January 6, 2003

VIA E-MAIL-RULE-COMMENTS@SEC.GOV

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC  20549-0609

Attention:  Jonathan G. Katz
Secretary to the Commission

Re:  Release No. 33-8154; 34-46934; 35-27610; IC-25838; IA-2088;
FR-64, File No. S7-49-02

Strengthening the Commission’s Requirements Regarding Auditor Independence

Ladies and Gentlemen:

I am enclosing comments on Proposed Rule RIN 3235-AI73, “Strengthening the Commission’s Requirements Regarding Auditor Independence” (the “Proposed Rule”), published in the Federal Register for December 13, 2002. The views expressed represent the position of the Section of Taxation of the American Bar Association, and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association or of any ABA entity other than the Section of Taxation.

The Section of Taxation is the principal organization of tax lawyers in the United States, with more than 20,000 members nationwide. Our goals include helping taxpayers better understand their rights and obligations under the tax laws and working to make the tax system fairer, simpler and easier to administer. Our membership includes not only lawyers in private practice, government service, academia, and for-profit and non-profit corporations, but also approximately 1,000 members who are affiliated with accounting firms. The attached comments were prepared by the Section’s Sarbanes-Oxley Task Force, which includes Section members who practice in accounting firms as well as in law firms. They do not necessarily reflect the views of all members of the Task Force on each item discussed.

The Proposed Rule raises important questions regarding the circumstances in which tax-related services may impair auditor independence. The Section of Taxation has over 40 committees that address issues arising under virtually every area of the tax laws. Our members have extensive collective knowledge and experience regarding the broad range of services that tax professionals provide in the course of federal, state, local and international tax practice. We therefore believe that we can be helpful to the Commission by identifying and describing the
principal types of tax services, and by providing recommendations as to when the performance of particular tax services by audit firms should be permitted, prohibited or subjected to special scrutiny by a registrant’s audit committee.

We appreciate the opportunity to submit these comments, and are available to meet with the Commission or its Staff to respond to any questions you may have. Please contact Stuart J. Offer, the Chair of our Sarbanes-Oxley Task Force (415/268-7052; soffer@mofo.com), if that might be helpful.

Respectfully submitted,

Herbert N. Beller
Chair, Section of Taxation

cc: A. P. Carlton, Jr.
    M. Peter Moser
    James H. Cheek, III
    Irwin L. Treiger
    Richard A. Shaw
    Stuart J. Offer
    Christine A. Brunswick
COMMENTS ON PROPOSED RULE: STRENGTHENING THE COMMISSION’S REQUIREMENTS REGARDING AUDITOR INDEPENDENCE
FILE NO. S7-49-02
PREPARED BY THE SARBANES-OXLEY TASK FORCE OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION

The following comments on Proposed Rule RIN 3235-AI73, “Strengthening the Commission’s Requirements Regarding Auditor Independence” (the “Proposed Rule”), published in the Federal Register for December 13, 2002, represent the position of the Section of Taxation of the American Bar Association (the “Tax Section”), and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association or of any ABA entity other than the Tax Section.

The comments were prepared by the Tax Section’s Sarbanes-Oxley Task Force, which includes Tax Section members who practice in accounting firms as well as in law firms. They do not necessarily reflect the views of all members of the Task Force on each item discussed.

I. Summary

The principal points addressed and conclusions expressed in these comments may be summarized as follows:

- **Our comments relate solely to appropriate activities for audit firms; we do not believe it would be appropriate for the Commission to regulate tax services provided by accounting firms for non-audit clients.** As the Sarbanes-Oxley Act (the “Act”) makes clear, audit firms play a unique and important role under the federal securities laws. Restricting the provision of non-audit services has nothing to do with the competence of accounting firms to provide such services to non-audit clients.

- **We support the general approach of the Proposed Rule with respect to tax services.** We believe an approach which evaluates whether tax services should be performed by audit firms based on the fundamental principles for evaluating auditor independence is appropriate as a matter of policy and consistent with the legislative history of the Act. Therefore, pursuant to the regulatory authority of the Commission under the Securities Exchange Act of 1934, as amended by the Act, an audit firm may be prohibited from providing certain tax services to an audit client.

- **We believe that in view of the breadth of services now provided by accounting firms under the category of “tax services,” it is beyond dispute that some tax services create auditor independence risks.** We detail in our comments tax services now commonly provided by accounting firms. Tax considerations pervade the business operations of registrants. Accounting firms have responded by offering tax capabilities to meet these needs. Some of these services are ministerial; many others involve judgment, evaluation of legal and business risks and advocacy.

---

We believe that some tax advocacy services raise sufficient concerns regarding auditor independence that they should be viewed as prohibited services. We separately analyze advocacy services and tax compliance and planning services. We believe that court litigation is inherently adversarial. We see no reason to distinguish between litigation in the U.S. Tax Court and in any other court. Moreover, where administrative tax proceedings, including audits and administrative appeals, move beyond marshalling of facts, we believe that it would be inappropriate for the audit firm to have primary responsibility for a tax dispute involving potentially material tax liabilities.

