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TAX ACCRUAL WORKPAPERS AND IRS SUMMONSES UNDER IRC § 7602: THE ACCOUNTANT WORK-PRODUCT PRIVILEGE

United States v. Arthur Young & Co.¹

In 1971, Arthur Young & Co. (Arthur Young), a firm of certified public accountants, was retained as the independent auditor for Amerada Hess Corporation (Amerada). Arthur Young was responsible for auditing the financial statements prepared by Amerada in accordance with the disclosure requirements of the federal securities laws.² Arthur Young did not participate in preparing Amerada’s tax returns.³

In April 1978, the Internal Revenue Service issued a summons⁴ directing Arthur Young to produce, among other documents, the tax pool analysis (tax accrual) files⁵ it had prepared in conjunction with its audit of Amerada’s financial statements.⁶ Arthur Young refused to produce the tax accrual workpapers, and the IRS sought an order enforcing the summons.

1. 677 F.2d 211 (2d Cir. 1982)), cert. granted, 51 U.S.L.W. 3611 (U.S. Feb. 22, 1983) (No. 82-687).
3. 677 F.2d at 214. In April 1976, Amerada formed a special committee to investigate the possibility that illegal payments had been made by the corporation. Arthur Young was to assist in this investigation along with an outside law firm. This investigation prompted the IRS to institute a criminal investigation of Amerada’s tax returns for the years 1972, 1973, and 1974, in addition to the civil audit already in progress. Id.
4. The summons was issued pursuant to I.R.C. § 7602 (1976) which provides: 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. (Emphasis added).
5. These documents are also referred to as the tax liability contingency analysis, tax accrual workpapers, tax cushion, or tax contingency reserve. See, e.g., Caplin, Should the Service be Permitted to Reach Accountants’ Tax Accrual Workpapers? 51 J. Tax’n 194 (1979).
6. The summons was issued in relation to the civil audit of Amerada Hess. 677 F.2d at 213.
The United States District Court for the Southern District of New York issued an order enforcing that part of the summons dealing with the production of the tax accrual workpapers. Arthur Young and Amerada appealed the order and were joined by a host of *amicus curiae* on their appeal.

The United States Court of Appeals for the Second Circuit reversed the district court’s order, holding that although the tax accrual workpapers were relevant to the IRS inquiry, the documents should remain confidential in order to protect the reliability of the independent audit process. To protect the tax accrual workpapers, the court established an auditor work-product privilege similar to the attorney work-product privilege fashioned in *Hickman v. Taylor*.

*Arthur Young* is the only case to recognize an auditor work-product privilege at the federal level. In establishing this privilege, the Second Circuit found that protection of the investing public by means of accurate financial statements required creation of a work-product privilege for tax accrual workpapers prepared by independent auditors. *Arthur Young* also highlights the conflict that has arisen between the circuits concerning the standard of relevance which should be applied to IRS summonses issued pursuant to I.R.C. § 7602. This Note will consider how such a privilege could, in fact, diminish the investing public’s confidence in the accuracy of financial statements and discuss the various standards of relevancy that have been applied by the courts.

Because the court based its decision on the need to maintain the integrity of the independent audit process, it is necessary to discuss the audit process and its application to a taxpayer’s contingent tax liabilities. It has been said that business history as revealed through financial statements is “somewhat akin to having a judge hear a case in which he is a litigant.” There is considerable opportunity for the results to be affected by bias, self-interest, or even outright dishonesty. In order to protect those who rely on financial statements, the Securities and Exchange Commission (SEC) requires that public corporations subject to federal securities laws file financial statements with the SEC and that these financial statements be verified by independent auditors in accordance with generally accepted

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8. Ten major accounting firms and the American Institute of Certified Public Accountants submitted briefs supporting the position taken by Arthur Young.
9. 677 F.2d at 214.
13. Regulation S-X, 17 C.F.R. § 210 (1981). *Id.* § 210.1-02(d) provides that the term “audit” when used in regard to financial statements means “an examination of the statements by an accountant in accordance with generally accepted auditing standards for the purpose of expressing an opinion thereon.”
auditing standards.\textsuperscript{14}

The purpose of the audit examination is to determine whether the financial statements fairly present the company's financial status in conformity with generally accepted accounting principles.\textsuperscript{15} This independent

\textsuperscript{14} Generally accepted auditing standards are concerned with the auditor's professional qualities and the judgment exercised by him in the performance of his examination and report. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 150.01 (1980). \textit{Id.} § 150.02 sets forth the generally accepted auditing standards as follows:

\textbf{General Standards}
1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

\textbf{Standards of Field Work}
1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

\textbf{Standards of Reporting}
1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

These standards provide assurance that the integrity of the auditing process is maintained by mandating a minimum quality of performance to be followed by independent auditors during the course of their examinations.

