought is relevant and competent).

The *Noall* court arguably referred to this distinction between court and agency process when it distinguished the cases that the taxpayer cited to show the inhibiting effect of compelled disclosure. The court noted that these cases were factually distinguishable and arose in the course of civil discovery. It then stated that, "[w]ith respect to enforcement of the tax laws, Congress itself has decided the policy issue, and it is not for the courts to challenge that determination. In this, as in many other procedural questions, the collection of the revenue stands apart." United States v. Noall, 587 F.2d 123, 126 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

184. United States v. Powell, 379 U.S. 48, 57 (1964).

boundaries.[185]

The concept of a legitimate congressional delegation of vast enforcement powers to administrative agencies, while not initially popular,[186] has been firmly fixed for many years. The Supreme Court in 1946 harmonized a series of partly conflicting precedents in *Oklahoma Press Publishing Co. v. Walling*[187] when it held that the Administrator of the Wage and Hour Division of the Department of Labor had the power to compel, by administrative subpoena, the production of compliance reports pursuant to the Fair Labor Standards Act.[188] The Court of Appeals for the Tenth Circuit[189] had ruled that the agency lacked subpoena power absent a showing of probable cause under the fourth amendment. The Supreme Court rejected both this notion and its corollary that a contrary rule would permit "general fishing expeditions into petitioners' books, records and papers, in order to secure evidence that they have violated the Act, without a prior charge or complaint and simply to secure information upon which to base one . . . ."[190] The Court reasoned that the subpoena does not amount to a traditional search and seizure, since it neither entails an entry nor a non-consensual search or seizure. The Court then stated that in balancing private against public interests at the administrative level, a court should give less deference to a corporation than to an individual, a rule of particular significance for custodians of tax reserve data. Unlike individuals, the Court noted, corporations historically have been subject to the "broad visitorial power"[191] of the state. Under this view, if the inquiry is otherwise statutorily authorized, and the data sought are relevant,[192] the fourth amend-

185. The fifth amendment's self-incrimination clause, for example, applies to civil proceedings, McCarthy v. Arndstein, 266 U.S. 34 (1924); and to the summons power, United States v. Slutsky, 352 F. Supp. 1105 (S.D.N.Y. 1972), as does the attorney-client privilege and work product doctrine. Upjohn Co. v. United States, 449 U.S. 383 (1981). *See also* I.R.C. §§ 7603, 7605 & 7609.

186. *See, e.g.*, FTC v. American Tobacco Co., 264 U.S. 298, 305-06 (1924) (overbroad subpoena); Silverthorne Lumber Co. v. United States, 251 U.S. 385 (1920) (illegal search and seizure).

187. 327 U.S. 186 (1946).

188. Ch. 676, § 1, 52 Stat. 1060 (1938) (current version at 29 U.S.C. §§ 201-219 (1976 & Supp. III 1979)). Section 11(a) of the Act, 29 U.S.C. § 211(a) (1976), endows investigators with authority, and § 9, 29 U.S.C. § 209 (1976), incorporates the subpoena power language of §§ 9 and 10 of the Federal Trade Commission Act, 15 U.S.C. §§ 50-51 (1914).

189. 147 F.2d 658 (10th Cir. 1945), *aff'd*, 327 U.S. 186 (1946).

190. 327 U.S. 186, 195 (1946).

191. *Id.* at 204.

192. The Court in *Oklahoma Press* stated,

> It is not necessary, as in the case of a warrant, that a specific charge or complaint

ment, if applicable at all,[193] at most guards against a traditional illegal search and seizure or an overbroad, vague, or indefinite subpoena.

The Supreme Court extended even further the proposition that administrative agency jurisdiction entails inquisitorial powers in *United States v. Morton Salt Co.*[194] In proceedings under section 5 of the Federal Trade Commission Act[195] seeking an order compelling Morton Salt to cease and desist from certain pricing, production, and marketing practices, the FTC, as part of its decision, directed the company to *create*[196] additional, highly particularized reports that would demonstrate compliance with the cease and desist order. The company refused, and the Court upheld the Commission's power to compel these reports through a mandatory injunction. In so doing, the Court expressly relegated corporations to a status inferior to that enjoyed by individuals with respect to fourth amendment privacy rights.[197] The Court noted that corporations are endowed with public attributes, that they have a collective impact on society, and that they exist solely at the sufferance of society, from which they derive the privilege of acting as artificial entities.[198] The Court went on to state that

> [e]ven if one were to regard the request for information in this case as caused by nothing more than official curiosity, nevertheless law-enforcing agencies have a legitimate right to satisfy themselves that corporate behavior is consistent with the law and the public interest.
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> . . . [I]t is sufficient if the inquiry is within the authority of the agency, the demand is not too indefinite and the information sought is reasonably relevant.[199]

The "official curiosity" standard—an outgrowth of the Court's

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of violation of law be pending or that the order he made pursuant to one. It is enough that the investigation be for a lawfully authorized purpose, within the power of Congress to command.

Id. at 208-09.

193. *Compare* Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186 (1946), *and* Hale v. Henkel, 201 U.S. 43 (1906) *with* G.M. Leasing Corp. v. United States, 429 U.S. 338 (1977).

194. 338 U.S. 632 (1950).

195. Ch. 311, § 5, 38 Stat. 717 (1914) (current version at 15 U.S.C. § 45 (1976 & Supp. III 1979)).

196. The *creation* of data has never heen urged as a component of the summons power. *See* United States v. Euge, 444 U.S. 707 (1980).

