

1982

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Recommended Citation

Katherine Pryor Burgeson, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 Fordham L. Rev. 468 (1982).

Available at: <https://ir.lawnet.fordham.edu/flr/vol51/iss3/4>

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IRS ACCESS TO TAX ACCRUAL WORKPAPERS: LEGAL CONSIDERATIONS AND POLICY CONCERNS

INTRODUCTION

Public corporations are required by the federal securities laws¹ to prepare and file with the Securities and Exchange Commission financial reports² certified³ by an independent public accountant.⁴ The certification process requires the accountant to audit the corporation's books and records to determine whether corporate transactions were properly recorded⁵ and whether the related financial statements were prepared according to generally accepted accounting principles.⁶

1. Securities Act of 1933 (1933 Act), 15 U.S.C. §§ 77a-77bbbb (1976); Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §§ 78a-78kk (1976).

2. 15 U.S.C. § 77(e) (1976); 15 U.S.C. § 78m(a) (1976). In enacting the securities laws, Congress gave the Securities and Exchange Commission (SEC) broad powers to prescribe the form in which the information required to be included in the financial reports shall be set forth. 15 U.S.C. § 77(s) (1976); 15 U.S.C. § 78m(b) (1976).

3. Pursuant to its powers under the securities laws, the SEC promulgated Regulation S-X, 17 C.F.R. § 210 (1982). Regulation S-X is the principal accounting regulation of the SEC in its administration of the securities laws, and sets forth the requirements of certification. *Id.* § 210.2-02.

4. Rule 2-01 of Regulation S-X provides a statutory basis for the independence of the accountant. *Id.* § 210.2-01(b). The independent status of the accountant has always been an important concern of the SEC. In an early decision under the 1933 Act, the SEC stated that

[t]he insistence of the Act on a certification by an 'independent' accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons . . . to the end that present and prospective security holders will be protected against unsound accounting practices

In re Cornucopia Gold Mines, 1 S.E.C. 364, 367 (1936). See generally L. Rappaport, SEC Accounting and Procedure ch. 26 (3d ed. 1972) (discussion on accountant's independence).

5. See J. Dearden & J. Shank, *Financial Accounting and Reporting: A Contemporary Emphasis* 189 (1975). See generally J. Burton, R. Palmer & R. Kay, *Handbook of Accounting and Auditing* 12-2 to 12-5 (1981) (discussion of audit objectives) [hereinafter cited as *Handbook of Accounting*]. Although examination of all entries in the corporate records may not be feasible, the auditor can achieve reasonable assurance that the results are fair by the use of a sampling procedure. *Id.* at 14-2.

6. See *Handbook of Accounting*, *supra* note 5, at 9-6 to 9-8. Although the SEC has the power to prescribe the form in which the required financial information must be set forth, see *supra* note 2, in 1938 it voted to accept for filing under the securities laws financial statements prepared according to accounting principles for which there is "substantial authoritative support," and that are not contrary to any express SEC position. Accounting Series Release No. 4, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,005. The Commission has thus generally deferred to the accounting profession to establish standards. *Handbook of Accounting*, *supra* note 5, at 40-5; see L. Rappaport, *supra* note 4, at 2.5.

Statements prepared according to these principles are deemed to reflect fairly the financial position of the corporation.⁷

Generally accepted accounting principles require that the corporation account for any contingencies, the occurrence of which may result in a liability.⁸ Given the complexities in the Internal Revenue Code (Code),⁹ one contingency that must be accounted for is the payment of additional income tax that may be required if the corporation has taken a challengeable tax position.¹⁰ The financial statements

In 1973 the SEC issued Accounting Series Release No. 150, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,172, reaffirming the profession's role in setting accounting standards. This release provides that principles, standards and practices promulgated by the Financial Accounting Standards Board shall be considered by the SEC as having substantial authoritative support, and those contrary thereto to have no such support. *Id.* The Financial Accounting Standards Board, established by the profession to promulgate and maintain the standards governing financial accounting and reporting, is an arm of the Financial Accounting Foundation, a non-profit corporation independent of other professional accounting organizations. Handbook of Accounting, *supra* note 5, at 40-5 to 40-7.

7. See Handbook of Accounting, *supra* note 5, at 9-8, 12-2. The author gives the following as an example of what might typically be included in an accountant's report: "In our opinion, the consolidated financial statements . . . present fairly the financial position of ABC, Incorporated and subsidiaries at December 31, 1979 and 1978, and the results of their operations and the changes in their financial position for the years then ended in conformity with generally accepted accounting principles applied on a consistent basis." *Id.* at 9-6 (emphasis in original).

8. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5: Accounting for Contingencies ¶¶ 1, 33-39 (1976) [hereinafter cited as FASB No. 5]. The SEC also specifically requires this information in the filings required to be made under the securities laws. Regulation S-X, 17 C.F.R. § 210.5-02(25) (1982).

FASB No. 5 requires the corporation to accrue an estimated loss from a contingency as a charge to income if the future event that will confirm the loss is "probable" (likely to occur) and estimable. If a loss is not probable, but is "reasonably possible" (more than remote but less than likely), the nature of the contingency and an estimate of the possible loss must be disclosed in the financial statements. FASB No. 5, *supra*, ¶¶ 3(a)-(b), 8-10; see J. Booker & B. Jarnagin, Financial Accounting Standards: Explanation and Analysis 230-31 (1979); Ijiri, *The Dilemma in Contingencies and Reporting Forecasts*, J. Acct., Nov. 1980, at 38. A "contingency" is defined in FASB No. 5 as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." FASB No. 5, *supra*, ¶ 1; see Nath, *Internal Revenue Service Summonses for "Sensitive" Accountants' Papers*, 34 Vand. L. Rev. 1561, 1565-66 (1981).

9. See, e.g., *United States v. El Paso Co.*, 682 F.2d 530, 534 (5th Cir. 1982) ("The income tax laws, as every citizen knows, are far from a model of clarity [N]o taxpayer completes a return with the certainty that the IRS will agree with the bottom line"); *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982).

10. Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185, 187-88 (1982) [hereinafter cited as *A Balancing Approach*].

of the corporation must reflect a reserve to cover the eventuality of such contingent liability.¹¹ In certifying these statements, the accountant is consequently obliged to determine the adequacy of such reserve.¹² This process requires the accountant to evaluate the strengths and weaknesses of the positions taken by the corporation on its tax return.¹³ In so doing, the accountant makes an assessment, often on a "worst case" basis,¹⁴ of the possible outcome of any litigation over the challengeable positions in the return.¹⁵ If the accountant determines that the contingent tax liability reserve is inadequate, the corporation's financial statements must be adjusted to reflect the vulnerability of the corporation to assessment of additional tax.¹⁶ Should the corporate management refuse to make such an adjustment, the accountant is required to disclose the inadequacy of the reserve in his written opinion.¹⁷

The workpapers¹⁸ generated by the accountant in the process of assessing the adequacy of the corporation's contingent tax reserve have increasingly been sought by the Internal Revenue Service (IRS or

11. FASB No. 5, *supra* note 8, ¶ 38; see *A Balancing Approach*, *supra* note 10, at 187-88. See *supra* note 8 and accompanying text.