\textsuperscript{15} \textit{Id.} § 110.01. AICPA CODE OF PROFESSIONAL ETHICS Rule 203 (1973) provides that an opinion shall not express "that financial statements are presented in conformity with generally accepted accounting principles if such statements con-
verification of the corporation’s financial statements encourages investors to supply the capital necessary for the nation’s industries by diminishing the fear of potential loss from reliance on misleading financial statements. The independent auditor’s role can be viewed as that of a disinterested observer owing a duty to the public as well as to his clients.

After examining the client’s financial statements, the independent auditor must form an opinion on the fairness of the client’s financial statements. If the auditor concludes that the financial statements fairly present the corporation’s financial status, he will issue an unqualified opinion. If, however, the financial statements do not fairly present the corporation’s financial status or if the scope of the auditor’s examination has been limited, he will issue either an adverse opinion, a qualified opinion, or a disclaimer of opinion. Such opinions will put investors on notice that the financial statements are either misleading, deficient in some area, or that the auditor’s examination was so limited that he was unable to express any opinion on them.

In the course of the audit examination, the auditor must review the client’s treatment of contingent liabilities. A contingent liability is a po-


17. AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 220.02 (1980), provides that the independent auditor has “an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely . . . upon the independent auditor’s report, as in the case of prospective owners or creditors.”


19. Id. at 20-23. An adverse opinion should be used only when the auditor believes the overall financial statements are so materially misstated or misleading that they do not present fairly the financial statements of the corporation. A qualified opinion should be issued when the auditor believes that the overall financial statements are fairly presented, even though there has been a limitation on the scope of his or her audit. A disclaimer of opinion should be issued when the auditor has been unable to satisfy himself that the overall financial statements are fairly presented, such as where there has been a severe limitation on the scope of the auditor’s examination. Id.

20. See id. at 665-71. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT ON ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES § 8 (1975), provides:

An estimated loss from a loss contingency . . . shall be accrued by a charge to income if “both” of the following conditions are met:

(a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a
potential future obligation to a third party for an uncertain amount which results from activities that have already occurred.21 One of the contingent liabilities included in a corporation's financial statements is its contingent tax liability. The contingent tax liability account represents an amount which the corporation may become liable to pay over and above the amount originally remitted in its initial return.22 The independent auditor must determine whether the client's provision for contingent tax liabilities is adequate.

To determine the adequacy of the contingent tax liability account, the auditor must examine the manner in which the taxpayer treated his income and expenses in the tax return and decide whether such treatment conforms to the Internal Revenue Code and the relevant case law. In the so-called "gray areas" of the tax law, the auditor must also form an opinion based on his knowledge as to the chances that the taxpayer's position will be upheld in court and must consider the probability that the client will settle the dispute.23 The examination necessarily entails discussions with management concerning questionable positions taken by them on the tax return. This analysis highlights soft spots on the client's tax returns and pinpoints vulnerable areas which upon challenge may require the payment of more taxes. The auditor's tax accrual workpapers are simply a memorialization of this analysis, including his mental impressions and conclusions regarding the contingent tax liability account.24

The court in Arthur Young relied primarily on two recent United States

liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of loss.

(b) The amount of loss can be reasonably estimated.

22. See United States v. El Paso Co., 682 F.2d 530, 534 (5th Cir. 1982).
23. Arthur Young, 677 F.2d at 217.
24. Throughout the examination of the client's contingent tax liability account, the auditor will be applying basic accounting principles, including the principle of conservatism. This principle provides that where acceptable alternatives for an accounting determination are available, the alternative having the least favorable immediate impact on owner's equity should be selected. See G. Welsch, C. Zlatkovich & W. Harrison, Intermediate Accounting 36 (5th ed. 1979). Conservatism is often applied in accruing loss contingencies. Id. In applying this principle to the contingent tax liability account, the auditor would be compelled to select the higher of two acceptable liability amounts. In short, the auditor would be reviewing the adequacy of the client's contingent tax liability account on a worst-case basis. In United States v. Coopers & Lybrand, 413 F. Supp. 942 (D. Colo. 1975), aff'd, 550 F.2d 615 (10th Cir. 1977), a past president of the American Institute of Certified Public Accountants testified that the tax accrual analysis is an endeavor to discover "what the worst possible nightmare is the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation." Id. at 953.
Supreme Court decisions in forging the new auditor work-product privilege for tax accrual workpapers: *Upjohn Co. v. United States* and *United States v. Euge.* In *Upjohn,* the Supreme Court held that the scope of the IRS summons power under section 7602 is subject to “traditional privileges and limitations.” The traditional privilege held to limit the summons power in *Upjohn* was the attorney work-product doctrine. In applying the *Upjohn* decision, the court in *Arthur Young* reasoned that *Hickman v. Taylor,* the case first recognizing the attorney work-product doctrine, requires courts to balance strong public policies against a party’s need for information whenever a conflict between the two arises. Thus, whenever public policies outweigh a party’s need for information, the courts should fashion a new privilege to protect that information.