197. 338 U.S. at 652. *See also* United States v. White, 322 U.S. 694 (1944); Hale v. Henkel, 201 U.S. 43 (1906); Guthrie v. Harkness, 199 U.S. 148 (1905) (corporations are subject to visitorial power of state).

198. 338 U.S. at 652.

199. *Id.* at 652.

rejection of the probable cause standard—was extended to the summons power in *Powell*.[200] The Court thus implied that the administrative nature of an IRS examination requires that the Service proceed under standards of inquiry that are identical to the ones which other administrative agencies follow. Moreover, in one of its most recent pronouncements on the summons power, the Court in *Euge* expanded the applicability of the *Powell* decision perhaps to the furthest practical extent when it held that the summons power is available "absent express statutory prohibition or substantial countervailing policies."[201]

(b) Policies Underlying the Revenue Laws

The Service's statutory authority and obligation to audit is embodied in section 7601 of the Code.[202] This section instructs the Secretary of the Treasury or his delegate, "to the extent he deems it practicable," to cause Treasury Department officers or employees to "proceed . . . and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax."[203] The summons power serves to implement this statutory mandate for four named purposes: To ascertain the correctness of a return, to make a return when none has been made, to determine the liability of any person for any internal revenue tax, and to collect any internal revenue tax.[204]

The courts often have endorsed[205] these wide-ranging powers of inquiry in decisions that bear the imprint of four distinct policy propositions: (1) Access to information promotes justice in administrative proceedings; (2) powerful weapons are necessary to assure the integrity and equity of the tax system; (3) the IRS requires a broad mandate and powerful tools of inquiry to accomplish its task; and (4) the IRS cannot know at the outset of an investigation the importance or relevance of all the documents it seeks—or sometimes even *what* data to seek—since the taxpayer typically is

200. 379 U.S. 48 (1964).

201. United States v. Euge, 444 U.S. 707, 711 (1980). The *Euge* standard comports with the standard applicable to the subpoena power of the SEC. *See* SEC v. Wheeling-Pittsburgh Steel Corp., 482 F. Supp. 555 (W.D. Pa. 1979); 15 U.S.C. § 79r(c) (1976). *See also* Hannah v. Larche, 363 U.S. 420 (1960); Smith v. ICC, 245 U.S. 33 (1917); Harriman v. ICC, 211 U.S. 407 (1908); Top Value Meats Inc. v. FTC, 586 F.2d 1275 (8th Cir. 1978).

202. I.R.C. § 7601.

203. *Id.*

204. *Id.* § 7602.

205. *See, e.g.*, United States v. Euge, 444 U.S. 707 (1980); United States v. Bisceglia, 420 U.S. 141 (1975); United States v. Powell, 379 U.S. 48 (1964).

in control of the facts.[206]

The first policy—access to information promotes justice—simply recognizes that in administrative and adversarial settings, the law is entitled to every person's evidence, or, as one court has stated in the grand jury context, that all citizens have a "strong obligation" to furnish all relevant evidence.[207] This general policy of antipathy toward concealing the truth applies to the administrative and litigative stages of a dispute, as well as to many types of regulatory agencies, including the IRS.[208] In addition, the need for a policy of open-ended truth-finding at the administrative level may be even greater when the nature of the inquiry is private and relatively informal, the issues at least initially are not precisely defined, and the outcome theoretically may even benefit the investigated party. This policy is so firmly embedded in the law that it ought to weigh heavily in any decision on the availability of accountants' workpapers, particularly since the courts generally do not recognize an accountant-client privilege or even quasi-privilege.[209]

The second and third policy principles are interrelated. They both assume that government cannot function without an effective tax system,[210] and that if the system is to maintain its effectiveness and treat all taxpayers equitably, the IRS must be given appropriately coercive tools. To create an island of secrecy by permitting accountants and their clients to preserve the confidentiality of tax reserve data and reports to management would offend the principle of equity, since other tax entities and individual taxpayers cannot claim the same privilege. In fact, the perceived fairness of the taxing system would be enhanced to the extent that courts refused to sanction special interests in the audit process. All other taxpayers are required to disclose tax-related data to the IRS, and the Supreme Court often has stated that corporations have lesser, not

206. *See* United States v. Brown, 349 F. Supp. 420 (N.D. Ill. 1972), *aff'd as modified*, 478 F.2d 1038 (7th Cir. 1973).

207. *In re* Grand Jury Subpoena Duces Tecum, 483 F. Supp. 1085, 1089 (D. Minn. 1979), *stay granted*, 483 F. Supp. 1091 (D. Minn. 1979); *accord*, United States v. Bremicker, 365 F. Supp. 701 (D. Minn. 1973) (duty to obey summons). The Supreme Court repeatedly has endorsed this general principle, even over the objections of the President of the United States. United States v. Nixon, 418 U.S. 683, 709 (1974).

208. *See* notes 183-201 *supra* and accompanying text; note 69 *supra*.

209. *See* notes 105-15 & 155-77 *supra* and accompanying text.

210. *See generally* Bull v. United States, 295 U.S. 247 (1935); Phillips v. Commissioner, 283 U.S. 589 (1931).

greater, rights than individuals.[211] Moreover, this lack of secrecy would not result in a significant impairment of the accountant's independent audit process;[212] data that taxpayers and accountants create for other, supervening legal reasons more than likely will survive the threat of summons, particularly when only money—not the life of the corporation—is at stake.