12. *A Balancing Approach*, *supra* note 10, at 187-88; see Nath, *supra* note 8, at 1566.

13. See *United States v. El Paso Co.*, 682 F.2d 530, 543 (5th Cir. 1982); *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 951 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

14. Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. Tax'n 194, 194 (1979); Nath, *supra* note 8, at 1571; *A Balancing Approach*, *supra* note 10, at 188-89. In the process of assessing the adequacy of the corporation's tax reserve, the accountant attempts to elicit from the corporate management "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. He may think up contingencies even more lurid than the worst contingencies a revenue agent comes up with" *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

15. *United States v. Arthur Young & Co.*, 677 F.2d 211, 217 (2d Cir. 1982); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); see *United States v. El Paso Co.*, 682 F.2d 530, 537 (5th Cir. 1982); Nath, *supra* note 8, at 1569.

16. See L. Rappaport, *supra* note 4, at 2.7; Nath, *supra* note 8, at 1565-66. See *supra* notes 8-10.

17. See *Handbook of Accounting*, *supra* note 5, at 16-5 to 16-8; L. Rappaport, *supra* note 4, at 25.20-.22. The written opinion of the accountant is the certification required under the securities laws. See *id.* at 24.5.

18. These workpapers, which are termed "tax accrual workpapers" in this Note, are referred to by the courts by various terms. *United States v. El Paso Co.*, 682 F.2d 530, 534 (5th Cir. 1982) (tax pool analysis); *United States v. Arthur Young & Co.*, 677 F.2d 211, 217 (2d Cir. 1982) (tax accrual workpapers); *United States v. Coopers & Lybrand*, 550 F.2d 615, 617 (10th Cir. 1977) (tax pool analysis); *United States v. Price Waterhouse & Co.*, 515 F. Supp. 996, 997 (N.D. Ill. 1981) (tax provision memorandum); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 325 n.3,

Service) in conducting audits of corporate tax returns.¹⁹ Tax accrual workpapers are valuable to the Service in that the independent accountant's assessment of the corporation's tax vulnerabilities provides a definitive roadmap of the soft spots in the return.²⁰ Additionally, the workpapers may reveal the willingness of the taxpayer to settle or litigate various positions taken on the return, giving the Service a distinct advantage in the resolution of issues raised during an audit.²¹

The accounting profession has vigorously resisted the efforts of the IRS to reach these workpapers,²² viewing them as beyond the summons power provided in section 7602 of the Code because they are not relevant to a determination of the corporation's actual tax liability.²³ Alternatively, the profession argues that even though the workpapers

327 (D. Mass.) (tax accrual workpapers), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980).

19. *United States v. El Paso Co.*, 682 F.2d 530, 547 (5th Cir. 1982) (Garwood, J., dissenting) ("The practice of attempting in cases of this kind to summon the tax pool analysis is almost uniformly recognized as being both a qualitatively significant and a relatively recent expansion of the Service's prior practice."); *see United States v. Arthur Young & Co.*, 677 F.2d 211, 217 (2d Cir. 1982).

20. *United States v. El Paso Co.*, 682 F.2d 530, 545 (5th Cir. 1982); *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); Caplin, *supra* note 14, at 194; *A Balancing Approach*, *supra* note 10, at 189.

21. *United States v. Arthur Young & Co.*, 677 F.2d 211, 217 (2d Cir. 1982); Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. Tax'n 66, 68 (1982).

22. Nath, *supra* note 8, at 1561-62; *see Caplin*, *supra* note 14, at 194, 197 n.1; Garbis & Struntz, *supra* note 21, at 67.

23. *See infra* pt. I. The summons power of the IRS is codified in I.R.C. § 7602 (1976), which provides as follows:

§ 7602. Examination of books and witnesses

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized—

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

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

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

Id. The summons power of the IRS is not self-executing. If a summons is challenged,

may be relevant and within the summons power, the judiciary should nevertheless deny enforcement of the summons for policy reasons.²⁴

The courts that have been confronted with the enforceability of a summons for tax accrual workpapers have reached divergent results. This Note examines the issues that a court should consider in deciding whether to enforce a summons issued pursuant to section 7602 of the Code, and the policy concerns that come into play when the summons is directed at tax accrual workpapers. Additionally, this Note analyzes the Second Circuit's recent decision in *United States v. Arthur Young & Co.*,²⁵ in which the court fashioned a work-product privilege that shelters these workpapers from the Service in most instances.

I. RELEVANCE

A. *The Shifting Relevance Standard*

In *United States v. Powell*,²⁶ the Supreme Court ruled that to obtain enforcement of a summons issued pursuant to section 7602, the IRS must make a preliminary showing²⁷ that: 1) the investigation will be conducted pursuant to a legitimate purpose;²⁸ 2) the inquiry will

the Service must seek enforcement in the federal district court for the district in which the taxpayer resides. *Id.* §§ 7402(b), 7604(b); see *A Balancing Approach*, *supra* note 10, at 190-91 & n.51.

24. See *infra* pt. II.

25. 677 F.2d 211 (2d Cir. 1982).

26. 379 U.S. 48 (1964).

27. The government's burden of proof does not rise to the level of probable cause. *Id.* at 57; *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 330 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980). Rather, the government's burden of proof has been characterized as "minimal," requiring only a prima facie showing. *United States v. El Paso Co.*, 682 F.2d 530, 536 (5th Cir. 1982); *United States v. Davis*, 636 F.2d 1028, 1034 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981); see *United States v. Silvestain*, 668 F.2d 1161, 1163 (10th Cir. 1982); *United States v. Kis*, 658 F.2d 526, 536 (7th Cir. 1981), *cert. denied*, 102 S. Ct. 1712 (1982); *United States v. Garden State Nat'l Bank*, 607 F.2d 61, 71 (3d Cir. 1979).

28. 379 U.S. at 57. The summons power provided for in § 7602 is not available to aid the IRS in a purely criminal investigation. See *United States v. LaSalle Nat'l Bank*, 437 U.S. 298, 314-16 (1978); *Donaldson v. United States*, 400 U.S. 517, 533 (1971); *United States v. Davis*, 636 F.2d 1028, 1036 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981); *United States v. Garden State Nat'l Bank*, 607 F.2d 61, 66 (3d Cir. 1979); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 328 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); *United States v. Smith*, 373 F. Supp. 14, 17 (S.D. Miss. 1975). By its very nature, however, a tax investigation is likely to raise questions of both criminal and civil liability. *United States v. LaSalle Nat'l Bank*, 437 U.S. 298, 309 (1978); *Couch v. United States*, 409 U.S. 322, 326 (1973); see *United States v. Crespo*, 281 F. Supp. 928, 935 (D. Md. 1968). When an investigation involves both civil and criminal probes, the Supreme Court has placed the burden on the summonee to disprove the existence of a valid civil tax determination purpose by the Service.

be relevant to that purpose;²⁹ 3) the information sought is not already within the possession of the Commissioner of Internal Revenue (Commissioner);³⁰ and 4) the administrative steps required under the Code have been followed.³¹ Once the Service has made this preliminary showing, the burden shifts to the summoinee to disprove the presence of one or more of these elements.³² Although the target of the summons will frequently allege the absence of several elements,³³ the primary argument advanced to defeat a summons for tax accrual workpapers is that they are not relevant to the inquiry.³⁴

United States v. LaSalle Nat'l Bank, 437 U.S. 298, 316 (1978). Also, the Court has refused to draw a line barring the use of a summons issued pursuant to section 7602 merely because the taxpayer is also under investigation for criminal fraud. *Id.* at 314-16; Donaldson v. United States, 400 U.S. 517, 535-36 (1971). See generally Comment, *The Improper Purpose Challenge to a Section 7602 Summons*, 31 Tax Law. 226 (1977).