We believe that although the provision of tax compliance services and tax planning services generally raise fewer auditor independence issues, we would strongly encourage audit committees not to provide blanket pre-approval of tax compliance and tax planning services. Certain tax planning services involve strong components of advocacy and may affect the registrant’s tax reserve; where the amounts involved are material, we believe the audit firm should not provide such services.

We believe that tax shelter products raise particular auditor independence concerns. Companies purchasing tax shelter products are exposed to a variety of risks over and above the calculation of tax liability. An accounting firm that markets a tax shelter product to a registrant should be prohibited from conducting the audit of the registrant because it cannot be expected to fairly evaluate the risks inherent in the tax shelter product. Moreover, it is common practice for a tax shelter product offered by one promoter to be quickly replicated by other promoters. Thus, even if an audit firm markets a particular tax shelter product only to non-audit clients, it may have an inherent conflict in evaluating the tax reserves of its audit clients if they acquire the same or similar product from another promoter. In these circumstances, the audit firm either (i) should be prohibited from conducting the audit; or (ii) should be permitted to conduct the audit only after special disclosure of the tax shelter situation to, and approval by, the registrant’s audit committee.

II. Overview

Enactment of the Sarbanes-Oxley Act of 2002 (the “Act”) has required the Commission to revisit its Rules, promulgated in 2000, relating to auditor independence. We commend the Commission for recognizing in the Proposed Rule and its accompanying commentary that excluding tax services from the general inquiry into activities implicating auditor independence concerns would undermine the Proposed Rule in important respects.

We recognize the difficulty of parsing the provisions of the Act relating to prohibited and permitted services by audit firms, particularly the interface between prohibited services and “tax services.” We strongly endorse the view taken in the Proposed Rule that the specific language of the Act must be interpreted in accordance with the fundamental principles that an auditor cannot (1) audit his or her own work; (2) perform management functions; or (3) act as an advocate for the client. We do not believe that the Act can or should be read as giving “tax services” a blanket exemption from these principles, particularly in light of the broad range of services, described below, which are now being provided by accounting firms as “tax services.”

---

4 We believe that the position espoused in the Proposed Rule harmonizes the rules for SEC audits with GAO Generally Accepted Government Auditing Standards (GAGAS) Amendment No. 3, Independence (January 2002) (GAO-02-388G).
It is important to recognize that restricting the tax services that may be provided by a public company’s auditors does not restrict that firm from providing those services to non-audit clients, or to non-public companies. Nor does the Act restrict accounting firms who are not a registrant’s auditors from providing a full panoply of non-audit services to a registrant. Some may express concern that application of the fundamental principles noted above to the evaluation of tax services will cause audit committees frequently to refrain from approving the provision of tax services provided by audit firms, with a resulting loss of efficiency and potential increased cost. We think it of greater concern that a broad grant of exemption for tax services from the prohibitions of Act § 201(a) would encourage audit committees routinely to approve the provision of “tax services” with respect to activities that are material to the financial health of the company and raise important auditor independence issues.

We believe that there are some tax services presently performed by accounting firms which clearly implicate the specific prohibitions in Act § 201(a) regarding performance of “legal services” or “expert services” by audit firms. Some members of the Tax Section believe that the positions taken in the Proposed Rule regarding whether “tax services” are properly characterized as “legal services” are too narrow. We have declined to comment on the question of whether “tax services” are “legal services,” however, because this issue could be viewed as raising “unauthorized practice of law” concerns. We do not believe that the Act authorizes or mandates the Commission to regulate with respect to what constitutes the unauthorized practice of law, and we assume that the Commission does not intend to do so. In any event, we believe that the core principles of auditor independence which are embraced by the Proposed Rule can and should be applied in evaluating the propriety of all types of tax services, irrespective of whether such services can be viewed as one or more of the “prohibited services” expressly identified and described in the Act.

We also believe that, in most cases, a materiality concept should be a part of any analysis of whether an audit firm should be permitted to perform non-audit services, including tax services. In general, we believe that the analysis of the Commission in SEC Staff Accounting Bulletin (“SAB”) 99, “Materiality,” with respect to the subjective nature of “materiality” is appropriate to apply in this context. We note in particular, however, that attention should be paid to the cumulative nature of the non-audit services, including tax services, performed by the audit firm. For this reason, we support the reporting provisions of the Proposed Rule.6

new GAO standard was adopted prior to enactment of the Act and, in the view of the Comptroller General of the United States, informed Congress in legislating new auditor independence standards:

The Sarbanes-Oxley provisions were based in large part on GAO’s new independence standards. Importantly, GAO saw the need for change in his [sic] area and we began the process to make the related changes long before Enron and other recent business failures came to light. Although GAO took a lot of heat in being out front on this controversial issue, in part due to recent events, we are getting a lot of accolades now!