The fourth policy recognizes that in IRS investigations—like most agency inquiries—the facts usually are within the virtually exclusive control of the investigated party.[213] If, for example, the IRS examines the taxpayer's reserve to determine whether to disallow a bad debt deduction, the taxpayer himself is the source of the facts concerning the collectibility of those debts. This problem becomes acute in large-case examinations. Major corporations tend to have tens of thousands of accounts, millions of documents, and hundreds of corporate auditors, while the number of IRS agents that are assigned to audit these corporations typically is fewer than ten.[214] Recognizing the gamesmanship that unfortunately attends IRS audits, courts generally have attempted to balance this disparity by defining the scope of the IRS compulsory process broadly.[215]

All of these policy considerations, of course, are interrelated and mutually reinforcing. The importance of revealing the truth in tax investigations reinforces the extra latitude that Congress and the courts have granted to the IRS when the truth resides in the taxpayer's control. Similarly, the high priority that society gives to

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211. Moreover, corporations are also the entities who more than likely have the most to hide—and thus to lose—from disclosure. They invoke the name of the public for a private purpose, which is to avoid paying more taxes. These corporations suggest, somewhat incredibly, that if the IRS obtains access to tax reserve data, they will be tempted to waiver in their compliance with other laws. In the post-Watergate era, the response to these arguments should be that the public interest lies in full disclosure—not in secrecy—and that public policy considerations do not entail picking and choosing among equally important lawful obligations.

212. *See* notes 119-33 *supra* and accompanying text.

213. *See* United States v. Riley Co., 45 A.F.T.R.2d 80-1164, 1165 (N.D. Ill. 1980) (mem.), *appeal dismissed,* No. 80-1124 (7th Cir. Sept. 16, 1980). The Court in *Riley* noted that the IRS could not be expected to know for certain what the summoned reports to management contained without seeing them first. *Accord,* United States v. Acker, 325 F. Supp. 857 (S.D.N.Y. 1971). In *Riley,* however, the Government did come close to acquiring this prior knowledge. The summons called for the production of "bluebacks," which are reports to management, that Arthur Andersen & Co. had prepared. The Government's expert witness, an Internal Revenue Agent, had previously worked for Arthur Andersen and had written portions of the same type bluebacks.

214. *See* United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), *aff'd,* 550 F.2d 615 (10th Cir. 1977).

215. United States v. Powell, 379 U.S. 48 (1964); United States v. Noall, 587 F.2d 123 (2d Cir. 1978), *cert. denied,* 441 U.S. 923 (1979).

the collection of revenue necessitates a rapid and effective enforcement machinery. Finally, the policy that the efficacy and legitimacy of the tax system's quasi-voluntary, self-assessment nature depends upon the equitable treatment of all taxpayers—that each pays his fair share—requires that the enforcement process reach the large and small taxpayer alike.

The centrality of these themes to the integrity of the entire taxing system contrasts sharply with the correspondingly narrow focus of an accountant's interests in protecting tax reserve data. Indeed, to balance the two interests against one another effectively decides the issue in favor of the IRS, a result which the case law thus far would support. This balancing, therefore, should continue to result in the disclosure of accountants' sensitive workpapers to the IRS.

To recapitulate, the policy arguments should be resolved as follows: (1) No accountant-client privilege exists; (2) neither the corporation nor the accountant should be entitled to either a subjective or a legitimate objective expectation of privacy; and (3) accountants will continue to create tax reserve data, in spite of the threat that it might be disclosed to the IRS. On the other hand, the policy considerations that favor the disclosure of accountants' sensitive workpapers are significant and can be enumerated as follows: (1) Tax reserve data and reports to management are highly useful and relevant to IRS investigations; (2) auditing major corporations is arduous without the taxpayer's cooperation; (3) ascertainment of the truth is a desirable goal; (4) effective enforcement tools are necessary to accomplish this goal; (5) the facts needed in an investigation are typically within the taxpayer's control; (6) all taxpayers should receive equitable and equal treatment; and (7) swift and effective revenue collection is a high priority national goal. Thus, it is little wonder that the court in *Noall* concluded that Congress had already decided the policy issues surrounding the confidentiality of accountants' papers when it enacted section 7602,[216] and that all which remained for a court to decide was whether the data were "relevant."[217]

C. "Other Data" Argument

Perhaps because of their lack of success with the relevance

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216. *See* notes 116-17 *supra* and accompanying text.

217. United States v. Noall, 587 F.2d 123, 126 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

and policy arguments, accountants and their clients appear to be developing a third litigating position: Tax reserve data and reports to management reflect opinions, judgments, and projections that are not "other data" within the meaning of section 7602.[218] This position has been litigated only once, and the court rejected it,[219] in part on the ground that section 7602 is to be liberally construed and that any interpretative restriction on otherwise relevant and summonable data should not be sanctioned.[220]

The "other data" argument would interpret section 7602's phrase "books, papers, records" and the undefined term "other data" somewhat narrowly. The predecessor to section 7602 provided for the summoning of "books, papers, records or memoranda,"[221] and this language was carried forward through successive revenue acts until the Internal Revenue Code of 1954.[222] The companion federal court jurisdictional statute provided for jurisdiction to enforce a summons for "books, papers, or other data,"[223]

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218. *See* note 2 *supra* and accompanying text. It will be recalled that § 7602 authorizes the Secretary to use the summons power "[t]o examine any books, papers, records, or *other data* which may be relevant or material to such inquiry." I.R.C. § 7602(1) (emphasis supplied). *See also* Caplin, *supra* note 36. Caplin recites this proposition as part of the AICPA's position. The initial problem with this concept is that it may be irrelevant that the tax reserve file and reports to management may not qualify as "other data" under I.R.C. § 7602, since it seems all too obvious that they are at least records and papers.

