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THE EXPANDED SCOPE OF THE IRS SUMMONS POWER AFTER *UNITED STATES V. ARTHUR YOUNG & COMPANY*

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Congress has granted the Internal Revenue Service (IRS) authority to summon documents relating to income tax liability from third persons under section 7602 of the Internal Revenue Code.[1] The Supreme Court's recent decision in *United States v. Arthur Young & Co.*[2] will have a substantial effect on the summons power of the IRS under section 7602 and on the defenses that may be asserted against that summons power.

This article will examine the approach taken by the Supreme Court in *Arthur Young*. It will then evaluate the impact of the Court's decision on the scope of the section 7602 summons power and on the doctrines of privilege and work product immunity. In addition, the article will suggest defenses that re-

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1. This section provides in pertinent part:

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

I.R.C. § 7602 (1982).

2. 465 U.S. 805 (1984).

main available to accountants and attorneys faced with a section 7602 summons.

I. BACKGROUND

Respondent Amerada Hess Corporation retained respondent Arthur Young & Company, a firm of certified public accountants, to audit the financial statements that Amerada was required to prepare under federal securities laws.[3] As part of its review of the financial statements, Arthur Young prepared "tax accrual workpapers" to verify the adequacy of Amerada's reserve for potential tax liabilities.[4]

In general, "tax accrual workpapers pinpoint the 'soft spots' on a corporation's tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes."[5] Specifically, tax accrual workpapers contain a complete record of an auditor's examination and analysis of a corporation's reserve account for contingent tax liabilities,[6] including an analysis of the client's books and records. They may also document the auditor's assessment of "the opinions and speculations of the client's financial personnel and legal counsel"[7] and contain the auditor's personal judgments on questions of potential tax liability, "alternative treatments and positions, and settlement potential."[8] These workpapers, which are not used in the preparation of the corporation's tax return,[9] are "usually prepared on 'worst-case'

3. *See, e.g.*, Securities Exchange Act of 1934 § 12(b)(1)(J)-(L), 15 U.S.C. § 78(l)(b)(1)(J) to (L)(1976); Regulation S-X, 17 C.F.R. § 210.1 to .12 (1985).

4. SEC regulations require that these financial statements be audited by an independent certified public accountant in accordance with "generally accepted auditing standards." Regulation S-X, 17 C.F.R. §§ 210.1-02(d) (1985). Thus, "An important aspect of the auditor's function is to evaluate the adequacy and reasonableness of the corporation's reserve account for contingent tax liabilities." 465 U.S. at 812. This task usually requires the preparation of tax accrual workpapers. *See id.* at 811-12; Amicus Brief of American Inst. of Cert. Pub. Accountants (AICPA) at 6-7.

5. 465 U.S. at 813.

6. This reserve account may also be referred to as the "tax accrual account," "tax pool," "tax pool analysis," "tax cushion," "noncurrent tax account," or "tax contingency reserve."

7. Caplin, *Accountants Lose Tax Work-Product Privilege*, 62 TAXES 373, 374 (1984).

8. *Id.*

9. United States v. El Paso Co., 682 F.2d 530, 532 (5th Cir. 1982).

assumptions."[10] As former IRS Commissioner Mortimer Caplin observed, tax accrual workpapers provide examining agents with a "definitive roadmap to the 'soft spots' in a corporation's tax returns—they pick out the needles in the haystack of raw data that corporations turn over to the IRS."[11]

In 1975 the IRS commenced a routine audit of Amerada's corporate income tax returns for the tax years 1972 through 1974. During the audit, the IRS issued an administrative summons to Arthur Young pursuant to section 7602, requiring the production of all Arthur Young files relating to Amerada.[12] The summons was issued as part of a joint IRS criminal investigation that was instituted when the audit revealed that Amerada had made questionable payments of $7,830 from a "special disbursement account." Amerada instructed Arthur Young not to comply with the summons.[13]

The IRS then commenced an enforcement action in district court against Arthur Young, pursuant to section 7604 of the Internal Revenue Code.[14] The district court found that the tax ac-

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10. Caplin, *supra* note 7, at 374.

11. *Id.* (footnote omitted). As the government frankly stated in its *Arthur Young* brief filed with the Supreme Court, "tax accrual workpapers may . . . shed important light on the taxpayer's state of mind regarding the treatment it ultimately presents in its tax returns." Brief for United States at 25. They may also contain the accountant's and, indirectly, the taxpayer's opinions and judgments about the propriety of the corporation's reporting positions and about the potential for and strength of an IRS challenge to those positions. *Id.* at 26. Tax accrual workpapers also contain analyses of the strengths and weaknesses of the client's tax positions, speculations about tax law developments, and conjecture regarding the litigating positions and settlement potential with respect to previously filed tax returns. Brief for Arthur Young & Co. at 2. *See* Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 VA. TAX REV. 57, 59-60 (1981); Brief for Amerada Hess Corp. at 2-4; Amicus Brief of AICPA at 6-7.

12. The requested files contained over 250,000 pages of documents, including Arthur Young's audit program files, audit workpaper files, tax pool analysis files, and "[a]ny other information pertinent to the audit of Amerada . . . covering the years 1972, 1973 and 1974." United States v. Arthur Young & Co., 677 F.2d 211, 215 n.4 (2d Cir. 1982).

13. 465 U.S. at 808-09.

14. Subsection (a) grants district courts jurisdiction to compel compliance with a summons "to appear, to testify, or to produce books, papers, records or other data . . . ." I.R.C. § 7604(a)(1976). Subsection (b) sets forth the procedure to compel compliance and authorizes the district courts "to issue an attachment, directed to some proper officer, for the arrest of such person," "to proceed to a hearing of the case," and "to make such order as he shall deem proper, not inconsistent with the law for the punishment of contempts, to enforce obedience to the requirements of the summons and to punish such person for his default or disobedience." I.R.C. § 7604(b)(West Supp. 1985).

crual workpapers met the standard of relevance under section 7602 and that no privilege barred their production.[15] The court, therefore, ordered enforcement of the summons.[16]

A divided panel of the Second Circuit affirmed in part and reversed in part.[17] The majority agreed with the district court that the workpapers met the requisite standard of relevance,[18] but concluded that a client might be less than candid with its auditor if the IRS could routinely summon the auditor's workpapers.[19] The quality and depth of financial reporting might decline, which could ultimately harm the investing public.[20] Based on these policy considerations, the Second Circuit, relying primarily upon *Hickman v. Taylor*,[21] fashioned a work product doctrine for independent auditors who prepare tax accrual workpapers in compliance with federal securities laws.[22] The court refused to require Arthur Young to produce the tax accrual workpapers because the IRS had not made a showing of sufficient need.[23] On appeal, the Supreme Court affirmed the Second Circuit's finding that the workpapers were relevant,[24] but reversed the court of appeals' creation of an auditor's work product immunity.[25]