6 In describing fees which should be separately reported as “Tax Fees,” the commentary on the Proposed Rule provides:
III. Description of Tax-Related Services

Accounting firms have traditionally provided tax services to their clients. Initially, those services consisted primarily of tax compliance, return preparation, representation in tax audits, obtaining rulings for clients from the Internal Revenue Service (“IRS”), monitoring and reporting on developments in the IRS, Treasury and Congress, and tax planning advice. However, consistent with the growth in consulting services generally provided by accounting firms, the menu of services offered by accounting firms has increased. Today, in addition to the “traditional” tax services noted above, the Big Four accounting firms offer a wide range of services, including cross-border tax planning, legislative and administrative lobbying, transfer pricing, the development and marketing of tax “products,” provision of non-U.S. legal services, and tax litigation before the United States Tax Court.

In order to offer this expanding array of tax consulting services, the major accounting firms have dramatically increased the size and scope of their tax departments. A typical Big Four firm has tax professionals in most of its regional or local tax offices who specialize in issues relating to particular industries or groups of clients, non-U.S. tax experts in foreign offices, and a U.S. national tax office staffed by experts who consult with tax personnel in the local offices, provide consulting services to clients, and develop or review non-client-specific tax ideas and products to be offered to audit clients and non-audit clients. A significant percentage of the professionals in these national tax offices are tax lawyers, many of whom were previously with law firms or in government service. Some smaller public accounting firms have broadened the tax services they can offer by joining alliances of U.S. and foreign firms that cross-refer clients and share tax expertise and ideas.

Most tax consulting services offered by public accounting firms fall into one of three categories: (i) return preparation and tax advisory services that are rendered prior to the filing of a return or declaration; (ii) tax controversy services that involve the resolution of disputes between taxpayers and tax authorities regarding the correct amount of tax liability for a previous taxable period; and (iii) legislative and administrative tax lobbying. The following is a non-exhaustive description of “tax services” regularly performed by public accounting firms.

A. Tax Advisory Services

1. Tax Compliance and Return Preparation

Public accounting firms offer assistance to clients in understanding and complying with their U.S. federal, state and local tax obligations as well as foreign tax obligations. Most public companies have in-house personnel who are responsible for tax compliance functions and may call upon tax professionals for

The “Tax Fees” category would capture all services performed by professional staff in the independent accountant’s tax division. Typically, it would include fees for tax compliance, consultation and planning. Tax compliance generally involves preparation of original and amended tax returns, claims for refund and tax payment-planning services. Tax consultation and tax planning encompass a diverse range of services, including assistance and representation in connection with tax audits and appeals, tax advice relating to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities.

We do not understand the description of “Tax Fees” for reporting purposes to constitute a determination by the Commission that the services described never implicate the fundamental concern for auditor independence. As discussed, infra, the Section of Taxation believes that, in certain circumstances, it would be entirely inappropriate for an audit firm to provide one or more of these services to a registrant. Of course, reporting of all Tax Fees should be required without regard to whether the service was appropriately authorized by the audit committee.
advice as needed. Other companies out-source some or all tax compliance and return preparation functions to an accounting firm.

Compliance and return preparation services generally involve routine, non-controversial application of the procedural and technical tax rules of one or more taxing jurisdictions. The value added by the accounting firm is attributable in large measure to its investment in personnel, systems and information. Non-routine technical or procedural tax issues may arise in the course of a compliance or return preparation engagement. To the extent that those issues give rise to contingent liabilities, the engagement takes on the characteristics of tax advice, discussed below.

2. **Tax Advice**

The tax departments of public accounting firms offer federal, state, local, and foreign tax advice. Tax planning advice generally addresses the tax consequences of future activities or transactions. A tax professional rendering planning advice often works with the client to structure the activity or transaction to secure the most tax-effective result. Tax reporting advice addresses the appropriate characterization and reporting of activities or transactions that have already occurred. Either type of advice can range from a technical explanation of a non-controversial “black and white” issue of tax law to an evaluation of the likelihood that an interpretation of a “gray area” issue would be sustained in litigation or, if not, might lead to the imposition of penalties.

When a tax engagement involves routine issues of tax law, the advice is usually provided via phone calls, e-mails, or in an informal writing. When the issues involve complex or novel issues of the tax law, or a material transaction, the client will generally want, in addition to the tax advisor’s informal answer, a written opinion or memorandum that describes the relevant facts, lays out the advisor’s analysis and conclusions, and evaluates the likelihood that the position would be sustained in litigation. Such an opinion or memorandum may be useful in the event of a tax audit to explain and document the technical basis for the position and to avoid the imposition of penalties if the position is not sustained. The opinion or memorandum also may be used to support management’s decision whether and how the tax contingencies addressed in the opinion should be reflected on the company’s financial statements. In some cases (usually associated with tax shelters, as described below), the opinion or memorandum may be prepared for disclosure to third parties to induce them to participate in the transaction with the company.