219. United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980).

220. *Id.* at 1159.

221. Act of February 24, 1919, ch. 18, § 1305, 40 Stat. 1057. The statute was codified as section 3614(a) of the Internal Revenue Code of 1939 and provided,

> The Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is authorized, by any officer or employee of the Bureau of Internal Revenue, including the field service, designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matters required by law to be included in such return, with power to administer oaths to such person or persons.

Int. Rev. Code of 1939, ch. 39, § 3614(a), 53 Stat. 1 (current version at I.R.C. § 7602).

222. Act of May 29, 1928, ch. 852, § 618, 45 Stat. 791; Act of February 26, 1926, ch. 27, § 1104, 44 Stat., pt. 2, at 9; Act of June 2, 1924, ch. 234, § 1004, 43 Stat. 253; Act of November 23, 1921, ch. 136, § 1308, 42 Stat. 227. This provision eventually became § 3614(a) of the Internal Revenue Code of 1939. Int. Rev. Code of 1939, ch. 34, § 3614(a), 53 Stat. 1 (current version at I.R.C. § 7602); *see* note 221 *supra*. *See generally* United States v. Campbell, 524 F.2d 604 (8th Cir. 1975); Brownson v. United States, 32 F.2d 844 (8th Cir. 1929); Brief for Respondent at 42-48, United States v. Euge, 444 U.S. 707 (1980).

223. Int. Rev. Code of 1939, ch. 34, § 3633(a), 53 Stat. 1 (current version at I.R.C. § 7604(a)). Section 3633(a) provided,

> If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the

which indicated that Congress was using the terms "memoranda" and "other data" interchangeably.[224] Thus, the 1954 Code revisions provided no "material" change in substituting the term "other data" for "memoranda" in section 7602.[225] The legislative history is otherwise silent on whether Congress intended "other data" to be restricted to hard numbers and facts, or whether it meant for the phrase to include judgments, evaluation, opinions, and speculation, which is the type of material available from tax reserve files and reports to management.

Few courts have addressed the issue of the meaning of "other data," but the reported cases appear consistent with the liberal construction and wide latitude typically given to the summons power.[226] In *Davey* the Second Circuit upheld enforcement of a summons for *original* computer tapes belonging to Continental Insurance Company that recorded and summarized expenses, income, and losses.[227] In rejecting Continental's argument that the magnetic tapes were not books, records, papers, or other data, the court stated that

> [s]ection 7602 is intended to allow the IRS access to all relevant or material records and data in the taxpayer's possession. It places no limit or condition on the type or form of the medium by which the record subject to summons is kept and nothing in the language or background suggests that such a limitation was intended. The purpose was to enable the IRS to get at the taxpayer's records, in whatever form they might be kept. The standard is not

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district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

Id. This statute likewise had undergone successive enactments. *See, e.g.*, Act of May 29, 1928, ch. 852, § 617(a), 45 Stat. 791; Act of December 16, 1926, ch. 27, § 1122(a), 44 Stat., pt. 2, at 1; Act of June 2, 1924, ch. 234, § 1025(a), 43 Stat. 253; Act of November 23, 1921, ch. 136, § 1305, 42 Stat. 227; *see* Brownson v. United States, 32 F.2d 844 (8th Cir. 1929).

224. The other antecedents of § 7602 were §§ 3615 and 3654 of the 1939 Code. Section 3615(a) provided in part,

> It shall be lawful for the collector, subject to the provisions of this section te summon any person to appear before him and produce books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income subject to tax or the returns thereof.

Int. Rev. Code of 1939, ch. 39, § 3615(a), 53 Stat. 1 (current version at I.R.C. § 7602).

225. H.R. REP. No. 1337, 83d Cong., 2d Sess. A436 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 617 (1954); HOUSE WAYS AND MEANS COMM., DETAILED DISCUSSION OF TECHNICAL PROVISIONS OF [H.R. 8300], 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & ADM. NEWS 4584.

226. *See* United States v. Davey, 543 F.2d 996 (2d Cir. 1976); United States v. Brown, 349 F. Supp. 420 (N.D. Ill. 1972), *aff'd as modified*, 478 F.2d 1038 (7th Cir. 1973).

227. United States v. Davey, 543 F.2d 996 (2d Cir. 1976). *See* notes 98-103 *supra* and accompanying text. An employer is required to keep these records. *See* Treas. Reg. § 1.6001-1(e) (1959). Under the regulations, a limited class of records can be stered on magnetic tape. Rev. Rul. 71-20, 1971-1 C.B. 392.

the form of the record but whether it might shed light on the accuracy of the taxpayer's returns.[228]

In a series of cases that culminated with the Supreme Court's decision in *Euge*,[229] various district courts and courts of appeals had addressed the issue whether handwriting exemplars are "other data" and thus subject to the summons power.[230] The court in *United States v. Brown*[231] held in the negative and reasoned that the summons power reaches only data that are actually in existence; since the handwriting exemplars in *Brown* were not in existence, they were not "other data." Some courts have also formulated an additional rationale for denying enforcement in these cases that derives from the doctrine of *ejusdem generis*.[232] These courts have held that "other data" must be defined by reference to the class represented by its companions: "books, papers, records." Since the giving of handwriting exemplars is clearly not within that class, the courts have reasoned that the exemplars cannot be "other data."