29. 379 U.S. at 57. See *infra* notes 35-41 and accompanying text.

30. 379 U.S. at 58. Courts have construed the term "in possession" literally, refusing to accept the argument that because the Service has possession of all the records of transactions from which tax accrual workpapers are derived, it has constructive possession of the information in the workpapers. *E.g.*, United States v. Noall, 587 F.2d 123, 125 n.2 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979); United States v. Arthur Andersen & Co., 474 F. Supp. 322, 330 (D. Mass. 1979), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); United States v. Coopers & Lybrand, 413 F. Supp. 942, 950 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); see Nath, *supra* note 8, at 1574 n.53.

31. 379 U.S. at 58. Violations of the Service's procedural manual or informal guidelines are not considered violations of the administrative steps of the Code. United States v. Price Waterhouse & Co., 515 F. Supp. 996, 999 (N.D. Ill. 1981); United States v. Arthur Andersen & Co., 474 F. Supp. 322, 331 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980).

32. United States v. El Paso Co., 682 F.2d 530, 536-37 (5th Cir. 1982); see United States v. Powell, 379 U.S. 48, 58 (1964); United States v. Silvestain, 668 F.2d 1161, 1163 (10th Cir. 1982); United States v. Davis, 636 F.2d 1028, 1034 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981); United States v. Garden State Nat'l Bank, 607 F.2d 61, 71 (3d Cir. 1979); Barnhart v. United Penn Bank, 515 F. Supp. 1198, 1201 (M.D. Pa. 1981); United States v. Arthur Young & Co., 496 F. Supp. 1152, 1154 (S.D.N.Y. 1980), *aff'd in part on other grounds, rev'd in part on other grounds*, 677 F.2d 211 (2d Cir. 1982).

33. See United States v. Noall, 587 F.2d 123, 125 & n.2 (information already in possession of Service and non-relevance), *cert. denied*, 441 U.S. 923 (1979); United States v. Price Waterhouse & Co., 515 F. Supp. 996, 998 (N.D. Ill. 1981) (all four elements); United States v. Arthur Andersen & Co., 474 F. Supp. 322, 328-331 (D. Mass.) (same), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); United States v. Coopers & Lybrand, 413 F. Supp. 942, 949-50 (D. Colo. 1975) (information already in possession of Service and non-relevance), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

34. Nath, *supra* note 8, at 1574-75; see Caplin, *supra* note 14, at 199; A *Balancing Approach*, *supra* note 10, at 193.

The viability of this argument depends on the standard of relevance to be applied. Although the Supreme Court has not formulated a test for determining the relevance required before a summons issued pursuant to section 7602 of the Code will be enforced,³⁵ the summons power of the IRS has been interpreted consistently as a "broad mandate, designed to give the Service the 'authority . . . necessary for the effective enforcement of the revenue laws.'"³⁶

In accordance with the view that the summons power of the IRS is to be liberally construed,³⁷ federal courts interpreting the *Powell* requirement of relevance³⁸ have considered the threshold to be a low one.³⁹ The standard commonly employed is that the summons must seek information that "might throw light upon the correctness of the taxpayer's return."⁴⁰ Certain courts have further refined this test,

35. The relevance of the summoned documents was not at issue in *Powell*. *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 950 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); *A Balancing Approach*, *supra* note 10, at 194.

36. *United States v. Arthur Young & Co.*, 677 F.2d 211, 218 (2d Cir. 1982) (quoting *United States v. Euge*, 444 U.S. 707, 715-16 (1980)); *accord United States v. Bisceglia*, 420 U.S. 141, 145 (1975). The breadth of the Service's power to investigate the records of taxpayers is commonly characterized as analogous to the inquisitorial power of a grand jury. *E.g.*, *United States v. Coopers & Lybrand*, 550 F.2d 615, 619 (10th Cir. 1981); *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States v. Widelski*, 452 F.2d 1, 4 (6th Cir. 1971), *cert. denied*, 406 U.S. 918 (1972); *see Falsone v. United States*, 205 F.2d 734, 742 (5th Cir.) (case concerning enforcement of summons issued pursuant to § 3633 of the Internal Revenue Code of 1933, 26 U.S.C. § 3633 (1933), predecessor of § 7602 of the 1954 Code), *cert. denied*, 346 U.S. 864 (1953).

37. *E.g.*, *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States v. Schwartz*, 469 F.2d 977, 982 (5th Cir. 1972); *United States v. Widelski*, 452 F.2d 1, 4 (6th Cir. 1971), *cert. denied*, 406 U.S. 918 (1972).

38. *See supra* notes 26-27, 29 and accompanying text.

39. *United States v. Arthur Young & Co.*, 677 F.2d 211, 218-19 (2d Cir. 1982); *United States v. Noall*, 587 F.2d 123, 125 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

40. *United States v. Wyatt*, 637 F.2d 293, 300 (5th Cir. 1981) (quoting *Foster v. United States*, 265 F.2d 183, 187 (2d Cir. 1959), *cert. denied*, 360 U.S. 912 (1960)); *accord United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States v. Turner*, 480 F.2d 272, 279 (7th Cir. 1973); *United States v. Egenberg*, 443 F.2d 512, 515 (3d Cir. 1971); *United States v. Shlom*, 420 F.2d 263, 265 (2d Cir. 1969), *cert. denied*, 397 U.S. 1074 (1970). When, however, the summons is directed not at the taxpayer himself but at a third party, a greater showing of relevance may be required, because "judicial protection against the sweeping or irrelevant order is particularly appropriate in matters where the demand for records is directed . . . to a third party who may have had some dealing with the person under investigation." *United States v. Harrington*, 388 F.2d 520, 523 (2d Cir. 1968); *see, e.g.*, *Venn v. United States*, 400 F.2d 207, 211-12 (5th Cir. 1968); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 948 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); *cf. In re Grand Jury Subpoenas Duces Tecum Involving Charles Rice*, 483 F. Supp. 1085, 1089 (D. Minn. 1979) (grand jury subpoena for tax accrual workpapers). *But see* *Nath*, *supra* note 8, at 1576-77 n.66 (suggesting that *Harrington* cannot fairly be read as imposing a higher degree of relevance for third party summonses).

requiring that the government demonstrate "a realistic expectation rather than an idle hope that something may be discovered."⁴¹

Relevance is implicit when the Service is seeking production of factual records of potentially taxable transactions.⁴² Tax accrual workpapers, however, are not records of transactions, but rather contain the thoughts and theories of the corporate taxpayer and its independent auditor concerning the tax consequences of past transactions.⁴³ Although these workpapers are relevant when the Service is attempting to establish fraud, intent being an integral part of the burden of proof,⁴⁴ relevance is tenuous when the Service is only concerned with the correctness of the taxpayer's return.⁴⁵