3. **Advance Rulings and Determinations**

Public accounting firms regularly assist clients in obtaining advance determinations of tax issues. IRS advance determination procedures include the private letter ruling (“PLR”) program to resolve technical issues, the advance pricing agreement (“APA”) program to resolve transfer pricing issues, and the pre-filing agreement (“PFA”) program to determine the tax treatment of specified items in an unfiled return. Some state and local tax authorities have advance ruling or determination procedures, as do many foreign countries.

---

7 Section 7525 of the Internal Revenue Code (the “IRC”) extends to a “federally authorized tax practitioner” [e.g., an accountant], with respect to tax advice provided by the practitioner, “the same common law protections of confidentiality which apply to communications between a taxpayer and an attorney . . . to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.” The privilege may only be asserted in noncriminal matters before the IRS and in any noncriminal tax proceeding in Federal court brought by or against the United States. The privilege does not apply to any written communication with representatives of a corporation in connection with the promotion of the direct or indirect participation of the corporation in any tax shelter (as defined in IRC § 6662(d)(2)(C)(iii)).
Representing a client in an advance ruling or determination proceeding typically involves investigating or marshalling the relevant facts, analyzing the applicable legal authorities, and preparing written submissions supporting the client’s position. In some cases, it also involves face-to-face meetings with the tax authorities to explain, advocate, or negotiate on behalf of the client. Unlike tax advice, an engagement to seek an advance ruling or determination generally does not involve a tax contingency or require a formal opinion. As long as the client’s return is prepared in accordance with the response of the tax authorities, the ruling or determination presumably will resolve the underlying tax issues.

4. Valuation and Transfer Pricing Services

Public accounting firms provide tax-related appraisal and valuation services for clients. Such work may be related to controversy work before federal and state taxing authorities, but often is not. Accounting firms traditionally have included groups of appraisal and valuation experts that assist clients in such diverse work as valuing stock options and stock compensation, purchase price allocations and other merger and acquisition related valuations. A form of valuation-related service commonly provided by accounting firm economists is in connection with transfer pricing, where valuations are made and relied upon in by the company in its tax reporting.

5. Tax Shelter Products

In recent years, a growing component of the tax services offered by major public accounting firms has been the marketing of tax-saving ideas, strategies and other “products.” Tax professionals within the firm are charged with adapting or developing non-client-specific tax elimination, reduction or deferral techniques. Some of these techniques are non-controversial solutions to tax problems faced by taxpayers; others are aggressive techniques commonly referred to as “tax shelter products.” Promising techniques are reviewed for technical merit and then made part of a firm-wide marketing effort. Potential purchasers include both audit clients and non-audit clients.

Development of tax shelter products typically involves a substantial investment of time and expense to refine and evaluate the tax analysis and design the prototype transaction and marketing package. These ideas may be created by professionals whose sole job is to develop new strategies, or may be adapted from ideas developed for specific clients which are determined to have potentially broader application. Thereafter, work is required to adapt the generic structure or technique to the particular circumstances of each purchaser. Tax shelter products often involve transactions that the taxpayer would not otherwise have entered into and entail significant tax contingencies. The accounting firm typically provides the client with an opinion (sometimes along with an opinion received from a law firm) that addresses the relevant technical tax issues and assesses the likelihood that the tax benefits will be sustained.

Services relating to tax shelter products typically are billed at a significant premium above normal hourly rates. Such products are typically brought to existing audit clients by the tax professionals assigned to that client or by professionals assigned to cover particular industries. Non-audit clients are typically approached by such industry professionals or by individuals hired specifically to market tax products to non-audit clients. The marketing team ordinarily attempts to negotiate a flat “value-based” rate or a rate determined by reference to the client’s anticipated tax savings, and assumes that the accounting firm can express an opinion at a specified level of confidence. Until recently, a fee agreement might provide that some or all of the fee would not be payable until realization of the promised tax benefits, or would be refundable if the relevant tax authorities succeed in disallowing part or all of the promised tax benefits on audit.8

8 Department of the Treasury Regulations governing practice before the IRS (the “Circular 230 Regulation”) were amended in July, 2002, to provide generally that a practitioner may not charge a contingent fee for preparing an original tax
Tax shelter products developed by one promoter, including an accounting firm, like financial products marketed by investment banks, are often replicated or “reverse engineered” by the other promoters, including accounting firms, and marketed under their own names. For this reason, an audit firm may have a conflict in reviewing a tax shelter product marketed by a promoter other than the audit firm to the audit firm’s clients, since the audit firm may be offering or assisting in offering the same or a substantially similar product to corporations which are not its audit clients.

B. **Tax Controversy Services**

1. **Tax Examinations**

   Public accountants offer their tax clients services relating to tax examinations. If the client has in-house tax personnel who are responsible for dealing with tax examiners on a day-to-day basis, the accounting firm may be engaged to provide advice and assistance to the in-house personnel.