These precedents imply that data which is "in existence" qualify as "other data," at least when they fall within the class of books, papers, and records. Under this reasoning, no distinction exists between papers that contain facts and those that do not; a paper's relevance, rather than its form, governs whether it qualifies as "other data." This interpretation is in accordance with the well-established general principle that the summons power reaches any material that is not specifically exempted.[233] Moreover, it is consistent with other cases that uphold the summons power for records such as valuation reports that express opinions rather than detail facts.[234]

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228. United States v. Davey, 543 F.2d at 999.

229. United States v. Euge, 444 U.S. 707 (1980); *see* notes 69 & 201 *supra* and accompanying text.

230. *See* United States v. Rosinsky, 547 F.2d 249 (4th Cir. 1977); United States v. Brown, 536 F.2d 117 (6th Cir. 1976); United States v. Hoopingarner, 438 F. Supp. 366 (N.D.N.Y. 1977); United States v. Camphell, 390 F. Supp. 711 (D.S.D. 1975), *aff'd in part*, 524 F.2d 604 (8th Cir. 1975).

231. 536 F.2d 117 (6th Cir. 1976).

232. *See* Mason v. United States, 260 U.S. 545, 553-54 (1923).

233. United States v. Euge, 444 U.S. 707, 711 (1980). The dictionary definition gives the common meaning of the term "data" and states that it includes organized information collected for a specific purpose. BLACK'S LAW DICTIONARY 356 (5th ed. 1979). Such a broad reading almost certainly would include opinions and speculations.

234. United States v. McKay, 372 F.2d 174 (5th Cir. 1967) (engineer's valuation report); *accord*, United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.). "[Accountants'] opinions are very likely to be relevant to the issue of tax liability." *Id.* at 1099.

Consideration of the Federal Rules of Civil Procedure in this analysis is also helpful.[235] Rule 26(b)(1)[236] provides that parties may obtain discovery of "any matter, not privileged, which is relevant to the subject matter involved in the pending action." The other provisions of rule 26 allow for the discovery of trial preparation materials[237] and experts' opinions—whether or not the experts are retained in anticipation of litigation.[238] Furthermore, even the work product of lawyers is not absolutely excluded from civil discovery.[239]

A close analogy exists between tax reserve files and reports to management on the one hand, and discoverable experts' opinons on the other. The accountants, whether they are independent or internal, function as experts[240] who evaluate raw data and form an opinion that is based upon established criteria—the tax law and GAAP. Thus, a tax reserve summons seeks material that would *not* be immunized from discovery in civil litigation on the ground that it contains opinions, evaluations, or conclusions. For example, if the shareholders in a shareholder's derivative suit sought discovery of the auditor's opinions and evaluations, rule 26 would not forbid disclosure merely because the data contained opinions and not facts.

The courts have, with some consistency, given wider latitude to administrative agencies—and to the IRS in particular—than to parties in civil litigation.[241] To sustain the contention that accountants' opinions are not summonable, however, would violate this rule and restrict the IRS to a narrower scope of inquiry than that available to civil litigants. Moreover, the opinion of an accountant may itself be construed as a "fact" for purposes of proving fraudulent intent. This interpretation is consistent with the policy of reading the summons power—and, therefore, the phrase "other data"—broadly. Certainly the power should be at least as liberally construed as it is in the civil litigation context.

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235. The Federal Rules of Civil Procedure are discussed only by way of analogy. Rule 81(a)(3), however, does provide that the civil rules generally are applicable to summons enforcement cases, even though the Supreme Court in Donaldson v. United States, 400 U.S. 517 (1971), indicated that they may be modified or suspended to accomplish the aim of summary adjudication. *Id.* at 528-29.

236. FED. R. CIV. P. 26(b)(1).

237. *Id.* 26(b)(3).

238. *Id.*

239. *Id.*

240. *See* United States v. Kovel, 296 F.2d 918 (2d Cir. 1961).

241. United States v. McKay, 372 F.2d 174, 176 (5th Cir. 1967).

IV. Future Trends

Despite the Government's record of success in litigating summonses for sensitive accountants' papers, the debate is still in its developing stages. Disputes between the IRS and accountants and their clients are virtually certain to continue, and thus it is important to anticipate and analyze some of the likely future trends in the area. These trends can be loosely grouped into two areas. First, litigation over the policy, relevance, and "other data" issues will in all likelihood continue. Second, accountants and their clients probably will attempt through other channels to restrain the IRS from obtaining sensitive accountants' papers.

A. Continued Litigation

The relevance and policy arguments will in all likelihood continue to be litigated until the decisions in the Supreme Court and the lower courts coalesce into an unassailable and definitive rule. These arguments undoubtedly will be refined in each succeeding case as the precedents become clearer. Eventually, accountants may be forced to take the position that while the IRS is entitled to the facts recited in tax reserve data and reports to management, it is not entitled to the accompanying opinions, speculations, or conclusions. The facts would, of course, be of considerable utility to the IRS agent, but it is unlikely that these alone would satisfy him. As noted above, the accountant's reasoning, opinions, speculations, and conclusions are both directly and indirectly relevant,[242] since they effectively achieve the utility of an expert's opinion.[243]

Furthermore, the Service is unlikely to be willing to leave to the taxpayer or accountants—or to the court for an *in camera* examination[244]—the judgment about what is fact and what is opinion. The Service guards closely its prerogative to conduct independent audits and decide for itself what is relevant, and judicial precedent appears to support this prerogative.[245] It is likely, there-

242. *See* notes 48-103 *supra* and accompanying text.

243. *See* notes 235-41 *supra* and accompanying text.