II. STANDARD OF RELEVANCE

Congress has authorized the IRS to summon the production of "books, papers, records, or other data which may be relevant or material" to an appropriate IRS inquiry.[26] In *United States v. Powell*,[27] the Supreme Court stated that a section 7602 summons may not be enforced unless the IRS can show that (1) the

15. United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980).
16. *Id.* at 1160.
17. United States v. Arthur Young & Co., 677 F.2d 211, 221 (2d Cir. 1982).
18. *Id.* at 218.
19. *Id.* at 220.
20. *Id.*
21. 329 U.S. 495 (1947)(work product of an attorney prepared in anticipation of litigation is privileged). *See also* FED. R. CIV. P. 26(b)(3); *infra* notes 131-49 and accompanying text.
22. 677 F.2d at 221.
23. *Id.*
24. 465 U.S. at 813-15.
25. *Id.* at 815-19.
26. I.R.C. § 7602(a)(1)(1976).
27. 379 U.S. 48 (1964).

investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry is potentially relevant to that purpose, (3) the information sought is not already within the Commissioner's possession, and (4) the administrative procedure required under the Internal Revenue Code has been followed.[28]

The major controversy in this area has focused on how the *Powell* standard of relevance should be interpreted. Interpretations have ranged from something less than probable cause[29] to a "license to fish."[30] This relevance requirement was a key issue in *Arthur Young*.

The Supreme Court agreed with the court of appeals and the district court that the tax accrual workpapers prepared by Arthur Young met the relevance standard of section 7602.[31] The Court flatly stated that "an IRS summons is not to be judged by the relevance standards used in deciding whether to admit evidence in federal court."[32] Rather, the statutory language " 'may be' reflects Congress' express intention to allow the IRS to obtain items of even *potential* relevance to an ongoing investigation, without reference to its admissibility."[33] Further, the Court laid to rest the argument that tax accrual workpapers are not relevant because they are not used in the preparation of tax returns.[34] The Court concluded that records which illuminate any aspect of the return "are . . . highly relevant to legitimate IRS inquiry."[35] The Court thus implicitly approved the relevance standard adopted by many lower courts[36] of "whether the documents at issue 'might have thrown light upon the correctness of

28. *Id.* at 57-58.

29. *Id.* at 57 (probable cause not required).

30. United States v. Giordano, 419 F.2d 564 (8th Cir. 1969), *cert. denied*, 397 U.S. 1037 (1970). In *Giordano*, the court commented that "[t]axpayer in his brief characterized the government's efforts as a 'fishing expedition.' If so, the Secretary or his delegate has been specifically licensed to fish by § 7602." 419 F.2d at 568. *Contra* United States v. Dauphin Deposit Trust Co., 385 F.2d 129, 131 (3d Cir. 1967), *cert. denied*, 390 U.S. 921 (1968)(summons does not authorize a fishing expedition).

31. *See* 465 U.S. at 813 n.10.

32. *Id.* at 814.

33. *Id.* (emphasis in original).

34. *Id.* at 815.

35. *Id.*

36. *See, e.g.*, United States v. Wyatt, 637 F.2d 293, 300 (5th Cir. 1981); United States v. Turner, 480 F.2d 272, 279 (7th Cir. 1973); United States v. Ryan, 455 F.2d 728, 733 (9th Cir. 1972); United States v. Egenberg, 443 F.2d 512, 515-16 (3d Cir. 1971); Foster v. United States, 265 F.2d 183, 187 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959).

the return.' "[37]

It is noteworthy that the Court failed to discuss three variations of this standard of relevance, despite the fact that all three had been briefed.[38] The first variant holds that the "might have thrown light upon" standard is only the beginning of the relevance inquiry; a more substantial showing of relevance should be required when the documents sought are in the possession of a third party rather than in the taxpayer's hands.[39] The Court implicitly rejected this interpretation. Although the summoned records were in the hands of a third party, no stricter standard was imposed or even alluded to in the opinion.

The second variation interprets the phrase "might have thrown light upon" as "[might] throw *factual* light upon."[40] This interpretation, espoused by a former IRS commissioner,[41] presupposes two categories of summoned documents: factual and nonfactual.[42] Factual documents are records of actual transac-

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37. 465 U.S. at 813 n.11. This standard presents a very low threshold for the IRS to surmount. United States v. Noall, 587 F.2d 123, 125 (2d Cir. 1978), *cert. denied*, 441 U.S. 961 (1979).

38. *See infra* notes 39-60 and accompanying text.

39. *See* United States v. Coopers & Lybrand, 550 F.2d 615 (10th Cir. 1977), *aff'g* 413 F. Supp. 942 (D. Colo. 1975); United States v. Harrington, 388 F.2d 520 (2d Cir. 1968)(judicial scrutiny of a summons is particularly appropriate where records summoned are those of a third party). *See generally* Brief of Amerada Hess Corp. at 37-38; Amicus Brief of AICPA at 14-17.

40. United States v. El Paso Co., 682 F.2d 530, 548 (5th Cir. 1982)(Garwood, J., dissenting), *cert. denied*, 465 U.S. 1041 (1984); *See* United States v. Coopers & Lybrand, 550 F.2d 615 (10th Cir. 1977), *aff'g* 413 F.Supp. 942 (D. Colo. 1975)(in order for the IRS to gain access to nonfactual material, it must show more than merely that the documents "might shed light upon" the investigation); Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194, 199 (1979)("What comes to mind . . . are items such as books, records and other factual materials—not opinions, projections, conjectures and other thought processes."); Note, *United States v. El Paso Co.: Unjust Enforcement of an IRS Summons for Tax Pool Analysis*, 78 NW. U.L. REV. 703, 716 (1983)(hereinafter cited as Note, *United States v. El Paso Co.*)("There is some evidence that the 'might throw light upon' test actually should be interpreted to 'mean throw *factual* light upon' . . . ."))(emphasis in original); 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, 208 (1982)("The division of potentially relevant documents according to their factual or nonfactual content is a logical first step."). *See generally* Brief of Arthur Young & Co. at 26-31; Brief of Amerada Hess Corp. at 41-42; Amicus Brief of AICPA at 11-12.