The court’s interpretation of *Hickman* is expansive. *Hickman* dealt only with the protection of an attorney’s work-product and considered only the public policy reasons why an attorney’s work-product should be shielded from discovery. The court’s reliance on *Upjohn* also seems misplaced, in that *Upjohn* only stated that traditional privileges limit the scope of the IRS summons power, and traditional privileges do not include either an auditor-client testimonial privilege or an auditor work-product privilege.

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27. 449 U.S. at 398.

28. *Id.* at 395.


31. The precise issue in *Hickman* was whether discovery devices could “be used to inquire into materials collected by an adverse party’s counsel in the course of preparation for possible litigation.” 329 U.S. at 505. An independent auditor is not an “adverse party’s counsel,” nor are tax accrual workpapers prepared in anticipation of litigation.


fact, the Supreme Court in *Couch v. United States*\(^{34}\) held that no confidential accountant-client privilege exists under federal law and that no state-created privilege had been recognized in federal cases.\(^{35}\)

The court in *Arthur Young* also placed great reliance on *United States v. Euege*,\(^{36}\) in which the Supreme Court held that substantial countervailing policies could undercut the otherwise broad authority accorded to the IRS in carrying out its functions.\(^{37}\) Seizing upon this language, the *Arthur Young* court found that there existed a conflict between two compelling congressional policies: the IRS need for broad access to relevant documents in order to properly enforce the revenue laws and the public's need for accurate financial statements.\(^{38}\) The court concluded that protecting the investing public was the most important of the two policies and accordingly fashioned a work-product privilege to protect auditors' tax accrual workpapers.\(^{39}\) The court reached this conclusion by reasoning that a corporation might not be perfectly candid with its independent auditors once it knew that the IRS would have routine access to its auditor's tax accrual workpapers, thus thwarting the full and frank disclosure of financial information envisioned by the federal securities laws.\(^{40}\)

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37. Id. at 711.

38. 677 F.2d at 219.

39. Id. at 219, 221. The court placed several limitations on this privilege. The privilege only applies to (1) independent auditors, (2) retained by publicly held corporations, (3) to comply with the federal securities laws, and (4) so long as the case does not involve allegations of fraud. Id. at 219, 220. See also Garbis & Strutz, The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers, 57 J. Tax'n 66, 69 (1982).

40. 677 F.2d at 220.
The court's main premise is that if the IRS were to have access to tax accrual workpapers, the accuracy of corporate financial statements might suffer. What the court failed to recognize is that an independent auditor has an obligation to the public to ascertain the fairness of financial statements. If the auditor believes that the scope of his audit examination was severely limited due to management's less than candid disclosure of its contingent tax liabilities, the auditor must either issue a qualified opinion or a disclaimer of opinion. Such an opinion would put the investing public on notice of potential problems in the corporation's financial statements. It is doubtful that a corporation would withhold such information from its auditor knowing it would be running the risk of receiving either a qualified opinion or a disclaimer of opinion.

The policy considerations held to necessitate an auditor work-product privilege in Arthur Young were, in fact, rejected for these reasons in United States v. El Paso Co. 41 In El Paso, the United States Court of Appeals for the Fifth Circuit was "not swayed by the argument that the public policy of the securities laws implicitly overrides the clear grant of summons power to the IRS."42 It is important to note, however, that the El Paso court did not decide whether an auditor work-product privilege was appropriate because the tax accrual workpapers involved in that case were prepared by the corporation itself, not by independent auditors.43

The court in Arthur Young, in weighing the policy considerations involved, also failed to consider the primary reason underlying the requirement for accurate financial statements: to encourage the public to invest capital in the nation's industries by obviating the fear of loss from reliance on inaccurate financial statements. When this underlying purpose is taken into consideration, it becomes apparent that the financial statements must not only be accurate, but the public also must perceive them as accurate.