244. The courts in *Noall* and *Riley* specifically disapproved of these *in camera* examinations. *But see* United States v. First Chicago Corp., 43 A.F.T.R.2d 79-704 (N.D. Ill. 1978) (mem.).

245. *See, e.g.*, Beatty v. United States, 227 F.2d 350 (8th Cir. 1955); United States v. Acker, 325 F. Supp. 857 (S.D.N.Y. 1971); Commissioner v. Backer, 178 F. Supp. 256 (M.D. Ga. 1959), *rev'd and remanded on other grounds*, 275 F.2d 141 (5th Cir. 1960); Application of Carroll, 149 F. Supp. 634 (S.D.N.Y.), *aff'd sub nom.*, Application of United States (Carroll), 246 F.2d 762 (2d Cir.), *cert. denied*, 355 U.S. 847 (1957).

fore, that litigation over these two arguments will continue to command the attention of the courts until all variations have been explored; but there is no reason to expect that the present pattern of decisions will be altered. Since the position that tax reserve data are not "other data" has so far been litigated only once,[246] it will most probably be tested again. Considering the argument's technical rationale and narrow interpretation of "other data," however, the success of this argument is doubtful at best.

B. *Other Efforts*

The accounting profession undoubtedly will make—indeed, already has made—efforts through channels other than litigation to deter the IRS from wielding its summons power to obtain tax reserve data and reports to management.[247] The Internal Revenue Audit Manual contains a self-imposed restriction on agents' access to tax reserve data.[248] According to the manual, this data is not to be requested as a matter of standard examining procedure, but only when the workpapers are believed to be material and relevant to the examination. The manual reminds the examiner that the taxpayer's records are the primary source of information, and that tax reserve data and reports to management are only collateral sources. The agent should "exhaust all reasonable means" to secure the data from the taxpayer before pursuing the independent auditor, which potentially includes a summons to the taxpayer's financial officer or tax manager. While these restrictions are not an outgrowth of the case law,[249] they nevertheless control and curtail the frequency and timing of requests for tax reserve data, and the

246. *See* note 219 *supra* and accompanying text.

247. *See* Caplin, *supra* note 36. Caplin describes a May 20, 1980, meeting of the Justice Department Advisory Committee on Tax Litigation in which the Assistant Attorney General (Tax Division) endorsed the principle of restraint in seeking enforcement of summonses for tax pool data. BNA Daily Tax Report May 21, 1980, at G-7, J-10. *See also* note 49 *supra.*

248. I INTERNAL REVENUE MANUAL-AUDIT (CCH) § 4024 (August 1981).

249. The courts do not purport to make or evaluate policy but only to consider whether the summons is enforceable under the *Powell* standards. *See, e.g.*, United States v. Noall, 587 F.2d 123, 125-26 (2d Cir. 1978), *cert. denied,* 441 U.S. 923 (1979). Even a violation of the Internal Revenue Audit Manual or Information Release 80-7, *see* note 49 *supra,* in the issuance of a summons, however, would be unlikely to render the summons unenforceable for this reason alone. *See* United States v. Caceres, 440 U.S. 741 (1979); United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981) (mem.); *cf.* United States v. Lockyer, 448 F.2d 417, 421 (10th Cir. 1971) (unpublished provision did not "exist for the protection of the taxpayer's interests and rights"; agent's violation of investigation guidelines could not inure to benefit of taxpayer).

accounting profession is certain to attempt to emphasize and employ them. In addition, the profession may lobby for the passage of some federal legislation. The intense interest of the professional associations, indicated by their formation of advisory committees on the topic, will enable the accountants to concentrate their efforts on this point.

The accounting profession also might seek to protect their papers under the umbrella of the attorney-client privilege in one of three ways: (1) By having the lawyer perform the accountant's task; (2) by the laywer's vitiating the accountant's independence; or (3) by each independent professional's using the other as a specialist. The first approach undoubtedly will encounter some resistance from the legal profession, since most lawyers are not professional accountants and would be loathe to trust themselves to so complex a task. Accountants' liability exposure also looms for lawyers who hold themselves out to be accountants. Moreover, the rules and laws that originally require the accounting services provide that an *independent* certified public accountant must perform the work.[250]

If the lawyer himself is a Certified Public Accountant (CPA), or if he hires a CPA, past experience suggests that the attorney-client privilege will not apply to the final work product; it has usually proved difficult to hire the lawyer's privilege. The mere transfer of accounting records to an attorney, for example, does not change their vulnerability to summons.[251] The rationale underlying this result is that the transfer does not satisfy the elements of the attorney-client privilege,[252] and the rights of the parties are fixed

250. The accountant must be independent of the client in the professional sense, according to SEC rules. Regulation S-X, 17 C.F.R. § 210.2-02(b) (1981). The attorney is by training and contract the agent and advocate of his principal; he is engaged *not* to be independent. Moreover, the attorney's ethical canons require that he take his client's side vigorously. *Compare* ABA CODE OF PROFESSIONAL RESPONSIBILITY Canon 5 *with* Canons 7 & 9.

251. Fisher v. United States, 425 U.S. 391 (1976); Bouschor v. United States, 316 F.2d 451 (8th Cir. 1963); United States v. De Castro, West & Chodorow, Inc., 35 A.F.T.R. 2d 75-1161 (C.D. Cal. 1975); United States v. Peden, 26 A.F.T.R. 2d 70-5342 (W.D. Ky. 1970).