In *United States v. Coopers & Lybrand*,⁴⁶ the first appellate decision on this issue, the Tenth Circuit affirmed the lower court's finding of an insufficient relationship between the "highly speculative and conjectural"⁴⁷ tax accrual workpapers and the purpose for which they were summoned, the determination of tax liability.⁴⁸ The court, in determining that the workpapers were not relevant, stressed that these papers had not been created or used in the preparation of tax

41. *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973) (quoting *United States v. Harrington*, 388 F.2d 520, 524 (2d Cir. 1968)). This language has subsequently been ignored by the Second Circuit. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 218-19 (2d Cir. 1982); *United States v. Noall*, 587 F.2d 123, 125-26 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

42. *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 950 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); see, e.g., *United States v. Wyatt*, 637 F.2d 293, 301 (5th Cir. 1981) (information concerning the payment of illegal bribes); *United States v. Continental Bank & Trust Co.*, 503 F.2d 45, 50 (10th Cir. 1974) (bank records of customer's deposits and cancelled checks); *United States v. Shlom*, 420 F.2d 263, 265 (2d Cir. 1969) (record of receipts, kept for sales monitoring purposes), *cert. denied*, 397 U.S. 1074 (1970); *United States v. Harrington*, 388 F.2d 520, 523-25 (2d Cir. 1968) (alimony payment records).

43. See *supra* notes 20-21 and accompanying text.

44. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 220-21 (2d Cir. 1982); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 330 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); cf. *In re Grand Jury Subpoenas Duces Tecum Involving Charles Rice*, 483 F. Supp. 1085, 1088 & n.2 (D. Minn. 1979) (grand jury subpoena for tax accrual workpapers).

45. See *United States v. El Paso Co.*, 682 F.2d 530, 548 (5th Cir. 1982) (Garwood, J., dissenting); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 950 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); *A Balancing Approach*, *supra* note 10, at 195-96.

46. 550 F.2d 615 (10th Cir. 1977).

47. *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

48. *Id.* at 954.

returns.⁴⁹ In suggesting that a document's use in connection with such preparation is a touchstone of its relevance,⁵⁰ however, the court may have been impressed by the fact that such documents implicitly (and customarily) establish the tax consequences of corporate transactions,⁵¹ unlike documents containing the thoughts and theories of the taxpayer and his independent auditor.

Although *Coopers & Lybrand* has been viewed as unduly emphasizing the fact that tax accrual workpapers are not prepared as part of the tax return process,⁵² this was not the sole basis for the court's determination that the workpapers were not relevant.⁵³ Rather, the court was concerned that the Service was seeking the documents merely for their value as a roadmap through the soft spots in the return.⁵⁴ Recognizing that relevance connotes more than convenience, the court concluded that the government had failed to establish relevance⁵⁵ and denied enforcement of the summons.⁵⁶ Nonetheless, the courts that have considered the relevance of tax accrual workpapers since *Coopers & Lybrand* have reached the contrary result.⁵⁷ How-

49. 550 F.2d at 621. The court also stressed that the accounting firm had no responsibility for the preparation of its client's tax returns. *Id.*

50. *Id.*

51. *See id.* at 618.

52. *See* United States v. Arthur Young & Co., 677 F.2d 211, 219 (2d Cir. 1982); United States v. Noall, 587 F.2d 123, 126-27 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979); United States v. Arthur Andersen & Co., 474 F. Supp. 322, 329 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); *cf. In re Grand Jury Subpoenas Duces Tecum Involving Charles Rice*, 483 F. Supp. 1085, 1088 (D. Minn. 1979) (grand jury subpoena for tax accrual workpapers).

53. *See* 550 F.2d at 620-21. The decision is frequently viewed, however, as turning primarily on this point. *See* United States v. Arthur Young & Co., 677 F.2d 211, 219 (2d Cir. 1982); United States v. Arthur Andersen & Co., 474 F. Supp. 322, 329 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); Nath, *supra* note 8, at 1578.

54. *See* 550 F.2d at 621.

55. *Id.*

56. *Id.*

57. United States v. El Paso Co., 682 F.2d 530, 537-38 (5th Cir. 1982); United States v. Arthur Young & Co., 677 F.2d 211, 218-19 (2d Cir. 1982). All district courts confronted with the issue since the *Coopers & Lybrand* decision have similarly rejected that holding, finding that the workpapers are relevant. United States v. Price Waterhouse & Co., 515 F. Supp. 996, 999-1000 (N.D. Ill. 1981); United States v. Riley Co., 45 A.F.T.R.2d 80-1164 (P-H) ¶ 80-551 (N.D. Ill. 1980); United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); *cf. In re Grand Jury Subpoenas Duces Tecum Involving Charles Rice*, 483 F. Supp. 1085, 1089 (D. Minn. 1979) (grand jury subpoena for tax accrual workpapers).

ever, although these courts nominally applied the “may shed light” test of relevance, they appear to have found the documents relevant for the convenience they represent. These courts thus may be employing an entirely different standard of relevance.

In *United States v. Arthur Young & Co.*,⁵⁸ the Second Circuit held tax accrual workpapers to be relevant to the Service’s inquiry,⁵⁹ reasoning that because “[d]ifferent tax positions lead to different amounts of liability [it would be] difficult to say that the assessment by the independent auditor of the correctness of positions taken [on the] return would not throw ‘light upon’ the correctness of the return.”⁶⁰ The court, however, did not respond persuasively to the argument that because tax liability depends not on how the taxpayer or his accountant views transactions that have already taken place, but rather on the consequences of the taxpayer’s actual transactions, the workpapers do not shed light on the question of actual tax liability.⁶¹ Thus, although the court’s articulated reasoning was that the workpapers meet the “may throw light upon” test of relevance,⁶² it is not clear how such papers are in fact relevant. Rather, it appears that the court considered the workpapers relevant because of the convenience that they represent to the Service. As the court itself noted, the IRS has access to all the data it needs to calculate the taxpayer’s liability,⁶³ and the roadmap provided by the workpapers would “merely save the IRS some time in finding the best arguments for asserting a deficiency.”⁶⁴

In *United States v. El Paso Co.*,⁶⁵ the Fifth Circuit was similarly persuaded that tax accrual workpapers are relevant,⁶⁶ holding that the

58. 677 F.2d 211 (2d Cir. 1982).

59. *Id.* at 218-19. In holding the workpapers to be relevant, the court rejected the defendant Arthur Young & Co.’s contention that because the summons was not directed at the taxpayer, but rather at a third party record keeper, a higher showing of relevancy should be required. *Id.* at 215-17. See *supra* note 40 and accompanying text. In refusing to require a higher standard, the court noted that Arthur Young & Co. had been hired to investigate the taxpayer’s financial affairs, and to involve itself in matters that were likely to be the object of a governmental inquiry. *Id.* at 216. There was thus no question of invading the privacy of a third party against his will. Cf. *United States v. Noall*, 587 F.2d 123, 126 (2d Cir. 1978) (threshold of relevance is “particularly low” when summons is directed at corporate employee), *cert. denied*, 441 U.S. 923 (1979).