For the public to have this faith in the reliability of a corporation's financial statements, it is necessary for them to perceive the auditor as an independent professional. The American Institute of Certified Public Accountants (AICPA) requires that the auditor be independent,44 both in fact and in appearance.45 A privilege for auditors would tend to destroy the appearance of independence by creating the impression that the auditor is an advocate for the client. Thus, the work-product privilege would seem to

41. 682 F.2d 530 (5th Cir. 1982).
42. Id. at 544.
43. Id. at 537 n.7.
44. AICPA CODE OF PROFESSIONAL ETHICS Rule 101 provides: "A member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise." See also AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 220.01 (1980) (auditor is to maintain an independence in mental attitude).
45. See A. ARENS & J. LOEBBECKE, supra note 18, at 50.
do more harm than good to the audit process, for "if investors believe auditors to be advocates for the client, most of the value of the audit function will be lost."46

The court in Arthur Young could have avoided this issue by finding the tax accrual workpapers not relevant to the IRS inquiry. The requirement that the documents summoned be relevant to the inquiry is but one of four criteria for judicial enforcement of the summons. United States v. Powell47 requires that the IRS show that (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry may be relevant to that purpose, (3) the information sought is not already within the Commissioner's possession, and (4) the administrative steps required by the Code have been followed.48

The Arthur Young court relied on the same relevance standard it had used previously in United States v. Noall:49 whether the documents requested "might throw light" upon the correctness of the return.50 Applying this standard to the tax accrual workpapers, the court concluded that it would be difficult to see how an independent auditor's assessment of the correctness of positions taken by the taxpayer in its return would not throw light upon the correctness of the return.51

The court's analysis of the relevance issue is consistent with Noall, but is in conflict with several other circuits' interpretation of the relevance standard.52 In order to understand this conflict, it is necessary to review the development of the relevance standard.

The inquiry begins with Foster v. United States,53 where the Second Circuit first set forth the fundamental test of relevance applicable to IRS summonses, whether the inspection sought "might have thrown light upon" the

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46. Id.
48. Id. at 57.
50. Id. at 125.
53. 265 F.2d 183 (2d Cir. 1959), cert. denied, 360 U.S. 912 (1960).
correctness of the taxpayer’s return. The court held that the term “might” requires a “realistic expectation rather than an idle hope that something may be discovered.”

In United States v. Matras, the Eighth Circuit, relying upon the Harrington standard, denied the IRS access to company-produced budgets. The court stated that the term “relevant” connotes and encompasses more than “convenience” and concluded that the government’s claim that the budgets would provide them with a “roadmap” did not satisfy the relevancy requirement. In contrast to this high standard of relevance, the Second Circuit opted for a low standard of relevance in United States v. Noall. Noall involved an IRS summons directing the taxpayer to turn over its internal audit reports. In applying the “might throw light” test, the court held that the threshold the Commissioner must surmount is very low, particularly when the documents requested are the taxpayer’s own. The court ignored Matras, and while it cited Harrington, it made no mention of the language in that opinion limiting the “might throw light” standard to that of a “reasonable expectation rather than an idle hope.”

Such divergent results have also been reached when the relevance standard has been applied to tax accrual workpapers. In United States v. Coopers & Lybrand, the IRS issued a summons to a firm of certified public accountants, directing it to produce the tax pool analysis files it had compiled during its audit of Johns-Manville, Inc. The IRS contended that the tax pool analysis file might shed some light upon possible inconsistent or improper figures contained in Johns-Manville’s tax returns. The United States District Court for the District of Colorado, relying on Matras, rejected this argument and held that the tax accrual workpapers were not relevant to the IRS investigation.