252. Courts have articulated the attorney-client privilege in a variety of ways. Judge Wyzanski in United States v. United Shoe Macb. Corp., 89 F. Supp. 357, 358-59 (D. Mass. 1950), made perhaps the most famous formulation on the subject when he stated,

> The privilege applies only if (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and

as of the time the summons is issued.[253]

The second approach contemplates the lawyer overcoming the normal presumption of an accountant's independence by making the accountant his "creature." Such a relationship has successfully withstood a challenge from the IRS in one reported case,[254] in which the taxpayer's lawyers hired the accountant pursuant to an employment agreement after the establishment of the attorney-client relationship. The taxpayers expressly were named as clients of the lawyers rather than the accountants, and the accounting services were shown to facilitate accurate and complete legal consultation. All records—even if the accountant prepared them—became the exclusive property of the law firm, which generated all billings. In addition, all information was to be kept confidential. Short of these extraordinary measures, however, a mere working relationship between lawyer and accountant would not bring the latter within the lawyer's privilege.[255] Since accounting records for the most part predate the creation of the attorney-client relationship, the privilege usually will have no application.[256] Tax reserve data and reports to management, which the client desires from the accountant for reasons other than exclusively legal advice, clearly fall into this category of accounting records.

Moreover, under this approach, only the legal advice would be protected, and then only when the lawyer generated it. The accountant's duty to judge the adequacy of the tax reserve clearly includes making a decision whether the components of that reserve are legally as well as actuarially sound. He must point out questionable positions and demonstrate or satisfy himself about the legal sufficiency of the accounting positions taken. Although legal

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(4) the privilege has been (a) claimed and (b) not waived by the client.

The transfer of records to an attorney presupposes either the existence of the records prior to the creation of the attorney-client relationship or the creation of the records with the intention that they will be disclosed to a person outside the privileged circle.

253. Couch v. United States, 409 U.S. 322, 329 n.9 (1973).

254. United States v. Schmidt, 360 F. Supp. 339 (M.D. Pa. 1973), *modifying*, 343 F. Supp. 444 (M.D. Pa. 1972).

255. *See also* United States v. Cote, 456 F.2d 142 (8th Cir. 1972). In *Cote* the privilege was sustained for an accountant's work memoranda that was used to prepare amended tax returns when (1) the lawyer retained the accountant to audit the taxpayer's books and records, (2) the accountant worked on the project only in the lawyer's office, and (3) based on the audit, the lawyer advised the clients to file amended tax returns. The extension of *Cote* to cover tax reserve data and reports to management would be questionable for the same reasons discussed in the accompanying text. *See also* Bauer v. Orser, 258 F. Supp. 338 (D.N.D. 1966).

256. *See* United States v. Gurtner, 474 F.2d 297 (9th Cir. 1973).

advice is rendered, the advice emanates from a nonlawyer and, therefore, would not be privileged.[257] Indeed, to bring some portion of the tax reserve data within the attorney-client privilege may require alterations in the normal division of labor that the parties would not undertake willingly. The actuarial accounting calculations and accounting judgments, for example, would have to be separated from the analysis of their legal results, so that the latter could be consigned to an attorney. Neither clients nor their accountants are likely to be professionally comfortable with abdication of the legal aspects of the accountant's role. Moreover, considerations of professional responsibility may well preclude it.[258] From the client's perspective—assuming that all other elements of the privilege are satisfied—the gain is to shield only the legal advice from the IRS. Important considerations such as the underlying facts, the actuarial sifting, the communications between accountant and client and between accountant and lawyer, the accounting advice and analysis, and the conclusions about the client's adherence to Generally Accepted Accounting Principles—anything in which nonlegal and legal advice are inextricably mixed—all would likely be outside the privilege. It is doubtful that clients, or their lawyers,[259] would conclude that the gain would be worth the price.

The third approach for an accountant who desires to be protected against production of sensitive papers is to use the lawyer, or to have the lawyer use him, as a specialist. Under this approach, an accountant must be necessary—or at least highly useful—for the effective consultation between client and lawyer that the attorney-client privilege is designed to permit.[260] Thus, if the lawyer di-

257. United States v. Heiberger, 37 A.F.T.R.2d 76-1281 (D. Conn. 1976); *cf.* United States v. De Castro, West & Chodorow, Inc., 35 A.F.T.R.2d 75-1161 (C.D. Cal. 1975) (client's transfer of accountant's records to attorney demonstrated privacy expectation; attorney-client privilege operated to protect records from summons). *But see* United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980).

258. In any event, the courts probably would not sanction such an abdication. *See* Falsone v. United States, 205 F.2d 734 (5th Cir. 1953) (taxpayers' and accountants' records in attorney's hands cannot be privileged; otherwise the transfer of records to an attorney could defeat the administration of justice). *But see* United States v. Kovel, 296 F.2d 918, 920-22 (2d Cir. 1961) (applicability of privilege depends on the extent to which the accountant's role is indispensible to the lawyer's function).

259. One recent article indicates that a national conference of lawyers and CPAs are preparing a statement on this possibility. Legal Times of Washington, Nov. 17, 1980, at 1, col. 1. The article suggests that the attorneys neither want the attendant liability exposure nor have the accounting expertise.