60. 677 F.2d at 219.

61. *Id.* at 218.

62. *Id.*

63. *Id.* at 220.

64. *Id.*

65. 682 F.2d 530 (5th Cir. 1982).

66. *Id.* at 537-38. Although the court was concerned with a summons for tax accrual workpapers that had been prepared by the corporation itself, it employed the same standard of relevance as that employed by courts confronted with a summons seeking production of the same documents prepared by independent accountants. See *id.* at 534, 537.

documents may shed light on the corporation's tax liability.⁶⁷ This court also appears to have considered the workpapers relevant because of the convenience that access would represent to the Service. As the court stated: "Documents that focus and concentrate the Service's energy on questionable positions in the return . . . are highly relevant."⁶⁸ The emphasis on the convenience these workpapers afford to the Service indicates that a standard other than "may shed light" is being used. Instead, convenience is being viewed as sufficient to establish relevance.

That Congress intended the summons power of the Service to reach non-factual documents solely because of the convenience that they represent is unlikely.⁶⁹ Although the grant of power to the Service is a broad mandate,⁷⁰ it is nevertheless a "limited power, and should be kept within its proper bounds."⁷¹ Section 7602 of the Code provides that the Service may examine any "books, papers, records, or *other data*" that may be relevant to the inquiry.⁷² The phrase "other data" suggests that those books, papers and records referenced must be generally similar to "data."⁷³ Documents containing opinions, theo-

67. *Id.* at 537-38.

68. *Id.* at 537.

69. When the government is attempting to establish fraud on the part of the taxpayer, however, the documents are independently relevant because they may shed light on the taxpayer's intent to defraud. *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 330 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); *cf. In re Grand Jury Subpoenas Duces Tecum Involving Charles Rice*, 483 F. Supp. 1085, 1088 (D. Minn. 1979) (grand jury subpoena for tax accrual workpapers). Precisely because the taxpayers were charged with fraud, each court rejected the contention that the workpapers were being sought solely for their convenience. 474 F. Supp. at 330; *see* 483 F. Supp. at 1088 & n.2. As the court in *Arthur Andersen* recognized, the workpapers were "clearly more than 'convenient' or a 'roadmap' [because] such evidence of knowledge of potential discrepancies appears to go directly to the heart of determining whether there has been civil or criminal fraud." 474 F. Supp. at 330 (footnote omitted).

70. *See supra* note 36 and accompanying text.

71. *United States v. Bisceglia*, 420 U.S. 141, 151 (1975) (quoting *People ex rel. McDonald v. Keeler*, 99 N.Y. 463, 482, 2 N.E. 615, 625 (1885)); *see United States v. Harrington*, 388 F.2d 520, 523 (2d Cir. 1968).

72. I.R.C. § 7602(1) (1976) (emphasis added). *See supra* note 23 for full text.

73. *United States v. El Paso Co.*, 682 F.2d 530, 548 (5th Cir. 1982) (Garwood, J., dissenting). This interpretation, however, has been characterized as contrary to the doctrine of *ejusdem generis*, *see Nath, supra* note 8, at 1613, a principle of statutory construction that provides that when general words follow an enumeration of words of a specific meaning, the general words are not to be construed to their widest extent, but are to be construed as applying only to things of the same general kind or class as those specifically mentioned. 2A C. Sands, *Sutherland's Statutes and Statutory Construction* § 47.17 (4th ed. 1973); *Black's Law Dictionary* 464 (5th ed.

ries and legal analyses, rather than factual data, are therefore beyond the scope of the summons power.⁷⁴

Former Commissioner Mortimer M. Caplin recently advocated this interpretation.⁷⁵ Noting that little discussion has taken place on the scope of the word "data," Caplin argued that "[w]hat comes to mind in the use of that term are items such as books, records and other factual materials—not opinions, projections, conjectures and other thought processes."⁷⁶ While recognizing that information of the second type would be of convenience to the Service, Caplin concluded that it is dubious that Congress intended this category of work product to be readily available to the IRS.⁷⁷ Moreover, if Congress had such an intent, a more likely wording of section 7602 would have provided for the power to examine books, papers, records, or other data "relevant 'to making such inquiry' or 'to performing such inquiry.'" ⁷⁸ Accordingly, Congress used the word "inquiry" not in the sense of the procedure to be followed, but rather "in the sense of 'question,' to refer to the *subject matter* inquired about" ⁷⁹ Therefore, section 7602 permits the summoning of material relevant to the correctness of the tax return, but not material that merely facilitates the process. Because the usefulness of tax accrual workpapers lies in their convenience as a roadmap, they are beyond the summons power of the IRS.

B. *Relevance in Large Corporate Audits*

In audits of medium and large corporations, it has been argued that without access to tax accrual workpapers, the Service will be unable to perform a thorough audit.⁸⁰ Accordingly, because in audits of such corporations the IRS is not seeking tax accrual workpapers for mere

1979). The doctrine, however, is only an aid to statutory construction. *United States v. Turkette*, 452 U.S. 576, 581 (1981). Also, because the doctrine works to limit the general words in a phrase to the character of the specific words, the specific words must be a subset of the general for the doctrine to apply. *See id.* at 581-82; *Mason v. United States*, 260 U.S. 545, 553-54 (1923). "Books, papers, and records" are not a subset of "data" because they exist in many other forms such as picture books or poetry. Because "of data" is not a more general description of "books, papers, and records," the doctrine should not be used to interpret the wording of § 7602. *See* 452 U.S. at 582.

74. *See United States v. El Paso Co.*, 682 F.2d at 548 (Garwood, J., dissenting); Caplin, *supra* note 14, at 199.

75. Caplin, *supra* note 14, at 199.

76. *Id.*

77. *Id.* at 199-200.

78. *United States v. El Paso Co.*, 682 F.2d 530, 546 n.5 (5th Cir. 1982) (Garwood, J., dissenting) (emphasis in original).

79. *Id.* at 546 (emphasis in original).

80. Nath, *supra* note 8, at 1585.

convenience, but rather out of necessity,⁸¹ the workpapers should be considered relevant.

While it is true that the Service has limited resources and, as a practical matter, must rely to a great extent on the integrity of the corporation's internal and independent auditors,⁸² it nonetheless has access to sufficient relevant documentation to perform such audits properly.⁸³ For example, the courts have almost without exception enforced summonses for the factual audit workplans created by the independent auditor in his determination of whether the corporation's books and records fairly reflect its revenues and expenses.⁸⁴ The Service may thus rely on the auditor's assessment of the correctness of the corporation's records,⁸⁵ and focus its energies instead on whether the tax treatment of the underlying transactions comports with the law. While access to tax accrual workpapers would certainly make the Service's task easier by focusing its attention on the transactions the accountant viewed as the subject of questionable positions,⁸⁶ "[t]he corporation's own books and the audit workpapers furnish the IRS

81. *Id.* As an example of what may be involved in an audit of a large corporation, the author notes that the record in *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977), contains references to the corporate taxpayer's 3000 company computer programs, 90,000 separate accounts, and 200,000 monthly invoices. Nath, *supra* note 8, at 1585.

