American College of Tax Counsel Letter to SEC on Sarbanes-Oxley Act

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SUMMARY BY TAX ANALYSTS

The American College of Tax Counsel in a letter to the Securities and Exchange Commission discussed its concerns about the Sarbanes-Oxley Act of 2002, specifically the phrase in the act that affects "le gal services and expert services unrelated to audits."

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ACTC Comments on Implementation of Section 201(a) of the Sarbanes-Oxley Act of 2002

The American College of Tax Counsel ("ACTC") respectfully submits the following comments concerning the implementation of Section 201(a) of the Sarbanes-Oxley Act of 2002 (the "Act"). These comments address the scope of the phrase "legal services and expert services unrelated to the audit" which cannot be performed by an accounting firm that performs an audit.

The ACTC is a nonprofit professional association of tax lawyers in private practice, law school teaching and government service, who are recognized for their excellence in the field of taxation and for their substantial contributions and commitment to the profession. The College is comprised of approximately 636 Fellows from throughout the United States chosen by their peers in recognition of their outstanding reputations and service to the tax law and the tax bar.

Section 201(a) of the Act amends Section 10A of the Securities Exchange Act of 1934 (the "SEA") by adding Section 10A(g), which, except as provided in new section 10A(h), prohibits a registered public accounting firm (and associated persons of that firm as determined by the SEC) from providing non-audit services to an audit client, including nine listed activities. New section 10A(h) provides that a registered public accounting firm may provide any non-audit service that is not described in the nine listed prohibited activities only if the activity is approved in advance by the audit committee of the issuer.

The nine prohibited non-audit activities include, among other things, "legal services and expert services unrelated to the audit." New Section 10A(h) of the SEA acknowledges "tax services" are a non-audit service. The interplay of new Sections 10A(g) and (h) therefore requires the SEC to determine the line between permitted "tax services" and proscribed "legal services and expert services unrelated to the audit."

The ACTC believes that in making this determination it is necessary to take the underlying principles and purposes of the Act into account. Title II of the Act is largely drawn from Title II of S. 2673. S. Rep. No. 107-205, Report of the Committee on Banking, Housing, and Urban Affairs of the United States Senate to accompany S. 2673 (July 3, 2002) explicitly states the underlying purpose and principles of Title II of the Act:

> Some argue that standards for auditor independence should be left to the SEC and the new Board. The approach adopted by this bill reflects the Committee's belief that the issue of auditor independence is so fundamental to the problems being experienced in our financial markets that statutory standards are needed to assure the independence of the auditor from the audit client.
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> The intention of this provision is to draw a clear line around a limited list of non-audit services that accounting firms may not provide to public company audit clients because their doing so creates a fundamental conflict of interest for the accounting firms. The list is based on simple principles. **An accounting firm**, in order to be independent of its audit client, **should**

> **not audit its own work,** which would be involved in providing bookkeeping services, financial information systems design, appraisal or valuation services, actuarial services, and internal audit outsourcing services to an audit client.
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> The accounting firm should not function as a part of management or as an employee of the audit client, which would be required if the accounting firm provides human resources services such as recruiting, hiring and designing compensation packages for the officers, directors, and managers of an audit client. **The accounting firm should not act as an advocate of the audit client, which would be involved in providing legal and expert services to an audit client in legal, administrative, or regulatory proceedings**, or serving as a broker-dealer, investment adviser, or investment banker to an audit client, which places the auditor in the role of promoting a client's stock or other interests. (Emphasis added.)

SEA Section 10A(g)(1) prohibits an accounting firm from providing bookkeeping or other services related to the accounting records or financial statements of the audit client. The ACTC believes this prohibition (and the underlying principle that an accounting firm should not audit its own work) raises a question as to whether the accounting firm should provide the audit client with tax planning or advice when such planning or advice is coupled with an appraisal or evaluation of the need for and amount of a tax liability provision or accrual. Providing such tax-planning services for an audit client would erode the accounting firm's independence because of the need, in preparing financial statements, to establish a reserve for potential income tax liabilities at the Federal, state, local and international levels. An accounting firm that engages in tax planning for an audit client cannot be regarded as independent in determining whether or not such tax planning "works" or the adequacy of the financial statement provision for potential tax liability associated with such advice.