In contrast with the decision reached in Coopers & Lybrand, the United States District Court for the District of Massachusetts, in United States v. Arthur Andersen & Co., held that tax accrual workpapers were relevant to the IRS inquiry into the correctness of the taxpayer’s tax returns. The

54. Id. at 186. See also United States v. Turner, 480 F.2d 272, 279 (7th Cir. 1973).
55. 388 F.2d 520 (2d Cir. 1968).
56. Id. at 524.
57. 487 F.2d 1271 (8th Cir. 1973).
58. Id. at 1275.
60. Id. at 126.
61. 413 F. Supp. 942 (D. Colo. 1975), aff’d, 550 F.2d 615 (10th Cir. 1977).
62. Id. at 952.
63. Id. at 954.
court reasoned that the "collective familiarity" of the agents involved in the case was enough to establish a "realistic expectation" of relevancy.\textsuperscript{65} The court also distinguished Matras by pointing out that the IRS in Matras sought the documents in issue only as a roadmap for its investigation, while in Arthur Andersen it sought the workpapers for the actual transactions contained therein. This made them more than a mere roadmap for the investigation.\textsuperscript{66}

The most recent decision involving an IRS attempt to attain access to tax accrual workpapers is United States v. El Paso Co.\textsuperscript{67} In El Paso, the IRS sought enforcement of a summons issued to El Paso Company directing it to produce the tax accrual workpapers compiled by its in-house accounting staff. The United States Court of Appeals for the Fifth Circuit, relying upon Noall and Arthur Young, held that the tax accrual workpapers were relevant, stating that "[d]ocuments which focus . . . the Service’s energy on questionable positions in the return, therefore, are highly relevant."\textsuperscript{68} As the dissent in El Paso noted, the majority’s holding—that documents merely enhancing the efficiency of an IRS audit are relevant—directly conflicts with the decision reached in Matras that mere convenience is not sufficient to establish relevance.\textsuperscript{69}

These decisions have brought about the existence of two different standards of relevance as applied to IRS summonses issued pursuant to section 7602. The Eighth and Tenth Circuits follow a rigorous standard requiring that the IRS demonstrate that the documents requested are more than a mere convenience. In contrast, the Second and Fifth Circuits are following a very low standard of relevance, only requiring the IRS to show that the document requested might be "helpful."\textsuperscript{70} Such divergent results have led to great uncertainty and apprehension in the accounting profession. A uniform standard of relevance is desperately needed in order that the accounting profession and others have some guidance in the area of IRS summonses.

The crux of the debate over the relevancy of tax accrual workpapers is whether the "may be relevant" language used in section 7602\textsuperscript{71} refers only to factual information or whether it also includes mental impressions and

\textsuperscript{65} Id. at 329.

\textsuperscript{66} Id. at 330.

\textsuperscript{67} 682 F.2d 530 (5th Cir. 1982).

\textsuperscript{68} Id. at 537.

\textsuperscript{69} Id. at 546 (Garwood, J., dissenting). "Accordingly, here the bottom line is not figures or facts or even opinions; it is, rather, the convenience of the Service. That will not suffice." Id.

\textsuperscript{70} The First Circuit seems to stand somewhere between these two extremes, as it has found tax accrual workpapers to be "relevant," but specifically pointed out that the documents in issue were more than a mere convenience to the IRS's investigation. United States v. Arthur Andersen & Co., 474 F. Supp. 322, 330 (D. Mass. 1979), aff’d, 623 F.2d 725 (1st Cir. 1980).

\textsuperscript{71} See supra note 4.
conclusions. Mortimer Caplin, a former Commissioner of Internal Revenue, has suggested that the IRS limit its requests to documents containing factual information relevant to the tax audit. 72 In support of his proposal, Caplin relies on the language contained in section 7602 permitting the IRS to examine “books, papers, records or other data which may be relevant or material to such inquiry.” Caplin argues that “other data” when used in context with “books, papers, and records” refers only to factual materials, not opinions or other thought processes. 73

The Arthur Young court should have applied this approach rather than developing a new work-product privilege for tax accrual workpapers. This new privilege will only aggravate the dispute between the IRS and the accounting profession and could very well undermine the public’s trust in the accounting profession. The best solution is for the courts to apply a stringent relevancy standard, requiring the IRS to show that the documents requested are factually relevant. Such a standard would go far toward reducing the tension between the IRS and the accounting profession and would permit the independent auditor to resume his role as a “disinterested observer” rather than an advocate for his clients.

STEVE R. LOONEY

72. See generally Caplin, supra note 5, at 199.

73. Id. The dissent in El Paso took a similar view, arguing that the “throw light upon” standard means “throw factual light upon.” 682 F.2d at 548 (Garwood, J., dissenting). A similar interpretation has been given to Tax Court Rules of Practice and Procedure 70(b) in P.T.&L Constr. Co. v. Commissioner, 63 T.C. 404 (1974), where the United States Tax Court held that “[w]hat is relevant is the factual information . . . . Mental impressions, legal analysis, conclusions, and recommendations are generally not relevant.” Id. at 414.