   The day-to-day handling of a tax examination entails responding to document requests and factual inquiries, providing explanations and reconciliations of items questioned by the examiners, and explaining the technical basis for the client’s characterization and reporting of transactions on its return. The IRS rules of practice allow any certified public accountant (“CPA”) to perform these functions by filing a power of attorney to represent the client in the tax examination. Most states also allow CPAs to represent taxpayers in tax examinations.

   To the extent that the tax examiners raise issues or propose adjustments involving potential tax liabilities, the accounting firm’s principal role shifts from intermediary to advocate. In that capacity, its services would include gathering facts, preparing memoranda supporting the taxpayer’s position, and participating in meetings and conferences with the tax authorities to resolve or settle the issues.

2. **Refund Claims**

   If a taxpayer believes that it has overpaid tax on a previously filed return, it can amend the return and file an administrative refund claim. Public accounting firms prepare amended tax returns for audit clients and represent audit clients in refund proceedings. If the refund claim is referred to tax examiners, the representation is similar to a tax examination.

3. **Administrative Appeals**

   When an IRS audit results in a proposal to assess additional tax or penalties, or when a refund claim is denied, the taxpayer generally has the option of taking an administrative appeal and attempting to resolve or settle the issues with representatives of the IRS Appeals Office. Most states and some foreign countries have analogous administrative tax appeal procedures. The IRS rules of practice permit a CPA to appear as a taxpayer’s representative in an administrative appeal.

---

return or for any advice rendered in connection with a position taken or to be taken on an original return. See 31 CFR § 10.27. The Circular 230 Regulation defines a “contingent fee” as any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the IRS or in litigation. The Regulation provides that a contingent fee includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client’s fee in the event that a position taken on a tax return or other filing is challenged by the IRS or is not sustained. Prior to the amendment, the Regulation prohibited contingent fees only in the context of preparation of returns, as distinguished from advice rendered in connection with a position to be taken on a return. It should be noted that the Regulation has no impact on contingent fee arrangements with respect to state and local tax “products.”
When tax personnel from an accounting firm represent a client in an administrative appeal, they function primarily as advocates. They prepare written memoranda marshalling the facts and legal arguments in opposition to the examiner’s findings and in support of the client’s position, appear at hearings or conferences to explain the client’s position to the appeals office representatives, and attempt to negotiate a compromise resolution of the case.

4. Tax Court Litigation

Under the rules of the United States Tax Court, CPAs and other non-lawyers can secure admission to practice before the court by taking a written examination. CPAs (as well as lawyers) employed by some accounting firms represent taxpayers in Tax Court litigation. In so doing, they perform services that are essentially identical to legal advocacy services performed by an attorney.

Most public companies engage attorneys practicing in law firms to represent them in the Tax Court. In such a case, the company’s audit firm may provide litigation support or expert services. Typical litigation support services include gathering and summarizing financial information and other evidence, performing economic or financial analyses, preparing exhibits, and providing other forms of technical or accounting assistance to the legal representatives. Expert services generally involve preparing an expert report to be submitted to the court and appearing as an expert witness on the client’s behalf.

5. Other Tax Litigation

Other federal courts, as well as most state courts and foreign courts, permit only attorneys to appear on behalf of the parties to a lawsuit. When a client’s tax case is brought in such a court, the accounting firm can perform only litigation support or expert services.

C. Legislative and Regulatory Lobbying

Accounting firms assist their clients to influence tax policy being developed in Congress, the Treasury Department, or the IRS. That assistance has come in the form of strategic advice, legislative or regulatory drafting, economic impact analysis and modeling, and direct lobbying. The lobbying generally has taken two forms: (i) lobbying Congressional tax staff on the technical merits of an issue; and (ii) working with clients who wish to provide input to Treasury or the IRS on regulatory guidance.

D. Specialty Tax Services

For certain corporate endeavors, qualification under the Internal Revenue Code is an integral part of the business or the activity. For example, the existence of real estate investment trusts or mutual funds may well depend upon the qualification of the trust or fund for favorable treatment under the Code. Tax services rendered by accounting firms include advising and representing clients in connection with such tax regulatory schemes. Similarly, accounting firms provide services to clients relating to the tax and non-tax aspects in the specialized areas of tax-exempt bond financing, qualified employee welfare and benefit plans, executive compensation, and golden parachute excise tax compliance.