41. Caplin, *supra* note 40, at 199.

42. United States v. Coopers & Lybrand, 413 F. Supp. 942, 950 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

tions,[43] which are always relevant.[44] In contrast, records not based on actual corporate transactions are not inherently relevant and require that the IRS satisfy a higher standard of relevance.[45] The nonfactual category includes all documents reflecting the "private thoughts and theories of the taxpayer."[46]

In *United States v. First Chicago Corp.*,[47] the district court, applying this variation, conducted an *in camera* relevancy inspection and found that certain documents satisfied the relevancy standard because they contained "records of actual transactions, whether of an external or an internal nature, having tax consequences of practical relevance to an IRS investigation."[48] The relevant documents included special reviews of periodic write-downs to the bond trading account, special reviews of the accrued interest receivable and unearned discount account, and an expense review of the operation of two leased private aircraft.[49]

On the other hand, in *United States v. Noall*,[50] the Second Circuit Court of Appeals adopted a different view:

> If what appellant desires is to have the district judge examine the materials *in camera* so as to increase his understanding of their relevancy and materiality to the tax investigation, this would be a task which, in most cases, certainly including this one, would be so burdensome and probably so impossible of performance that Congress could not have meant to impose it upon busy district judges.[51]

This second variation of the "might have thrown light upon" test, like the first, is probably no longer viable. Although the tax accrual workpapers in *Arthur Young* admittedly con-

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43. United States v. Coopers & Lybrand, 413 F. Supp. 942, 950 (D. Colo. 1975); United States v. Matras, 487 F.2d 1271 (8th Cir. 1973); United States v. First Chicago Corp., 79-1 U.S. Tax Cas. (CCH) ¶ 9111 (N.D. Ill. 1978).

44. United States v. Coopers & Lybrand, 413 F. Supp. 942, 950 (D. Colo. 1975). *See also* United States v. El Paso Co., 682 F.2d 530, 537 (5th Cir. 1982), *cert. denied*, 465 U.S. 1041 (1984)(the corporate taxpayer conceded that the IRS had a right to all factual information upon which the income tax return was based).

45. United States v. Coopers & Lybrand, 413 F. Supp. 942, 950 (D. Colo. 1975).

46. *Id.*

47. 79-1 U.S. Tax Cas. (CCH) ¶ 9111 (N.D. Ill. 1978).

48. *Id.* at 86,037.

49. *Id.* at 86,035.

50. 587 F.2d 123 (2d Cir. 1978).

51. *Id.* at 127.

tained private thoughts and theories of the taxpayer,[52] the Court did not suggest that any higher standard of relevance should be required.[53]

The third, and arguably most important, of these variations was applied in *United States v. Harrington*,[54] in which the Second Circuit found that "the 'might' in the articulated standard, 'might have thrown light upon' . . . is . . . an indication of a realistic expectation rather than an idle hope that something may be discovered."[55] The validity of this third interpretation is still uncertain. In the same footnote in which it implicitly adopted the "might have thrown light upon" standard, the Supreme Court noted the use of the *Harrington* version, but failed to pass judgment on it.[56]

Under the broadest reading of *Arthur Young*, the *Harrington* version is still alive. If, however, it is no longer viable, the IRS will face an extremely low relevance threshold[57] and, thus, will have almost unlimited summons power under section 7602.[58] Taxpayers may take little comfort in the Supreme Court's prior assurance that the IRS would not be allowed to conduct limitless "fishing expeditions" by summoning every document cre-

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52. *See* Brief of United States at 25-26.

53. As one pessimistic commentator noted, "The alternative approach, however, which allows the IRS to summon both factual and nonfactual material, probably would have the result that every document created by a corporation or its accountants would be 'relevant' to a tax investigation." Note, *United States v. El Paso Co.*, *supra* note 40, at 716-17. *See also* United States v. Bisceglia, 420 U.S. 141, 154 (1975)(Stewart, J., dissenting)("Our economy is 'tax relevant' in almost every detail.").

54. 388 F.2d 520 (2d Cir. 1968). This modification has been adopted by several other courts. *See* United States v. Wyatt, 637 F.2d 293, 300-01 (5th Cir. 1981); United States v. City Nat'l Bank & Trust Co., 642 F.2d 388, 389 (10th Cir. 1981); United States v. Matras, 487 F.2d 1271, 1274 (8th Cir. 1973).

55. 388 F.2d at 524. This test requires that the IRS have particular facts or some other basis to support its claim of relevance. Thus, the test restricts the ability of the IRS to routinely request tax accrual workpapers, particularly at the beginning of an audit.

56. 465 U.S. at 813 n.11.

57. United States v. Noall, 587 F.2d 123, 125-26 (2d Cir. 1978).

58. *See* Case Comment, *Internal Revenue Service Accessibility to Auditors' Tax Accrual Workpapers*, 72 GEO. L.J. 1211, 1223 (1984)("The 'might throw light upon' formulation, however, minimizes the Service's burden to show a desired document's relevance to the correctness of a return. It would be difficult to imagine the existence of a document that would not be relevant under this test. Any document with any relationship to the taxpayer in question *might* throw light upon the correctness of his return. If this is indeed the relevance standard envisioned by the Supreme Court in *Powell*, it hardly seems necessary to have a standard at all."(emphasis in original)).

ated by a taxpayer.[59] Realistically, the only remaining relevance defense would be that the summons is overly broad.[60]

For taxpayers and their representatives, the *Arthur Young* opinion's broad interpretation of the *Powell* relevance requirement leaves little in the way of defense to a section 7602 summons. It is, therefore, necessary to examine other parts of the decision to determine which defenses, if any, are still available.

III. PRIVILEGE

The accountant-client privilege is not recognized under common law, nor has it been enacted by federal statute. Some states, however, have enacted statutes establishing an accountant-client privilege.[61] The Supreme Court's opinion in *Arthur Young* arguably precludes any further judicial attempt to create or expand the accountant-client privilege.

With little discussion, the Court cited its earlier decision in *United States v. Couch*[62] for the proposition that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases."[63] Thus, the court of appeals' attempt to create such a privilege "conflicts with what we see as the clear intent of Congress."[64]

Some commentators and courts had suggested that *Couch* might not be the last word on accountant-client privilege,[65] but

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59. United States v. Bisceglia, 420 U.S. 141, 150-51 (1975).

60. *See* United States v. Theodore, 479 F.2d 749 (4th Cir. 1973)(court refused to enforce a § 7602 summons issued to an accountant requesting production of all files for all clients).

61. 8 J. WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2286 (rev. ed. 1961). *See, e.g.*, FLA. STAT. ANN. § 473.316 (West Supp. 1981).

62. 409 U.S. 322 (1973).

63. 465 U.S. at 817.