82. Nath, *supra* note 8, at 1585.

83. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); see *United States v. El Paso Co.*, 682 F.2d 530, 547 (5th Cir. 1982) (Garwood, J., dissenting); *Auditors Say IRS Demand for Documents is Poisoning Relations with Client Firms*, Wall St. J., Jan. 15, 1981, at 25, col. 4 [hereinafter cited as *IRS Demand for Documents*].

84. *United States v. Arthur Young & Co.*, 677 F.2d 211, 216-17 (2d Cir. 1982); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 324 n.2, 325 n.3, 332 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), *aff'd as to the second party*, 623 F.2d 725 (1st Cir. 1980); Nath, *supra* note 8, at 1584-85; *cf.* *United States v. Noall*, 587 F.2d 123, 126-27 (2d Cir. 1978) (summons for audit workplans prepared by in-house accountants), *cert. denied*, 441 U.S. 923 (1979). *But see* *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977) (denying enforcement). For a background discussion on audit procedures that generate audit workplans, see *Handbook of Accounting*, *supra* note 5, at 12-1 to 12-7.

85. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 221 (2d Cir. 1982); Nath, *supra* note 8, at 1584. In *Arthur Young* the Second Circuit found the audit workplans to be relevant not because of the convenience that they might represent, but rather because they do shed light on the correctness of the return: "Tax liability depends on a taxpayer's actual revenue and expenses, not on his bookkeeping. The IRS has an appropriate interest in ensuring that the latter accurately reflects the former." 677 F.2d at 216.

86. *IRS Demand for Documents*, *supra* note 83. The reporter quotes an IRS team coordinator as saying: "If we can get the papers, we can make a determination (of tax liability) much quicker . . ." *Id.* at col. 6; see Caplin, *supra* note 14, at 194. See *supra* note 20 and accompanying text.

with all the raw data that it needs to calculate the taxpayer's tax liability."⁸⁷ Consequently, because the Service's reliance on tax accrual workpapers does not rise to the level of necessity, the workpapers do not become relevant for that reason alone. That the Service does not require these documents is further evidenced by the fact that compelled production of tax accrual workpapers is a relatively recent phenomenon.⁸⁸ Because tax accrual workpapers do not meet the applicable standard of relevance,⁸⁹ courts should decline enforcement of summonses seeking their compelled production.

II. POLICY

A. Threat to Financial Disclosure under the Securities Laws

Another, and perhaps more convincing argument against compelled production of tax accrual workpapers is that, should these papers be readily available to the IRS,⁹⁰ a corporation might conceal

87. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982). Although the court did not particularize the size of the audit involved in *Arthur Young*, the audit was clearly of the large scale that has been characterized as impossible to perform without access to tax accrual workpapers. See *supra* notes 80-81 and accompanying text. The subject of the audit in *Arthur Young* was Amerada Hess, a Fortune 500 company. *The 500*, Fortune, May 1982, at 258, 260. The audit covered a three-year period of operations. 677 F.2d at 214, 215 n.4.

88. See *United States v. El Paso Co.*, 682 F.2d 530, 547 (5th Cir. 1982) (Garwood, J., dissenting) ("After all, for a great many years the Service effectively employed its summons power in routine audits . . . of large corporate taxpayers without the necessity of attempting to acquire their 'tax pool' analyses.").

89. See *supra* notes 37-41 and accompanying text. However, the workpapers are independently relevant when the government must establish fraudulent intent. See *supra* notes 44, 69 and accompanying text.

90. Although the Service has recently amended its procedure manual to instruct its field agents not to routinely summon tax accrual workpapers, 1 Internal Revenue Manual (Audit) (CCH) ch. 4024.4, at 7019 (May 14, 1981), the Service does not appear to be exercising restraint in summoning these workpapers. In *Arthur Young*, decided over a year after the new guidelines were issued, the Second Circuit referred to the "Service's emerging practice of requesting tax accrual workpapers." 677 F.2d at 217 (footnote omitted). Also, as noted by former Commissioner Caplin, "[present] Commissioner Kurtz will not give up easily on this issue." Caplin, *supra* note 14, at 199; see *The IRS Plays Hardball*, J. Acct., June 1981, at 119. Furthermore, violations by the IRS of the Manual are not considered a violation of the *Powell* requirement that the administrative steps required by the Code must be followed. See *supra* note 31 and accompanying text. The Manual's provision that tax accrual workpapers should not routinely be sought thus "provides scant protection for the taxpayer." *A Balancing Approach*, *supra* note 10, at 192 (footnote omitted). See generally Parnell, *The Internal Revenue Manual: Its Utility and Legal Effect*, 32 Tax Law. 687, 699-701 (1979) (discussion of legal ramifications of the Manual).

its contingent tax liabilities from its independent auditors, thus preventing the auditors from verifying the accuracy of the corporation's financial statements.⁹¹ Because the financial statements required by the securities laws may be the most significant element on which investors in the financial market base their investment decisions,⁹² the public interest requires that integrity in the independent auditing process be fostered.⁹³

The concern that the independent auditing process, and ultimately the integrity of the securities market, will suffer⁹⁴ should the IRS have access to tax accrual workpapers is based on the belief that the free and candid client-auditor exchange regarding the existence of contingent liabilities, which is vital to the effectiveness of the financial audit process, is largely founded upon the client's expectation of confidentiality.⁹⁵ Absent such confidentiality, the client would not feel free to reveal to his auditor the potential weaknesses in the tax return, thus impairing the ability of the auditor to evaluate the corporation's contingent tax reserve.⁹⁶

Whether the free flow of information between client and auditor will in fact be hampered depends, however, on whether there are sufficient independent reasons for a corporation to be candid with its auditors even though the Service might gain access to the resulting documentation.⁹⁷ Corporations have an obligation under the secur-

91. *United States v. Arthur Young & Co.*, 677 F.2d 211, 219-20 (2d Cir. 1982); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953-54 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); Caplin, *supra* note 14, at 199; Garbis & Struntz, *supra* note 21, at 67; *A Balancing Approach*, *supra* note 10, at 190. See *supra* notes 8-17 and accompanying text.

92. L. Rappaport, *supra* note 4, at 2.1; see *United States v. Arthur Young & Co.*, 677 F.2d 211, 220-21 (2d Cir. 1982). See *supra* notes 1-4 and accompanying text.

93. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220-21 (2d Cir. 1982); Garbis & Struntz, *supra* note 21, at 67.

94. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 219-20 (2d Cir. 1982); Garbis & Struntz, *supra* note 21, at 67; *A Balancing Approach*, *supra* note 10, at 190.

95. *United States v. Arthur Young & Co.*, 677 F.2d 211, 219-20 (2d Cir. 1982); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953-54 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); Caplin, *supra* note 14, at 199; *IRS Demand for Documents*, *supra* note 83, at cols. 4-5.

96. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953-54 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); *IRS Demand for Documents*, *supra* note 83, at cols. 4-5.