---

9 IRC § 7452 provides, with respect to taxpayer representation, that “[n]o qualified person shall be denied admission to practice before the Tax Court because of his failure to be a member of any profession or calling.”
IV. Analysis and Recommendations

In light of the preceding description of tax services offered by modern public accounting firms, it should be evident that an interpretation of the Act that would provide a blanket exemption of tax services from the prohibitions of the Act would be inappropriate because, as correctly recognized in the commentary to the Proposed Rule, some tax services will necessarily raise issues regarding the basic principles of auditor independence. Moreover, we do not believe that a simple requirement for audit committee pre-approval of tax services would provide sufficient protection to the investing public. Thus, we fully support the conclusions expressed in the following passage from the commentary on the Proposed Rule:

Classifying a service as a "tax service" … does not mean that the service may not be within one of the categories of prohibited services or may not result in an impairment of independence under Rule 2-01(b). The accounting firm and the registrant's audit committee should consider, for example, whether the proposed non-audit service is an allowable tax service or constitutes a prohibited legal service or expert service. As part of this process, the accounting firm and the audit committee should be mindful of the three basic principles which cause an auditor to lack independence with respect to an audit client: (1) the auditor cannot audit his or her own work, (2) the auditor cannot function as a part of management, and (3) the auditor cannot serve in an advocacy role for the client. For example, where an accountant provides representation before a tax court the accountant serves as an advocate for his or her client and the accountant's independence would be impaired. Another example would be the formulation of tax strategies (e.g. tax shelters) designed to minimize a company's tax obligations. The provision of these types of services may require the accountant to audit his or her own work, to become an advocate for the client's position on novel tax issues, or to assume a management function. [Citations omitted.]

It is incumbent on the Commission, therefore, to identify in advance the types of tax services that involve a sufficient degree of risk to auditor independence under the three basic principles, and to subject the audit firm and the registrant to the sanctions of the Act if any such services are performed by the audit firm. In the following sections of these comments the Tax Section expresses its views, based on its extensive experience with the described services. Inherent in our analysis is the assumption that either (i) the matters involved in the tax services, taken individually or cumulatively, are material to the registrant, or (ii) the performance of the services by the audit firm reasonably would cause a shareholder or potential shareholder of the registrant to question whether the performance of the service is consistent with the anticipated independent status of the auditor.

A. Advocacy Services

We begin with advocacy services, since the provision of advocacy services by an audit firm appears to us to provide the greatest risk that auditor independence will be undermined, both in appearance and in fact.

We believe that tax litigation is inherently adversarial so that any service in tax litigation other than testimony as a fact witness is inherently the service of an advocate and should be prohibited on the ground that it jeopardizes the auditor’s independence. We see no basis for distinguishing between

---

10 We again emphasize that our views do not relate to whether any accounting firm should provide these tax services; rather, they relate to whether a registrant’s auditor should provide these services.

11 Our comments are limited to the performance of tax services in the United States; we have not analyzed whether rules of practice outside the United States might lead to different conclusions for foreign-based audit firms.
different courts, taxes or taxing bodies. Thus, our comment applies to litigation over federal tax in the United States Tax Court or other federal courts and also to non-federal court litigation regarding state or local taxes.

Administrative or regulatory tax proceedings present somewhat different considerations from court litigation. It can be argued that the concern that the auditor will be viewed as an advocate of the audit client by the investing public is less, since the proceedings are less public. However, any assumption that administrative tax proceedings simply involve marshalling of facts for an examining agent is not consistent with actual practice; the great majority of public company tax disputes, frequently involving millions of dollars in potential tax liabilities, are resolved administratively, after extensive legal briefing and negotiation. Where the auditor is also the advocate, its ability to evaluate for financial reporting purposes the strength of the registrant’s arguments may be compromised.

At such time as a tax controversy involving potential material tax liabilities moves beyond fact gathering and fact presentation, we believe it inappropriate for the audit firm to have primary responsibility for a tax dispute. We do not believe a distinction appropriately can be drawn based on the procedural phase of the controversy, i.e., whether it is in audit, administrative appeal, or litigation. All of these services involve significant advocacy on behalf of the client. In many instances, the related tax controversy also may be material to the client’s financial reporting. Thus, in addition to raising the question of the appearance of auditor independence, providing advocacy services with respect to the tax controversy also may compromise the auditor’s objectivity with respect to the financial reporting impact of the controversy itself.

Beyond the tax controversy services described in Section III.B above, certain other services that are provided in connection with tax proceedings may be permissible, even though involving advocacy on behalf of an audit client. For example, services in obtaining a private ruling from the Internal Revenue Service or a state tax authority in advance of a proposed transaction typically involves an element of advocacy, but generally offer little danger of compromising the auditor’s independence. Because the advance ruling will determine the tax consequences of the transaction, there should be no contingency or uncertainty regarding the associated tax expense or reserve for financial reporting purposes. Accordingly, we believe that obtaining an advance ruling on a transaction from a tax authority should be considered a tax service that can be approved by an audit committee.

Different considerations arise in the context of lobbying services provided in connection with possible legislation or administrative rule making. In some situations, the overriding concern may be simply the risk of a perception of compromised independence, particularly where the activity is conspicuous or public. In others, where the lobbying activities are not publicly associated with a particular client and relate solely to a prospective change in law, the danger of actual or perceived compromised independence may be negligible because, as with an advance ruling by the Internal Revenue Service, there is no issue as to the financial accounting treatment of a completed transaction.

---

12 It would not be inappropriate for the audit firm to continue to assist the registrant in fact gathering and explanation of tax return entries.

