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Should Accounting Firms Be Tax Advisors?

By: Carolyn Joy Lee

That is the burning question being addressed anew, this time by the Public Company Accounting Oversight Board ("PCAOB"). PCAOB was created under the Sarbanes-Oxley Act of 2002, to oversee financial reporting by public companies and establish standards relating to the ethics and independence of accounting firms engaged in audits of public companies.

In adopting Sarbanes-Oxley, Congress analyzed the services that accounting firms provide to their clients and, with the objective of achieving a greater degree of independence, decided to specifically prohibit the provision of eight non-audit services to public clients. But tax services were neither restricted nor prohibited. Instead, all manner of tax services could continue to be provided by the audit firm so long as each service was pre-approved by the company's audit committee or board of directors.

Tax Role of Accounting Firms

Few question the ability of accounting firms to provide competent tax services. Taxation has become a major part of their business, and they have amassed a pool of talent capable of addressing all areas of taxation. But if they provide such services to public companies, the question that must be addressed is how they, as auditors of their tax clients, can maintain their "independence" in auditing those same clients?

Analyzing the broad area of tax services from an independence perspective is a challenge. Some services suggest obvious conclusions. For example, if a tax shelter is marketed by the accounting firm, it would be virtually impossible for that firm to be independent in evaluating the merits of the tax shelter. However, other situations are more difficult to evaluate. For example, in a complex corporate restructuring, where the tax consequences are uncertain and time does not permit an advance ruling, the accounting firm may render a "tax opinion" or recommend the tax treatment in anticipation of the transaction. When it comes time to audit the year in which the transaction occurred, how can it audit its own tax opinion, and still maintain its "independence"?

Independence

Auditor independence is crucial both to the substantive quality of the audit, and to the public's perception that financial reporting is reliable. If the independence of an audit firm is impaired, or is perceived to be impaired, that represents both an ethical issue for the accounting firm, and a severe SEC compliance problem for the audit client.

Recent Developments Prompt Action

Since Sarbanes-Oxley was enacted, a number of disquieting developments have occurred. Reacting to a variety of tax shelter-related investigations initiated by Congress, the Treasury Department, the IRS, and the Justice Department, as well as high-profile tax meltdowns like that which befell Sprint and its management, PCAOB concluded that it had become necessary to

evaluate "whether an auditor's provision of tax services, or any class of tax services, to an audit client impairs the auditor's independence from that audit client, in fact or appearance."[1] PCAOB thus initiated an investigation into the interrelationship between an accounting firm's involvement in providing tax services to a client, and that same firm's role and obligations as an independent auditor of the client. In several significant areas, PCAOB identified concerns that, they concluded, required new ethics and independence standards. As a result of this analysis, PCAOB announced proposed rules designed to address ethical problems posed by audit firms' involvement in providing tax services.[2]

New Independence Proposals

Specifically, in December 2004, PCAOB proposed "Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees." If adopted, these rules would significantly change the role of accounting firms in providing tax advice to the public companies they audit. Among the proposals, three areas identified as impairing an auditor's independence are of particular significance.

Contingent Fees

Setting forth a clear prohibition against contingent fees, Proposed Rule 3521 provides that an accounting firm "is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides a service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission." A contingent fee is defined as "any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service."

Providing Tax Services to Financial Officers

Citing "concerns that performing tax services for certain individuals involved in the financial reporting processes of an issuer creates an appearance of mutual interest between the auditor and those individuals," Proposed Rule 3523 provides that *no* tax services can be provided by the audit firm to certain executives, whether paid for by the client or by the executive. As explained by PCAOB, the persons sought to be covered here are "individuals in a position to play a significant role in the audit client's financial reporting," whether formally officers or not. Drawing that line will be an interesting problem for many companies.

Providing Substantive Tax Advice

Finally, in announcing Proposed Rule 3522, PCAOB couched it as intended to "prohibit auditors from providing services, other than auditing services, related to planning or opining on the tax consequences of certain transactions that pose special challenges to an auditor's independence." This rule "is intended to describe a class of tax-motivated transactions that present an unacceptable risk of impairing an auditor's independence."

In confronting this particularly challenging issue, PCAOB noted it had convened a Roundtable in July, 2004, to consider the ethics and auditor independence problems attending the provision of tax services generally. A number of participants in that Roundtable reportedly articulated concerns that accounting firms' involvement in abusive tax shelters had "damaged investors' confidence in the judgment and objectivity of firms that engage in such transactions."