64. *Id.*

65. *In re* A Special Investigation No. 202, 53 Md. App. 96, 100 n.1, 452 A.2d 458, 461 n.1 (1982)(distinguishing *Arthur Young* from *Couch* because the latter involved a criminal investigation, while the former did not); *The Supreme Court, 1983 Term*, 98 HARV. L. REV. 4, 305 n.66 (1984)("The Court's decision in *Couch* . . . did not irrevocably foreclose the creation of a testimonial accountant-client privilege under federal law. The Court in *Couch* merely noted that such a privilege did not yet exist and that there was no justification in the case before it for fashioning one. Moreover, documents such as those in *Couch* would not have been privileged even had the accountant been an attorney."); Note, *United States v. El Paso Co.*, *supra* note 40, at 721 n.130 (*Couch* precludes application of an accountant-client privilege for tax pool analyses, but the scope of the decision may be limited to individual criminal investigations in which the taxpayer has deliv-

the *Arthur Young* Court appears to have slammed the door on these dissenters.[66] Any creation of an accountant-client privilege in the future can come only from Congress.[67]

While any per se accountant-client privilege has probably been foreclosed, *Arthur Young* did not rule out the possibility that the accountant could be sheltered under the attorney-client umbrella.[68] Therefore, it is beneficial to examine the operation of the attorney-client privilege in situations similar to that found in *Arthur Young*.[69]

A. *Attorney-Client Privilege*

> Where legal advice of any kind is sought from a professional legal advisor in his capacity as such, the communications relating to that purpose, made in confidence by the client, are at his instance permanently protected from disclosure by himself or by the legal adviser, except that the protection may be

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ered possibly incriminating documents to an accountant); Stoltenberg & Robinson, *Enforcement of Summonses in Requesting Accountants' Workpapers*, 60 TAXES 673, 680 (1982)(*Couch* may be distinguishable because it was a criminal investigation and concerned documents employed in preparing the tax return).

66. It is significant that despite the arguments of counsel for both Arthur Young and Amerada Hess, the Supreme Court ignored FED. R. EVID. 501, which authorizes judicial creation of new privileges. *See* Brief for Arthur Young & Co. at 21, 22, 25; Brief for Amerada Hess Corp. at 21-24, 26. The Supreme Court had previously noted that Congress, in enacting FED. R. EVID. 501, "manifested an affirmative intention not to freeze the law of privilege," but instead intended "to 'provide the courts with the flexibility to develop rules of privilege on a case-by-case basis' . . . and to leave the door open to change." Trammel v. United States, 445 U.S. 40, 47 (1980)(quoting 120 CONG. REC. 40891 (1974)(statement of Rep. Hungate)). *See* Caplin, *supra* note 7, at 376 n.15; Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66, 68 (1982).

67. As of this writing, no bills were pending in Congress.

68. I.R.C. § 7602 (1976) is still " 'subject to the traditional privileges and limitations.' " 465 U.S. at 816 (quoting United States v. Euge, 444 U.S. 707, 714 (1980)).

69. It is unclear at this point what impact I.R.C. § 6661 (West Supp. 1985) will have on attorney-client privilege. Section 6661 provides for the imposition of a penalty if there is a substantial understatement of income tax. Except in the area of tax shelters, the penalty shall be reduced by that portion of the understatement which is attributable to the tax treatment of an item if there is substantial authority for such treatment or if the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. I.R.C. § 6661(b)(2)(B)(West Supp. 1985). The question arises whether such a disclosure would amount to a waiver of the privilege. *See* Treas. Reg. §§ 1.6661-4(b)(1)(1985)(disclosure in attached statement), 1.6661-4(b)(2)(1985)(disclosure of legal issue), 1.6661-4(b)(3)(1985)(requirement of particularity).

waived.[70]

This statement is the most frequently cited definition of the attorney-client privilege. The policy underlying this privilege is "to encourage full and frank communication between attorneys and their clients"[71] and " 'to encourage clients to make full disclosure to their attorneys.' "[72]

Even though neither section 7602 nor its legislative history refers to the attorney-client privilege, the Supreme Court has concluded that a tax summons remains "subject to the traditional privileges and limitations."[73] Nevertheless, "not all communications between an attorney and his client are privileged . . . . Attorneys frequently give to their clients business or other advice which, at least insofar as it can be separated from their essentially professional legal services, gives rise to no privilege whatever."[74] Thus, courts have had little difficulty in rejecting the attorney-client privilege when the attorney gave investment advice,[75] acquired real estate as an agent for the client,[76] served as the client's business manager or collection agent,[77] participated with the client in business ventures,[78] or executed finan-

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70. 8 J. WIGMORE, *supra* note 61, § 2291. The attorney-client privilege applies only if (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communciation was made (a) is a member of the bar of a court, or his subordinate, and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily (i) either an opinion of law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.

United States v. United Shoe Mach. Corp., 89 F. Supp. 357, 358 (D. Mass. 1950).

71. Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).

72. *Id.* (quoting Fisher v. United States, 425 U.S. 391, 403 (1976)).

73. United States v. Euge, 444 U.S. 707 (1980).

74. Colton v. United States, 306 F.2d 633, 638 (2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963).

75. *Id.*

76. Pollock v. United States, 202 F.2d 281 (5th Cir.), *cert. denied*, 345 U.S. 993 (1953).

77. *See* Kelly v. Simon, 9 A.F.T.R.2d (P-H) ¶ 62-462 (S.D. Cal. 1962). *But see In re* Schwarz, 56-2 U.S. Tax Cas. (CCH) ¶ 10,061 (D.D.C. 1956), *aff'd on other grounds*, 247 F.2d 70 (D.C. Cir. 1957)(list of doctor's clients given to an attorney for collection was protected by the attorney-client privilege).

78. Lowy v. Commissioner, 262 F.2d 809 (2d Cir. 1959). Although not discussed in *Lowy*, it is questionable whether an attorney and his client engaged in business together as principals can even assert attorney-client privilege as a defense. THE MODEL CODE OF

cial transactions for the client.[79] When attorneys perform quasi-legal services, such as the preparation of tax returns or tax workpapers, courts face a much more troublesome decision.

In *Colton v. United States*,[80] the IRS sought to compel the defendants' attorneys to give testimony and produce "copies of income tax returns, workpapers, correspondence files, memoranda and all other data relating to the preparation and the filing of Federal Income Tax Returns."[81] The attorneys appeared, but refused to produce the records, asserting the attorney-client privilege. The Second Circuit Court of Appeals affirmed the district court's holding[82] and stated that the attorney-client privilege permits an attorney

> to withhold any particular confidential papers which were "specifically prepared by the client for the purpose of consultation with his attorney" and any of the firm's memoranda and worksheets "to the extent of any unpublished expression made by an attorney therein of confidences which had passed between him and his clients."[83]

In the course of its discussion the court observed:

> "There can, of course, be no question that the giving of tax advice and the preparation of tax returns—which unquestionably constituted a very substantial part of the legal services rendered . . . are basically matters sufficiently within the professional competence of an attorney to make them prima facie subject to the attorney-client privilege."[84]

PROFESSIONAL RESPONSIBILITY DR 3-103(A)(1970) provides: "A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law." *See* ABA CANONS OF PROFESSIONAL ETHICS, Canon 33 (1908).