13 Our views encompass substantially all of the tax controversy services described in Section III.B., above. We would except the filing of a refund claim, even a claim involving a material amount, where the audit firm will not provide advocacy services in connection with the claim if it is examined by a tax authority.

14 In contrast, obtaining “technical advice” from the National Office of the Internal Revenue Service in the context of an examination of an audit client’s return generally will involve substantial advocacy services and a completed transaction as to which the adequacy of a financial accounting tax expense or reserve may be a material issue. Accordingly, that type of service, where the potential tax liability is material, should be classified as a prohibited service. Similar considerations should govern advance pricing agreements, which may involve completed transactions as well as future transactions.
Accordingly, tax lobbying services generally should be considered permitted tax services that can be authorized by an audit committee in appropriate circumstances, rather than prohibited expert advocacy services.

B. Tax Compliance and Planning Services

1. Tax Return Preparation

We concur with the Commission’s interpretation that tax return preparation generally should be within the category of permitted tax services that may be approved by the audit committee. In simply preparing a return, the auditor is not acting as advocate or providing an opinion as to the likelihood of the client’s success in sustaining the various return positions. We also believe that cost-benefit analysis leads to the same conclusion; the audit firm is likely to be in the best position to perform return preparation services because of its in-depth knowledge of the registrant’s financial statements. Our view in this case is a pragmatic one. We know from experience that substantial issues can arise during the course of “routine” return preparation which have the potential for material liability, but we do not believe a rule would be practicable which would require the auditor to stop return preparation in mid-stream or risk committing a violation of the securities laws.

2. General Tax Planning

Research and tax planning in connection with routine and even non-routine business transactions initiated by the audit client generally do not impair auditor independence. Except in the case of marketing and evaluation of tax shelter products, addressed below, we believe it would be difficult to establish a bright line test with respect to the impact of general tax planning services on auditor independence. We are concerned, however, that the failure to establish such a test might lead audit committees to pre-approve “tax planning services” wholesale, without due consideration of the risks of the adopted tax strategy. We believe that audit committees should be sensitive to tax planning projects involving significant potential liabilities where the tax results are uncertain. Accordingly, we recommend that, in adopting the final Rule, the Commission consider adding language cautioning audit committees against providing blanket pre-approval of tax planning services and suggesting that, if in the tax accrual workpapers the item is a specific component of the tax reserve and the audit firm has rendered tax advice with respect to the item, the audit committee consider obtaining additional (i.e., “second opinion”) review by a tax professional other than the audit firm.

3. Valuation and Transfer Pricing Services

Valuation positions taken by a registrant for tax purposes, including in the context of purchase price allocations or transfer pricing arrangements, may be of considerable financial importance to the registrant. When the registrant engages its auditor to perform valuation or appraisal services, there may be an implication that the resulting tax reporting position will be approved on audit of the company's tax reserve. We believe that such valuation and appraisal services inherently involve strong components of advocacy that align the accounting firm with management to the prejudice of auditor independence, and that such services usually result in the audit of the accounting firm's own work. Where the amounts involved are material, we believe the audit firm should not provide such services.

4. Tax Shelter Products

The Tax Section has consistently expressed its concern over the proliferation of corporate tax shelter products in recent years, and the impact that these products have on tax compliance, tax
collections, and the perceived legitimacy of our tax system. The risks to corporate consumers of tax shelter products go beyond the financial risks -- although with steadily increasing penalties and more aggressive enforcement by the IRS, the financial risks may be very significant. More fundamentally, participation in questionable tax shelters implicates basic questions of corporate ethics and places the reputation of the corporation at significant risk. We recognize that accounting firms have not been alone in the aggressive marketing of tax shelter products. However, to the extent that the registrant’s audit firm had any association at all with the development or marketing of the particular tax strategy involved, public confidence in the results reflected in the registrant’s audit financial statements can only be eroded.

One important consideration in regulating tax shelter product activity by audit firms is the need to recognize that the firms may have a significant interest not only in tax shelter products the audit firm markets to its audit clients, but also in tax shelter products marketed by others to these clients. The structures of most widely-used tax shelter products are known to all of the accounting firms shortly after the product is exposed to the market, and the same or similar tax shelter products quickly find their way into the inventories of multiple firms. In these circumstances, it is unreasonable to expect the audit firm to provide an unbiased, frank evaluation of a tax shelter product to an audit client.

The Tax Section strongly believes that an audit firm should be prohibited in all events from auditing a registrant to which it has provided a “tax shelter product” (as defined below). We further believe that, because of the inherent conflict presented, the Commission logically could conclude that audit firms should likewise be prohibited from advising audit clients with regard to the financial statement impact of a tax shelter product if the audit firm has participated in the development or marketing of the same or a substantially similar tax shelter product to any taxpayer, not simply to the audit client. An audit firm, invariably, will need to reach a judgment with respect to any tax shelter product in evaluating the adequacy of a registrant’s tax reserves. In our view, that places the auditor in an untenable position when it has a similar product “on the market.” If not flatly prohibited from conducting the audit in such circumstances, the audit firm should be required to specifically notify the audit committee prior to commencing the audit (or as soon as the issue is discovered during the course of the audit), so that the audit committee can determine what prophylactic measures to take in order to assure the integrity of the audit. For example, the audit committee may wish to obtain independent review of the registrant’s tax reserves, in order to determine that the reserves appropriately reflect the potential risks inherent in the tax shelter product.