97. Nath, *supra* note 8, at 1590-91. In *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), the court accepted the argument that a corporation has sufficient independent reasons to assist in the creation of comprehensive tax accrual workpa-

ities laws to maintain a reserve for contingent tax liabilities,⁹⁸ and to cooperate with their auditors' efforts to evaluate the adequacy of this reserve. A corporation not complying with this process would be violating its obligations under the securities laws,⁹⁹ a factor that in the past has prompted corporations to be candid in discussing questionable tax positions with their independent auditors. An additional incentive to be candid lies in the knowledge that an auditor, suspecting undisclosed contingent liabilities, would decline to certify the corporation's financial statements or would issue a qualified opinion.¹⁰⁰ A corporation threatened with an "unclean" opinion arguably would prefer to be candid with its auditors even though the Service could reach the resulting workpapers.¹⁰¹

The prejudice to the corporation should the Service access the underlying workpapers, however, is considerable.¹⁰² The workpapers highlight the soft spots in the return and expose the settlement and litigation positions that management is prepared to take upon challenge by the IRS.¹⁰³ Divulging this information puts the corporation at such a disadvantage when audited by the IRS "that a prudent organization might not be perfectly candid with independent auditors" if such information would be reachable under section 7602.¹⁰⁴ That

pers. *Id.* at 544. Initially, the court rejected the premise that corporations would flout their obligations under the securities laws. *Id.* See *infra* note 99 and accompanying text. Additionally, the court was convinced that concern about being denied certification would prompt candor. 682 F.2d at 544. See *infra* note 100 and accompanying text. The court was substantially in agreement on these points with the dissenting opinion in *United States v. Arthur Young & Co.*, 677 F.2d 211, 222-24 (2d Cir. 1982) (Newman, J., concurring in part, dissenting in part).

98. Regulation S-X, 17 C.F.R. § 210.5-02(25) (1982). See *supra* note 11 and accompanying text.

99. See *United States v. El Paso Co.*, 682 F.2d 530, 544 (5th Cir. 1982); *United States v. Arthur Young & Co.*, 677 F.2d 211, 223 (2d Cir. 1982) (Newman, J., concurring in part, dissenting in part); Nath, *supra* note 8, at 1590-91.

100. *United States v. El Paso Co.*, 682 F.2d 530, 544 (5th Cir. 1982) (quoting *United States v. Arthur Young & Co.*, 677 F.2d 211, 224 (2d Cir. 1982) (Newman, J., concurring in part, dissenting in part)); Nath, *supra* note 8, at 1592-93. Accountants have a duty to withhold certification or issue a qualified opinion if they feel that the financial statements have not been properly prepared. AICPA Statement on Auditing Standards No. 31, J. Acct., Mar. 1981, at 122. This statement, issued in 1981, was intended as a reminder to members of the profession that when an auditor is prevented from examining data that he or she considers necessary to audit a tax accrual, the auditor should consider issuing a qualified opinion or disclaiming the opinion. *IRS to Clarify Rules Limiting Agents' Probes of Tax Workpapers*, J. Acct., May 1981 at 8.

101. See Nath, *supra* note 8, at 1593.

102. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982).

103. *United States v. Arthur Young & Co.*, 677 F.2d 211, 217 (2d Cir. 1982); Garbis & Struntz, *supra* note 21, at 66; *A Balancing Approach*, *supra* note 10, at 189-90; *IRS Demand for Documents*, *supra* note 83, at col. 4. See *supra* notes 20-21 and accompanying text.

104. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982).

corporations may not be candid with their auditors is indicated by the accounting profession's deep concern that their corporate clients will not provide sufficient information to permit the evaluation of contingent tax reserves.¹⁰⁵ Furthermore, even though the practice of summoning tax accrual workpapers is relatively recent,¹⁰⁶ members of the profession have already noticed that clients have in fact become reluctant to discuss sensitive tax areas.¹⁰⁷ As noted by one professional, "[e]very major corporation, faced with the thought that [its] auditors will have to make disclosures that they didn't have to in the past, is positioning itself to defend its privacy."¹⁰⁸ Considerable evidence thus indicates that the free flow of information concerning tax contingencies will be impaired despite the independent reasons that would seemingly prompt a corporation to remain candid with its independent accountants.¹⁰⁹ Absent such free flow of information, accountants will be unable to verify the adequacy of their clients' contingent tax reserves, with resulting detriment to financial reporting under the securities laws.

B. A Work-Product Privilege for Tax Accrual Workpapers

The Supreme Court has recognized that contrary legislative purposes may undercut the broad grant of authority to the IRS under section 7602 of the Code.¹¹⁰ Because it appears that financial disclosure under the securities laws will suffer should the IRS have routine access to tax accrual workpapers,¹¹¹ courts considering enforcement of

105. *IRS Demand for Documents*, *supra* note 83, at col. 5; *see* Caplin, *supra* note 14, at 197 n.1, 199. Former Commissioner Caplin has noted that the American Institute of Certified Public Accountants (AICPA) has formed a special committee to deal with the problem. *Id.* at 197 n.1.

106. *See supra* note 88 and accompanying text.

107. *Interpretation Guides Auditor Who Cannot Obtain Evidence on Income Tax Accruals*, J. Acct., Mar. 1981, at 18, 20; *IRS Demand for Documents*, *supra* note 83, at col. 4.

108. *IRS Demand for Documents*, *supra* note 83, at col. 5 (remarks of David Bucholz, Managing Director, Tax Policy and Procedure, Arthur Andersen & Co., Chicago, Ill.).

109. *See* *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). The court quoted extensively the testimony of an expert witness: "[W]ith that information available to the revenue agent just for the asking, I think it would terribly impede and I think eventually destroy the system of auditing that we have established because it would eliminate the freedom that the client feels of being able to muse with us about, well, what if this capital gains is treated as an ordinary income?" *Id.* *But see* *United States v. El Paso Co.*, 682 F.2d 530, 544-45 (5th Cir. 1982) (court considered "wholly speculative" the argument that corporations would not continue to be candid with their independent auditors).

110. *United States v. Euge*, 444 U.S. 707, 715-16 (1980).

111. *But see* *United States v. El Paso Co.*, 682 F.2d 530, 544-45 (5th Cir. 1982) (court did not accept that the accuracy of financial reporting would suffer if tax

a summons for these workpapers should determine whether the policies of disclosure vindicated by the securities laws justify restricting the power of the Service to summon documents.¹¹²

In *United States v. Arthur Young & Co.*,¹¹³ the Second Circuit expressed concern about the effect that enforcing IRS summonses for tax accrual workpapers would have on the securities market.¹¹⁴ In denying enforcement of such a summons, the court balanced the Service's need for the information contained in the tax accrual workpapers against the policies of disclosure represented by the securities laws.¹¹⁵ While investors were found to rely "most exclusively" on the statements generated as a result of corporate compliance with the securities laws,¹¹⁶ the IRS was found to have access to sufficient other material to enable it to make a determination of the correctness of the tax return.¹¹⁷ Because the harm resulting from granting the Service routine access to tax accrual workpapers would be substantial,¹¹⁸ whereas the collection of revenues could continue relatively unhampered even though access is denied, the court concluded that protection must be afforded the independent auditing process.¹¹⁹

To provide such protection, the court fashioned a work-product privilege¹²⁰ similar to that developed for the work product of attorneys in *Hickman v. Taylor*.¹²¹ In *Hickman*, the Supreme Court provided the attorney with a sheltered area in which to prepare his client's case without concern that his thought processes will be discoverable by the

accrual workpapers were available to the IRS). See *supra* notes 97-109 and accompanying text. Consequently, the court did not need to make inroads in the summons power of the Service. See *id.* at 544.

112. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); see *United States v. El Paso Co.*, 682 F.2d 530, 544-45 (5th Cir. 1982); Garbis & Struntz, *supra* note 21, at 67.

113. 677 F.2d 211 (2d Cir. 1982).

114. *Id.* at 220-21.

115. *Id.* at 219. The court viewed *Hickman v. Taylor*, 329 U.S. 495 (1947), as requiring it "to balance strong public policies against a party's need for information whenever a conflict between the two arises." 677 F.2d at 219. See *infra* notes 118-19 and accompanying text.

116. 677 F.2d at 220-21.

117. *Id.* at 220. In finding that the Service has access to all the documentation that it needs, the court specifically excepted cases involving fraud on the part of the taxpayer. Absent allegations of fraud, the Service does not need to know the taxpayer's thoughts. *Id.* See *supra* note 44 and accompanying text. When the taxpayer is under investigation for fraud, the court suggests that the Service may have made a sufficient showing of need to override the privilege. See *infra* note 125 and accompanying text.

118. 677 F.2d at 220-21; see *United States v. El Paso Co.*, 682 F.2d 530, 544 (5th Cir. 1982).

119. 677 F.2d at 220-21.

120. *Id.* at 221.

121. 329 U.S. 495 (1947).

opposing party.¹²² Similarly, the accountant work-product privilege provides the independent auditor with a protected area in which he may freely analyze his corporate client's contingent tax liabilities.¹²³

The accountant work-product privilege is a sound response to the concerns posed by routine enforcement of summonses for tax accrual workpapers. As structured by the Second Circuit, the privilege shelters only the work that independent auditors, retained by publicly owned companies, put into the preparation of workpapers created to assist their client's compliance with the federal securities laws.¹²⁴ Furthermore, the Service may override the privilege by making a showing of substantial need, such as when the corporation's records have been destroyed by fire.¹²⁵ The objectives of the securities laws are thus achieved without undue interference with the collection of national revenues.¹²⁶

The dissent in *Arthur Young*, however, viewed the enactment by Congress of section 7602 as preempting the power of the judiciary to restrict the summons authority beyond the "traditional" privileges¹²⁷ to which the Supreme Court held the summons power subject in *Upjohn Co. v. United States*.¹²⁸ However, Rule 501 of the Federal Rules of Evidence,¹²⁹ which governs the existence of privileges in federal courts, provides that privileges "shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience."¹³⁰ Congress, in enacting Rule 501, did not intend to freeze the law of privileges as then in existence, but rather intended the law to "continue to be developed by the courts."¹³¹ Therefore, the judiciary has the power to recognize any new privileges that are justifiable "in light of reason and experience." Such privileges become part of the federal common law and, under the rule of *Upjohn*, act to restrict the summons power of the Service.¹³² The majority in *Arthur Young*, having found that the integrity of the securities market would be jeopardized

122. *Id.* at 510-11; see *United States v. Nobles*, 422 U.S. 225, 238 (1975) ("At its core, the work-product doctrine shelters the mental processes of the attorney, providing a privileged area within which he can analyze and prepare his client's case.").

123. See 677 F.2d at 219-20.

124. *Id.* at 219; see Garbis & Struntz, *supra* note 21, at 69.

125. 677 F.2d at 221 & n.10. If the corporation is under investigation for fraud, there may be a sufficient showing of need to overcome the privilege. *But see* Garbis & Struntz, *supra* note 21, at 69 (suggesting that the privilege does not apply at all if there are allegations of fraud).

126. See *id.* at 220-21. See *supra* notes 118-19 and accompanying text.

127. 677 F.2d at 222 (Newman, J., concurring in part, dissenting in part).

128. 449 U.S. 383, 398 (1981).

129. Fed. R. Evid. 501.

130. *Id.*

131. *Id.* report of House Committee on the Judiciary.

132. See Garbis & Struntz, *supra* note 21, at 68-69.

if the Service could freely access tax accrual workpapers¹³³ therefore had the power to fashion a privilege protecting them.

The dissent in *Arthur Young* further criticized the privilege as facilitating duties already imposed by law¹³⁴ (maintenance of accurate financial statements), whereas privileges are traditionally created to promote a relationship not already served by independent legal obligations and which would be impaired absent the protection afforded by the privilege.¹³⁵ The work-product privilege, however, was not created for the purpose of protecting the relationship between accountant and client, but rather to ensure the vindication of an important public policy, the integrity of the marketplace.¹³⁶ That the relationship and communications made therein are also protected is incidental. Similarly, the attorney work-product privilege was not created for the purpose of protecting non-privileged communications made to the attorney, but rather to ensure "an orderly working of our system of legal procedure."¹³⁷ In each instance, it is the thought processes essential to achieve an important public policy that are being sheltered. The creation of the accountant's work-product privilege is thus a valid response to the concern that access by the Service to tax accrual workpapers will result in "inaccuracy and untrustworthiness" in financial reporting.¹³⁸

133. 677 F.2d at 220-21.

Id. at 224 (Newman, J., concurring in part, dissenting in part).

135. *Id.* In his treatise on privileges, Professor Wigmore predicates four fundamental conditions as prerequisites to the existence of a privilege:

(1) The communications must originate in a confidence that they will not be disclosed.

(2) This element of confidentiality must be essential to the full and satisfactory maintenance of the relation between the parties.

(3) The relation must be one which in the opinion of the community ought to be sedulously fostered.

(4) The injury that would inure to the relation by the disclosure of the communications must be greater than the benefit thereby gained for the correct disposal of litigation.

8 J. Wigmore, *Evidence* § 2285 (McNaughton rev. 1961) (emphasis and footnote omitted).

The dissent in *Arthur Young* further suggested that to the extent the majority created a privilege to encourage the client to communicate with its accountant, it created a testimonial privilege for the corporation, rather than a work-product privilege for the accountant. 677 F.2d at 223 n.5 (Newman, J., concurring in part, dissenting in part). That such communications are sheltered, however, is incidental to the court's purpose.

136. 677 F.2d at 219, 221.

137. 329 U.S. at 512.

138. 677 F.2d at 221 (quoting *Hickman v. Taylor*, 329 U.S. 495, 513 (1947)).

CONCLUSION

The practice of summoning tax accrual workpapers poses a significant threat to the integrity of financial reporting under the securities laws. Although courts may decline to enforce summonses directed at these workpapers on the basis of non-relevance, a more effective way to ensure that the workpapers are protected is to shelter them by means of a privilege. A work-product privilege, similar to that existing for the work-product of attorneys, is a sound way to provide this protection. Such a privilege shelters the documents from the Service in most instances, thus preventing the adverse impact on financial reporting that would result from the routine enforcement of summonses. At the same time, the privilege is defeasible by the IRS upon a showing of substantial need. The integrity of financial reporting may thus be maintained by an accountant's work-product privilege without compromising the collection of national revenues.

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