79. McFee v. United States, 206 F.2d 872 (9th Cir. 1953).

80. 306 F.2d 633 (2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963).

81. *Id.* at 634.

82. *In re* Colton, 201 F. Supp. 13 (S.D.N.Y. 1961).

83. 306 F.2d at 639.

84. *Id.* at 637. *Accord In re* Shapiro, 381 F. Supp. 21, 22-23 (N.D. Ill. 1974)(preparation of tax returns is sufficiently within an attorney's professional competence to be protected by the attorney-client privilege, but only if the preparation of the return is part of a bona fide attorney-client relationship evidenced by significant other legal services rendered by the attorney to the taxpayer). *Contra* Canaday v. United States, 354 F.2d 849, 857 (8th Cir. 1966)(attorney-client privilege denied to taxpayer seeking to prevent the government from compelling attorney to produce documents, workpapers, and tax returns prepared by attorney for the client; attorney's services in preparing tax returns compared to that of a "scrivener").

The court cautioned, however, that "[p]articularly in the case of an attorney preparing a tax return . . ., a good deal of information transmitted to an attorney by a client is not intended to be confidential, but rather is given for transmittal by the attorney to others—for example, for inclusion in the tax return."[85]

The extent to which the attorney-client privilege applies to tax information transmitted by a client to an attorney is still unclear. Two cases dealing with estate tax returns yielded contrary results. In *Baldwin v. Commissioner*,[86] the Ninth Circuit held that an attorney's communications with the decedent regarding the motivation for executing a deed were privileged and refused to require the attorney to testify.[87] The court implied that only those portions of the decedent's communications appearing on the face of the deed were not subject to the privilege.[88] On the other hand, in *United States v. Lawless*,[89] the Seventh Circuit held that documents which the executors of an estate had submitted to an attorney for the preparation of an estate tax return were not protected from a summons because the client intended that the attorney disclose the information to another party.

In *United States v. El Paso Co.*,[90] the Fifth Circuit Court of Appeals was squarely confronted with the question of whether a tax pool analysis prepared by an attorney was legal advice and, therefore, protected by the attorney-client privilege. The court managed to avoid answering this difficult question by holding that El Paso had waived any possible privilege when its attorneys discussed portions of the tax pool analysis with the corporation's independent auditors.[91] The opinion is noteworthy, however, because of the court's suggestion that under proper circumstances, a client *could* assert the privilege: "[W]e would

85. 306 F.2d at 638. *See* United States v. Willis, 565 F. Supp. 1186, 1189-91 (S.D. Iowa 1983)(privilege held inapplicable to communications made by taxpayers to their attorneys in the course of routine income tax return preparation and not made for the purpose of seeking legal advice, with two exceptions: (1) when tax planning advice is sought from a lawyer and (2) when a taxpayer under civil or criminal tax investigation seeks an attorney's advice regarding his liability).

86. 125 F.2d 812 (9th Cir. 1942).

87. *Id.* at 816.

88. *Id.* at 815-16.

89. 83-1 U.S. Tax Cas. (CCH) ¶ 9414 (7th Cir. 1983).

90. 682 F.2d 530 (5th Cir. 1982), *cert. denied*, 465 U.S. 1041 (1984).

91. *Id.* at 539-40.

be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of litigation on it are not legal advice."[92]

Because the question of whether tax returns and related memoranda prepared by an attorney are protected by the attorney-client privilege remains unanswered, courts will continue to decide this issue on a case by case basis. Meanwhile, taxpayers and their representatives will rarely be able to predict with any certainty whether the privilege will be permitted.[93]

B. Accountant as the Attorney's Agent

Case law suggests that two factors assume primary importance in determining the availability of the attorney-client privilege for protecting tax returns and tax workpapers prepared by an accountant. First, was the attorney retained by the taxpayer prior to preparation of the materials by the accountant? Second, were the materials prepared at the direction of the attorney or the client?[94] Although these issues arise most frequently in criminal tax litigation, they are equally applicable to civil tax cases.

Thus far the Supreme Court has addressed the issue of attorney-client privilege for tax preparation by an accountant in

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92. *Id.* at 539. *But cf.* Note, *United States v. El Paso Co., supra* note 40, at 722-23 ("[T]ax pool analyses, which are not even advice *per se*, should be classified as business services, rather than legal services.").

Aside from the issue of privilege, it is uncertain whether the accounting profession would even accept a tax pool analysis performed by an attorney as a substitute for its own independent inquiry. In 1981 the Auditing Standards Division of the Auditing Standards Board was posed the following question: "May the auditor consider [outside legal counsel or in-house legal or tax counsel] as a specialist within the meaning of SAS No. 11 (Using the Work of a Specialist), and rely solely on counsel's opinion as an appropriate procedure for the financial statements?" The Board replied: "The opinion of legal counsel in this situation would not provide sufficient competent evidential matter to afford a reasonable basis for an opinion on the financial statements." *Auditing Standards Division, SAS No. 31: Evidential Matter, reprinted in* 151 J. ACCT. 122, 122-23 (March 1981).

93. "An uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all." Upjohn Co. v. United States, 449 U.S. 383, 393 (1981). For the remainder of the discussion of privilege, it is assumed that the attorney-client privilege may be applicable to an attorney's preparation of a tax return or a tax pool analysis.

94. *See* Petersen, *Attorney-Client Privilege in Internal Revenue Service Investigations*, 54 MINN. L. REV. 67, 86 (1969). The following discussion assumes that these services are legal services. *See supra* note 93.

only one case, *Fisher v. United States*.[95] In *Fisher* the IRS issued a summons to the taxpayer's attorneys requiring them to produce workpapers prepared by an independent accountant and relevant to the preparation of the taxpayer's tax returns. The attorneys argued that production of the workpapers would violate the attorney-client privilege because they had been furnished for the purpose of obtaining legal advice and representation. The Court rejected this contention, stating that "pre-existing documents which could have been obtained by court process from the client when he was in possession may also be obtained from the attorney by similar process following transfer by the client in order to obtain more informed legal advice."[96] Thus, preexisting documents that are not privileged when in the taxpayer's possession do not become privileged simply because they are transferred to an attorney.