The Tax Section is well aware of the difficulty of differentiating between tax shelter products and general tax planning. For this reason, we recommend a definition of “tax shelter product” for purposes of the Proposed Rule that is considerably narrower than definitions in use by the IRS. We would limit the definition of tax shelter product to a transaction that: (i) the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction for purposes of IRC § 6011, or is substantially similar to such a transaction; or (ii) has a principal purpose of tax avoidance and the audit firm actively participates in the promotion or marketing of the transaction.

---

15 See, e.g., Statement of Stefan F. Tucker before the Subcommittee on Oversight of the House Committee on Ways of Means on the Subject of Revenue Provisions in the President’s Fiscal Year 2000 Budget, March 10, 1999; Statement of Paul J. Sax before the Senate Finance Committee, March 9, 2000, on the Subject of Penalty and Interest Provisions in the Internal Revenue Code and Corporate Tax Shelters.

16 If such a rule were adopted, the Tax Section believes that a transition rule would be appropriate so that audit disqualification would not be required solely because an audit firm marketed a tax shelter product (to the registrant or another corporation) in a fiscal year of the registrant ending prior to the date the Proposed Rule is adopted.

17 For purposes of the Proposed Rule, a principal purpose of a transaction would not be tax avoidance if the transaction had as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with specific Internal Revenue Code provisions and their underlying legislative purpose. Cf. Treas. Reg. § 1.6662-4(g)(2)(ii).
to potential corporate consumers; or (iii) is offered under conditions of confidentiality,18 or (iv) provides
the taxpayer contractual protection against the possibility that the intended tax consequences of the
transaction will not be sustained (other than a customary indemnity provided by a principal to the
transaction that did not participate in the promotion or offering of the transaction to the taxpayer)19— but
in each case, only if the accounting firm has been a “material advisor” for a client. An accounting firm
would be considered a “material advisor” if it had received a fee of $250,000 or more from any person in
connection with the offering of the tax strategy to any corporation (not limited to the registrant) and made
or provided any statement, oral or written, to any person as to the potential tax consequences of that
transaction.20

5. **Opinions**

   a. **Generally**

      As described above, tax compliance, return preparation and tax-planning activities may involve
the preparation of an opinion or memorandum by the accounting firm regarding the issues involved.
Accordingly, the audit committee’s decision to engage the audit firm to prepare such opinion or
memorandum should involve the same considerations as whether to engage the accounting firm to assist
with the service in the first instance. To reiterate, as a general matter, the Tax Section believes that such
work should not be viewed as impairing auditor independence unless the subject matter of the opinion
affects an item that is potentially a specific component of the tax reserve in the tax workpapers. However,
if the opinion or memorandum involves a position where the tax exposure is significant by reason of the
amounts involved and the uncertainty of the result, the audit committee should consider whether to
engage a different tax professional to provide the opinion or to provide a second opinion.

   b. **Third-Party Opinions**

      The Commission is considering whether special considerations apply when the auditor provides a
tax opinion for the use of a third party in connection with a business transaction between the audit client
and the third party. The Commission is concerned that the tax opinion may be vital in the audit client’s
efforts to induce the third party to enter into the transaction, particularly when the transaction is tax-
driven and, therefore, the auditor may be acting as an advocate for the audit client.

      In our view, the provision of tax opinions, other than for tax shelters, would not impair, or appear
to impair, an auditor’s independence. Usually, third-party-opinions are given on routine business
transactions, such as mergers, spin-offs, and other corporate restructurings. These opinions generally are
not used to induce a third party to enter into the transaction in the same sense as tax shelter opinions may
be used. Accordingly, outside of the area of tax shelter products, we believe that the same considerations
applicable to tax opinions provided to the registrant should apply to tax opinions provided to third parties.

* * * *

We appreciate the opportunity to submit these comments, and are available to meet with the
Commission or its Staff to respond to any questions you may have. Please contact Stuart J. Offer, the
Chair of our Sarbanes-Oxley Task Force (415/268-7052; soffer@mofo.com), if that might be helpful.

---

18 See Treas. Reg. § 1.6011-4T(b)(3) (effective for transactions entered into on or after January 1, 2003).

19 Cf. Treas. Reg. § 1.6011-4T(b)(4) (effective for transactions entered into on or after January 1, 2003).

20 Cf. Treas. Reg. § 301.6112-1T(c)(2) (effective for transactions entered into on or after January 1, 2003).