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[1] PCAOB Release 2004-015, December 14, 2004 ("Release") p. 12.

[2] Release. p. 13.

In other words, tax shelter activity had come to be perceived not only as inimical to the tax system (and of course a potential source of material financial exposures for participating taxpayers), but also as undermining public confidence in the basic integrity of accounting firms, and in the reliability of their audits and financial reporting.

To address this threat to public accounting, Proposed Rule 3522 states that a firm is not independent if, during the audit period, the firm or any affiliate "provides any non-audit service to the audit client related to planning, or opining on the tax treatment of" certain specified transactions. The transactions from which accounting firms are banned from planning and opining (but not auditing) for audit clients are: (i) "listed transactions,"[3] (meaning those tax shelters the Treasury Department has identified under Code §6011 as particularly egregious and ineffective); (ii) "confidential transactions" (meaning transactions in which the marketers prohibit disclosure in order to protect their secret tax strategies); and (iii) "aggressive tax positions."

What Are Aggressive Tax Positions?

This last category of banned transactions – "aggressive tax positions" – is defined in the Proposed Rules as any transaction, whether initiated by the accounting firm or any other tax advisor, having a "significant purpose" of tax avoidance, unless the proposed treatment "is at least more likely than not" to succeed. (In theory, if a client conceives the plan the prohibition does not apply, but whether an audit firm can get comfortable that a plan has no outside initiator is a difficult question.)

The very broad definition proposed for "aggressive tax positions" would ban audit firms from involvement in virtually all forms of tax planning unless the firm can establish, "based on its analysis of the pertinent facts and authorities, that there is *a greater than 50-percent likelihood that the tax treatment of the transaction would be upheld* if challenged by the IRS."[4] If a tax plan has a 50% or less chance of success, the proposed rules would consider it "aggressive," and not a proper subject for the audit firm's involvement.

This proposed restriction on tax planning and advice to issues "more likely than not" to succeed presents interesting and difficult problems for accounting firms. This is a fairly high standard, especially given the rapid mutation of the tax laws, and the frequent instances in which people of good faith truly do not know what the "right" answer is. Nonetheless, under PCAOB's rule, substantial authority for a position is not enough; the audit firm must demonstrate its substantive conclusion that the transactions on which it advises audit clients stand a better than 50% chance of success. If it cannot, it will have compromised its independence. (Whether that determination can be made in-house, or will require an independent third-party opinion, is a question specifically left open by PCAOB.)

Should PCAOB's proposal regarding the provision of substantive tax advice be finalized, it seems quite likely that tax professionals at accounting firms will be precluded from advising firm audit clients on much more than plain vanilla tax issues.

Areas Not Restricted

PCAOB has thus made three significant proposals to curtail audit firms' provision of tax services. The Board did not, however, go so far as to preclude the provision of "routine tax return preparation and tax compliance" services, noting that this area has not raised independence

[3] Since "listing" (category (i)) can occur after a transaction has closed, PCAOB has requested comments on how to deal with situations in which an audit firm has advised on a transaction that subsequently is listed.

[4] Release p. 34, citing federal tax regulations regarding penalty standards.

concerns thus far, and therefore did not warrant a *per se* prohibition. International assignment tax services, and employee personal tax services (other than to financial reporting executives) also were determined not to require any new prohibitions at this time.

Swinging Pendulum?

The era in which accounting firms aggressively marketed tax shelters to their audit clients for large and contingent fees has understandably given way to new concerns that auditors remove themselves entirely from any self-interest in the evaluation of a client's tax strategies, in the interests of restoring confidence in public accounting. It may be that PCAOB's proposals go too far in removing an audit firm's tax experts from providing advice to clients on difficult or complex matters. On the other hand, and as several commentators continue to urge in response to PCAOB's proposals, ensuring the reliability and independence of auditors, and restoring public confidence in audit firms, might indeed require a sea change in the delivery of tax services, and may in fact require separating audit from tax altogether.

Whatever the specifics of the final rules, it is clear that new controls and oversight will soon be in place, and that the role of audit firms as tax advisors will change as well – perhaps dramatically. That presents management with the challenge of deciding how best to secure the tax advice necessary to support corporate decision-making in complex transactions.