The holding in *Fisher* does not indicate when an accountant may come within the attorney-client umbrella, but several recent court of appeals cases provide some assistance. In *United States v. Kovel*,[97] the Second Circuit extended the attorney-client privilege to communications made by a client to an accountant who was employed full time by a tax law firm. The client had been instructed to provide the accountant with his business records and any necessary explanations of his financial dealings. When the IRS summoned the accountant to disclose statements made by the taxpayer, he refused, asserting that the communications were protected by the attorney-client privilege. Initially the Second Circuit noted:

> Nothing in the policy of the privilege suggests that attorneys, simply by placing accountants, scientists or investigators on their payrolls and maintaining them in their offices, should be

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95. 425 U.S. 391 (1976).

96. *Id.* at 403-04. A troublesome tangential issue was presented in Bouschor v. United States, 316 F.2d 451 (8th Cir. 1963). On facts very similar to *Fisher*, the court held the privilege inapplicable on two grounds: the workpapers and tax returns were prepared by the accountant prior to the attorney's entry into the case, and the accountant, not the taxpayers, owned the documents and workpapers. *Id.* at 456. In order to avoid the second problem, it has been suggested that the prudent attorney should obtain a surrender of title from the accountant to all reports and workpapers if reliance on the attorney-client privilege is anticipated. Petersen, *supra* note 94, at 88; Lofts, *The Attorney-Client Privilege in Federal Tax Investigations*, 19 TAX L. REV. 405, 427 (1964).

97. 296 F.2d 918 (2d Cir. 1961).

> able to invest all communications by clients to such persons with a privilege the law has not seen fit to extend when the latter are operating under their own steam.[98]

The court reasoned, however, that

> if the lawyer has directed the client . . . to tell his story in the first instance to an accountant engaged by the lawyer, who is then to interpret it so that the lawyer may better give legal advice, communications by the client related to that purpose ought fall [sic] within the privilege . . . .[99]

The court then attempted to define the boundaries within which the attorney-client privilege would apply to accountants and concluded:

> What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal* advice *from the lawyer*. If what is sought is not legal advice but only accounting service . . . or if the advice sought is the accountant's rather than the lawyer's, no privilege exists.[100]

In *United States v. Judson*,[101] the Ninth Circuit also found that the attorney-client privilege protected documents prepared by an accountant. The taxpayer in that case learned that he was under investigation by the Intelligence Division of the IRS for tax evasion. At his attorney's direction, he retained two accountants to prepare a net worth statement for the attorney's use. This statement and the accountants' workpapers were then given to the attorney. The court concluded that the net worth statement had been "prepared at the attorney's request, in the course of an attorney-client relationship, for the purpose of advising and defending his clients"[102] and that the accountants' role had been "to facilitate an accurate and complete consultation between the client and the attorney about the former's financial picture."[103] The court held that the documents were,

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98. *Id.* at 921. *See, e.g.*, United States v. McKay, 372 F.2d 174 (5th Cir. 1967)(report prepared by appraisers, employed by the attorney, for possible use in tax litigation was not protected by the privilege).

99. 296 F.2d at 922.

100. *Id.* (emphasis in original).

101. 322 F.2d 460 (9th Cir. 1963).

102. *Id.* at 462.

103. *Id.* In *Judson* the Ninth Circuit implicitly overruled its much criticized decision in Himmelfarb v. United States, 175 F.2d 924 (9th Cir.), *cert. denied*, 338 U.S. 860

therefore, privileged.

In numerous other cases on this subject, the outcome has generally turned on the two previously discussed factors.[104] With proper planning, an accountant's workpapers and memoranda can be protected under the attorney-client privilege. It is vital, however, that the accountant, upon learning that the taxpayer is under investigation, inform the taxpayer of the legal consequences of further communication and insist that the taxpayer retain counsel.[105]

C. *The Attorney-Accountant*

When the attorney is also an accountant, the primary restriction on application of the attorney-client privilege is the same as in the usual attorney-client situation: the client's com-

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(1949). In *Himmelfarb* an attorney retained an accountant to assist in the preparation of a tax case. The accountant was present at meetings between the taxpayer and the attorney. The court held that the client's communications to the accountant were admissible at trial, stating: "[The accountant's] presence was not indispensible in the sense that the presence of an attorney's secretary may be. It was a convenience which, unfortunately for the accused, served to remove the privileged character of whatever communications were made." *Id.* at 939. The only subsequent approval of *Himmelfarb* was by the Sixth Circuit in Gariepy v. United States, 189 F.2d 459 (6th Cir. 1951).

104. *See* United States v. Brown, 478 F.2d 1038 (7th Cir. 1973)(no attorney-client privilege for accountant's notes of a meeting when accountant was retained by taxpayer, not by attorney, and accountant's presence was requested by taxpayer's assistant, not by attorney); United States v. Cote, 456 F.2d 142 (8th Cir. 1972)(attorney-client privilege extended to memoranda and workpapers prepared by accountant at attorney's request for purpose of giving legal advice to taxpayers as to whether they should file amended returns); United States v. Clark, 74-2 U.S. Tax Cas. (CCH) ¶ 9562 (D. Idaho 1974)(accountant's employment was divisible into two periods: before and after employment by taxpayer's attorney; attorney-client privilege applied only to period after employment by attorney); Bauer v. Orser, 258 F. Supp. 338, 340 (D.N.D. 1966)(privilege held applicable when taxpayers consulted an attorney who retained an accountant to assist him so that he "could properly advise the [taxpayers] as to their legal rights"). *Accord* United States v. Schmidt, 360 F. Supp. 339 (M.D. Pa. 1973).

105. The possibility of waiving the attorney-client privilege should not be forgotten. Disclosure to an agent of an attorney, however, should not waive the privilege. *See* E. CLEARY, MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 91, at 188-89 (2d ed. 1972). *See also* United States v. Kovel, 296 F.2d 918, 922 (2d Cir. 1961). ("[T]he presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege . . . ."). Where disclosure is made to an independent auditor, the privilege is inapplicable. Note, *United States v. El Paso Co.*, *supra* note 40, at 721 n.128. *Cf. Arthur Young*, 465 U.S. at 818-19 (independent auditor owes ultimate allegiance to the corporation's creditors, the stockholders, and the investing public).

munication to the attorney-accountant must have been made for the purpose of obtaining legal advice, not accounting services.