For example, some of the tax shelters that have been the subject of recent press reports were designed and sold by accounting firms. It would be very difficult for an accounting firm that has sold such a "tax product" to its audit client to be expected to maintain the necessary independence in reviewing that product for purposes of preparing a financial statement for the client. Similarly, as reflected in the briefs filed by KPMG and PricewaterhouseCoopers in pending tax litigation, when an accounting firm has sold a product or given advice on an issue to a client, its independence is compromised when it reviews the financial statements of an audit client who has similar tax issues because of a product or advice furnished by a third party. In evaluating the substantially identical product or advice furnished by another, the audit firm is, in substance, evaluating or auditing its own work. This effect is not dissimilar to the "issue conflict" faced by attorneys who have advised a client on a legal issue.

Rules will need to be drafted to address the scope of the prohibition on an accounting firm rendering legal services and expert services unrelated to the audit. Advising a client on the interpretation of the law, the application of law to facts, or the probable outcome if a particular legal position is challenged administratively or judicially, all appear to be legal services, whether the law in question is domestic or foreign, state or federal, and without regard to what type of legal issue is involved. Advising an audit client concerning the necessity of audit committee approval for a non-audit service is no different from advising a client on the likely result of taking a particular legal position regarding the reporting of a transaction on a tax return. Both are legal services, and a registered accounting firm should be prohibited from rendering such legal advice services to an audit client that is an issuer.

The prohibition against providing "legal services" and the underlying principle that the audit firm should not act as an advocate of the audit client by providing non-audit services in connection

with an administrative, regulatory, or judicial proceeding is the essence of the provision.[1] There is no exclusion for administrative proceedings before the Internal Revenue Service or state tax authorities, regulatory proceedings before the Treasury Department or state rulemaking bodies, mediations or arbitrations, or judicial proceedings before state courts, the United States Tax Court, the United States Court of Federal Claims, or the United States district courts, Courts of Appeal, or the Supreme Court. Thus, it would seem that any Rules issued by the SEC should prohibit registered accounting firms and their associated persons from engaging in representation of an audit client in examinations, administrative appeals or hearings before the Internal Revenue Service and similar proceedings before state, local, and international authorities.

Similarly, the prohibition against the provision of "expert services not related to the audit" seems to clearly encompass providing expert testimony or expert reports in administrative, judicial, regulatory, mediation, or arbitration proceedings relating to an audit client in local, state, federal, or international proceedings.

The scope of the prohibition against such advocacy engagements involving legal services or "expert services unrelated to the audit" by an accounting firm should be fully addressed in any Rules issued by the SEC. The ACTC believes the Rules might contain bright-lines as to whether the prohibited services include, among other things, (i) appearing in any court on behalf of an audit client, (ii) representing the audit client in any appeals or other administrative procedure, (iii) representing the client in any examinations or similar inquiry by any Federal, state, local, or international tax authority, or (iv) providing any services to a client or the client's representative in connection with any such litigation, appeal or audit other than providing information concerning the financial statements (and, where appropriate, the tax returns) prepared by the accounting firm.

When the purpose of the Act is taken into account, it may well be that the permitted "tax services" which may be performed by an accounting firm for an audit client relate to the preparation and filing of income tax returns for such clients. The preparation and filing of such returns is not generally regarded as the provision of legal advice; indeed, the courts have concluded that there is no attorney-client privilege attached to communications made for the purpose of the preparation of tax returns. *See, e.g.*, *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999). Similarly, tax return preparation activity does not presently require any federal or state license or permits, and therefore seemingly does not constitute an "expert service."

Accordingly, the ACTC respectfully requests that the SEC issue Rules under Section 201 of the Act setting the scope of "legal services and expert services unrelated to the audit" consistent with these comments and suggestions.

Questions regarding these comments should be directed to:

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[1] *See United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n. 15 (1984): "The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries. It is therefore not enough that financial statements *be* accurate; the public must also *perceive* them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public's perception of the outside auditor as an independent professional. . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost." (Emphasis in original.)