260. *See In re* Grand Jury Subpoena, 599 F.2d 504, 513 (2d Cir. 1979) (accountants' workpapers reflecting oral conversations with corporate employees could qualify as attorney work product); United States v. Kovel, 296 F.2d 918 (2d Cir. 1961); United States v. Arthur

rects the client to tell his story first to the accountant whom the lawyer has engaged, and the accountant then interprets the story so that the lawyer can give better legal advice, the communications to the accountant may be privileged. The test, however, is still whether the communication is made in confidence for the purpose of obtaining legal advice. If only accounting advice is sought, or if the advice sought is the accountant's rather than the lawyer's, then the privilege will not apply.[261] Tax reserve data and reports to management consist exclusively of accounting data that is researched, compiled, and analyzed by accountants whose duty requires independence from both the client and, presumably, his agent, the lawyer. The data, except for raw data, originate with the accountant and remain with him. Some legal analysis undoubtedly is a part of the data—the analysis of the doubtfulness of a client's position before the IRS on a topic, for example—but that advice may constitute only the normal legal advice that accountants expect to give their clients. Alternatively, the accountants might try to rely more heavily on the opinions of other experts such as lawyers about the adequacy of the tax reserve.[262] Although the accounting guidelines specifically sanction reliance on the opinion of an expert,[263] use of a specialist is confined to matters such as valuation, physical characteristics, actuarial determinations, and interpretation of technical requirements, regulations, or agreements. This standard does not appear to contemplate obtaining and relying on the opinion of a lawyer as an expert on the adequacy of the tax reserve. In any event, an expert in accounting would be unlikely to rely on a nonaccountant for an expert opinion in his own field. Thus, accountants will only rarely—if at all—be able to protect their workpapers by invoking the attorney-client privilege through an adherence to its elements.

The final avenue that the accounting profession might pursue is to tailor the accounting process in a way that either will restrict the flow of data to accountants or circumscribe the data that they retain to support their final opinion. Each of these approaches,

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Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980) (work of accountants under aegis of attorneys held to be protected).

261. *In re* Grand Jury Subpoena, 599 F.2d 504, 510 (2d Cir. 1979); *accord,* United States v. Schoeberlein, 335 F. Supp. 1048 (D. Md. 1971). *But see* United States v. Schmidt, 360 F. Supp. 339 (M.D. Pa. 1973), *modifying,* 343 F. Supp. 444 (M.D. Pa. 1972).

262. *See* Cohen, *supra* note 37, at 35; Holloran & Krongard, *The Client-Accountant Relationship,* in IRS ACCESS TO ACCOUNTANTS' WORKPAPERS 151 (N.Y.L.J. Law Journal Seminars-Press 1980).

263. AICPA STATEMENT ON AUDITING STANDARDS No. 11. *See also Id.,* No. 12.

however, has significant drawbacks. The client's refusal to provide adequate data may well result in either the accountant's having to qualify his opinion or his declining to give one at all. The accountant must have sufficient, competent information from the client and the client's resources to form a reasonable opinion.[264] Anything less may not be acceptable to the SEC or to the corporation's shareholders.

The failure to *retain* data by destroying all that is not deemed material to or supportive of the final report potentially exposes the accountant to an obstruction of justice charge.[265] Moreover, GAAS may require the preservation of these workpapers,[266] and, in any event, the workpapers enable the accountants to understand other audited transactions. In addition, should the IRS also request and obtain the audit workplan,[267] it will be able to determine what areas are the most sensitive; if the underlying papers no longer exist, the agent will immediately become suspicious. Finally, the following years' audits may well require resort to prior years' records, and, of course, the accountants ultimately must guard against exposure to personal liability.

V. CONCLUSION

The choice may well be one of undesirable alternatives for the accounting profession and its clients. After the accountants' initial success in *Coopers & Lybrand,* the litigated cases have, with rare exceptions, resulted in full enforcement of summonses for tax reserve data and reports to management. Indeed, one might wonder why the profession has litigated so vigorously on the theory that the data are "irrelevant." Common sense suggests that data which the profession acknowledges is tax-related, and which highlights questionable tax positions, would be highly useful to the IRS. Therefore, the courts are not likely to entertain arguments for long about the irrelevance of tax reserve data and reports to management.

Nor are they likely to give great credence to the proposition that a balancing test should be established. If such a test were to be formulated, however, it would almost surely favor the IRS in the great majority of cases. Likewise, the courts should reject the

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264. AICPA STATEMENT ON AUDITING STANDARDS No. 11, §§ 330, 510-514, 541.
265. 18 U.S.C. §§ 1505, 1510 (1976).
266. *See* AICPA STATEMENT ON AUDITING STANDARDS No. 1, § 338.08.
267. *See* notes 27-29 *supra* and accompanying text.

various interpretations of section 7602 that would impose a "convenience" standard on the IRS or narrowly construe the phrase "other data." Finally, attempts to bring what are essentially accounting workpapers under the protection of the attorney-client privilege should not prevail.

The best hope for the accounting profession may well lie in lobbying efforts, or in encouraging the IRS and the Department of Justice to establish self-imposed restraints. Another alternative might be for accountants to flag controversial or potentially questionable items on the return itself.[268] This idea, however, obviously has not met with the overwhelming acceptance of those who would be called upon to make the disclosures. On the other hand, if corporations succeed in making the audit process truly a "game of hare and hounds,"[269] universal, mandatory reporting requirements might well result, which undoubtedly would cause corporations serious concern.

Beyond these options, relief appears unlikely. Accountants and their clients may simply have to live with the not so outrageous notion that the weaknesses in a corporation's tax positions, which its own auditors may have highlighted, will be exposed, and that materials whose creation stems from an element of voluntarism may be used for other purposes. This disclosure is not an undesirable result when no recognizable rights of either the accountants or their clients are violated.

268. *See* Kurtz, *Discussion on "Questionable Positions,"* 32 TAX LAW. 13 (1978).
269. United States v. Bryan, 339 U.S. 323, 331 (1950).