The leading case in this area is *Olender v. United States*.[106] In *Olender* the attorney-accountant, a member of an accounting firm, prepared federal income tax returns for the client and produced a net worth statement in response to an IRS investigation. In denying the taxpayer the benefits of the attorney-client privilege, the court stated that "the privilege has been held inapplicable to communications to one who was both an attorney and accountant where made solely to enable the practitioner to audit the client's books . . . or to simply prepare a federal income tax return."[107] This case is distressing to tax practitioners because of the court's implied characterization of the preparation of income tax returns as an accounting service rather than as legal work.[108]

Arguably, the *Olender* holding could be restricted to the particular facts of the case. As a member of an accounting firm, the attorney-accountant was not actively engaged in the practice of law. Further, a practicing attorney was consulted when questions arose regarding the inclusion of certain information in the net worth statement. Nevertheless, it is clear that the court did not view preparation of a federal income tax return as a legal service, regardless of the circumstances.[109]

The Fifth Circuit applied an expansive reading of *Olender* to a case in which the attorney-accountant was actually a member of a law firm. In *United States v. Davis*,[110] the IRS issued a summons to Davis, an attorney and certified public accountant who had prepared the taxpayer's tax returns for several years. The summons requested production of tax return workpapers and the tax records upon which they were based. The court denied privilege to both sets of documents "because although preparation of tax returns by itself may require some knowledge of the law, it is primarily an accounting service."[111]

In a footnote, however, the court observed that accounting

106. 210 F.2d 795 (9th Cir. 1954).
107. *Id.* at 806.
108. Petersen, *supra* note 94, at 92.
109. 210 F.2d at 806. *See* Petersen, *supra* note 94, at 92-93.
110. 636 F.2d 1028 (5th Cir. 1981).
111. *Id.* at 1043.

services performed ancillary to giving legal advice may be within the attorney-client privilege.[112] The court conceded that the preparation of tax returns may, in some circumstances, come within this category, as when a taxpayer's attorney prepares amended tax returns after the IRS has begun investigating the original returns.[113]

Davis is subject to criticism because the court based its holding primarily on *Olender* and provided little additional analysis of either *Olender* or the many other cases in this area. Nevertheless, *Davis* and *Olender* stand firmly for the proposition that the routine preparation of federal income tax returns is an accounting service, not a legal service.[114]

D. Documents Produced by Taxpayer

Whether the attorney-client privilege applies to tax returns or tax pool analyses prepared by in-house counsel is open to speculation. In *Upjohn Co. v. United States*,[115] the Supreme Court held that certain communications between lower echelon employees and the corporate general counsel were protected by the attorney-client privilege.[116] Thus, it appears that in the appropriate circumstances, certain internally produced memoranda may come within the privilege.[117]

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112. *Id.* at 1043 n.17.

113. *Id. See* United States v. Higgins, 266 F. Supp. 593 (S.D.W. Va. 1966) (workpapers and schedules prepared for an IRS audit by an attorney-CPA, practicing as an attorney, held privileged).

114. *But see* Colton v. United States, 306 F.2d 633 (2d Cir. 1962)(preparation of tax returns is prima facie subject to the attorney-client privilege). *See also supra* notes 80-85 and accompanying text.

115. 449 U.S. 383 (1981).

116. *Id.* The communications were responses to questionnaires prepared by Upjohn's general counsel and distributed by him to certain corporate employees in the course of his investigation of possible illegal payments to foreign officials.

117. In United States v. United Shoe Mach. Corp., 89 F. Supp. 357 (D. Mass. 1950), the district court stated that each document for which the attorney-client privilege is claimed must meet the following test:

> (a) the exhibit itself was prepared by or for either (1) independent counsel or (2) . . . one of his immediate subordinates; and (b) as appears upon the face of the exhibit, the principal purpose for which the exhibit was prepared was to solicit or give an opinion on law or legal services or assistance in a legal proceeding; and (c) the part of the exhibit sought to be protected consists of either (1) information which . . . was not disclosed in a public document or before a third person, or (2) an opinion based upon such information and not intended

The two leading cases in this area are *John Doe Corp. v. United States*[118] and *United States v. El Paso Co.*[119] In *John Doe Corp.*, the defendant corporation conducted an internal investigation of its business practices, during which Doe's legal department prepared a detailed questionnaire that was completed by more than three hundred employees. This investigation culminated in a report entitled the Business Ethics Review (BER) and dated January 23, 1978.[120]

In 1978 Doe showed the BER to its auditors, once in January and once in February, and to the attorney representing an underwriter in connection with a public offering of Doe's securities. Subsequently, a grand jury issued a subpoena to Doe for all drafts of and memoranda relating to the BER and to the auditors for all records relating to audits during the relevant period. Doe and the auditors refused to comply, citing *Upjohn* to support their claims of attorney-client privilege.

The Second Circuit ruled that the February 1978 disclosure to the auditors acted as a waiver of the privilege. In the court's view, this disclosure "was sparked by [the auditor's] responsibilities in conducting the audit, not by Doe Corp.'s seeking of legal advice requiring the aid of an accountant."[121] The court found that the disclosure to the underwriter's counsel also constituted a waiver. Doe Corp. had argued that this disclosure was not voluntary because "it was coerced by the legal duty of due diligence and the millions of dollars riding on the public offering of registered securities."[122] The court, however, viewed this claim "with no sympathy whatsoever."[123] According to the court, these two disclosures "evidence[d] a corporate decision to use the materials for purposes other than seeking legal advice."[124]

The *Doe* opinion is also important for what it left unresolved. Regarding the January 1978 disclosure to the auditors, the court stated:

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for disclosure to third persons.
Id. at 361.

118. 675 F.2d 482 (2d Cir. 1982).
119. 682 F.2d 530 (5th Cir. 1982).
120. 675 F.2d at 484-85.
121. *Id.* at 488.
122. *Id.* at 489.
123. *Id.*
124. *Id.* at 488.

> We do not reach the question of whether the January 1978, disclosure of the BER to the accounting firm constitutes a waiver. [The trial judge] found that disclosure to be part of the BER process in which the accounting firm was participating as an aid to the legal department. . . . Accountant testified, however, that the 1977 financial statement would have received only a qualified opinion if the BER had not been produced. This disclosure of the BER, therefore, may well have been for the additional purpose of facilitating the public offering of registered securities.[125]

In *United States v. El Paso Co.*,[126] El Paso received a summons requiring production of its tax accrual workpapers. El Paso argued that the workpapers had been created exclusively by its in-house tax department comprised of attorneys and accountants and, consequently, were protected by the attorney-client privilege. The Fifth Circuit rejected this argument and held that El Paso could not make a blanket assertion of the privilege on all documents in its tax pool analysis.[127] The court further held that even if the attorney-client privilege had previously existed, confidentiality was destroyed when El Paso disclosed its tax pool analysis to its independent auditors.[128]

While *El Paso* left unanswered the question of whether a tax pool analysis can ever be privileged if the preparer is an attorney, the opinion is, nevertheless, important. In critical language, the court observed:

> The line between accounting work and legal work in the giving of tax advice is extremely difficult to draw . . . . We have held that the preparation of tax returns is generally not legal advice within the scope of privilege. *United States v. Davis*, 636 F.2d at 1043. . . . *Davis* withheld the privilege from communications made to an attorney to prepare a tax return because such work is primarily an accounting service. The tax pool analysis may also be considered an accounting service since it is often performed by accountants . . . . *Nevertheless, we would be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome*

125. *Id.* at 488-89 n.4 (citations omitted).
126. 682 F.2d 530 (5th Cir. 1982).
127. *Id.* at 539.
128. *Id.* at 541.

of litigation on it are not legal advice.[129]

The last sentence in the quotation is particularly important because it comes from the same circuit that had decided *Davis* only a year earlier, although from a different panel of judges. Thus, the question of whether the attorney-client privilege protects a tax pool analysis prepared by in-house counsel remains unanswered.[130] Courts will, presumably, continue to deal with this issue and the application of privilege to the preparation of tax returns on a case by case basis.

At the risk of gross generalization, the case law seems to imply that routine preparation of tax returns is not privileged, regardless of the preparer's profession, but that amended returns, net worth statements, schedules, and workpapers may be privileged if either an attorney prepares them for the purpose of giving legal advice or an accountant does so at an attorney's direction in order to assist the attorney in giving legal advice.

E. Work Product Immunity

In general terms, the work product immunity rule protects materials prepared by an attorney or his representative in anticipation of litigation.[131] Work product immunity, however, is not absolute; it can be overcome by a showing of substantial need.[132] Further, the doctrine does not protect materials assembled in the ordinary course of business or pursuant to public requirement unrelated to litigation.[133]

The Supreme Court's decision in *Arthur Young* shed little light on the doctrine of work product immunity. In a very narrow ruling, the Court held that work product immunity does not protect tax accrual workpapers prepared by an independent auditor in the course of a routine review of corporate financial statements.[134] The Court stated that Congress, in enacting section 7602, had intended to grant the IRS "expansive informa-

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129. *Id.* at 539 (emphasis added)(citations omitted).

130. *See* Note, *United States v. El Paso Co.*, *supra* note 40, at 720 (arguing that tax pool analyses should be classified as business services, not legal services).

131. *See* Hickman v. Taylor, 329 U.S. 495 (1947); FED. R. CIV. P. 26(b)(3).

132. FED. R. CIV. P. 26(b)(3).

133. *See* FED. R. CIV. P. 26 advisory committee note; *Proposed Amendments to the Federal Rules of Civil Procedure Relating to Discovery*, 48 F.R.D. 487, 501 (1970).

134. 465 U.S. at 815-18.

tion-gathering authority" in order to encourage effective tax investigations.[135]

The Court appeared to reach its decision with relative ease. The Court noted that the doctrine was "founded upon the private attorney's role as the client's confidential advisor and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light."[136] By contrast, the independent auditor serves as a "public watchdog" who maintains total independence from the client at all times and who assumes a public responsibility transcending any employment relationship with the client.[137]

While the Court unequivocally refused to recognize an independent auditor's work product immunity, the case has little, if any, impact on the application of the doctrine to other situations involving taxpayers and their representatives. In fact, the Court explicitly stated that section 7602 is still "subject to the traditional privileges and limitations."[138] Nevertheless, the Court cautioned that "courts should be chary in recognizing exceptions to the broad summons authority of the IRS or in fashioning new privileges that would curtail disclosure under section 7602."[139] It is appropriate, therefore, to consider the applicability of the work product doctrine to an accountant when not acting as an independent auditor.

The work product doctrine was first recognized by the Supreme Court in *Hickman v. Taylor*[140] and was later codified in Federal Rule of Civil Procedure 26(b)(3).[141] In *Upjohn Co. v.*

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135. *Id.* at 816. Even though there is almost no legislative history for I.R.C. § 7602, it has evolved into "the centerpiece" of Congress' intent to give the IRS "expansive information-gathering authority." *Id.* In discussing the congressional intent underlying § 7602, the Supreme Court stated: "[T]his Court has consistently construed congressional intent to require that if the summons authority claimed is necessary for the effective performance of congressionally imposed responsibilities to enforce the tax Code, that authority should be upheld absent express statutory prohibition or substantial countervailing policies." United States v. Euge, 444 U.S. 707, 711 (1980).

136. 465 U.S. at 817.

137. *Id.* at 817-18.

138. *Id.* at 816 (quoting United States v. Euge, 444 U.S. 707, 714(1980)).

139. 465 U.S. at 816-17.

140. 329 U.S. 495 (1947).

141. This rule provides in pertinent part:

> (3) *Trial Preparation: Materials.* Subject to the provisions of subdivision (b)(4) of this rule, a party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and pre-

United States,[142] the Supreme Court upheld the right of an attorney to assert the work product doctrine as a defense to an IRS summons. A 1970 amendment to rule 26(b)(3) expanded the scope of protection to include the work product of a "party's representative (including his attorney, consultant, surety, indemnitor, insurer or agent)."[143] The advisory committee notes to rule 26(b)(3) state that "the weight of authority affords protection of the preparatory work of both lawyers and non-lawyers (though not necessarily to the same extent) . . . ."[144] The notes further state that "[t]he subdivision . . . protect[s] against disclosure the mental impressions, conclusions, opinions, or legal theories concerning the litigation of an attorney or other representative of a party."[145] Arguably, then, Congress intended to extend the scope of the work product immunity doctrine to accountants in appropriate situations, although no cases have so held.

The opinion in *Arthur Young* indicates that an accountant attempting to assert work product immunity must show that his duty to his client as a "confidential adviser and advocate" outweighs the IRS' "expansive information-gathering authority."[146] Presumably, the work product doctrine should apply to an accountant acting as a taxpayer's representative or agent while performing legal services in anticipation of litigation.[147] This position is supported both by the policies underlying the work

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pared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including his attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions or legal theories of an attorney or other representative of a party concerning the litigation.

FED. R. CIV. P. 26(b)(3).

142. 449 U.S. 383 (1981).

143. FED. R. CIV. P. 26(b)(3).

144. FED. R. CIV. P. 26(b)(3) advisory committee note.

145. *Id.*

146. See *Arthur Young*, 465 U.S. at 815-17; *supra* notes 134-35 and accompanying text.

147. U.S. TAX CT. P. R. 200(a)(3) permits a nonlawyer to practice before the tax court upon passage of an examination.

product doctrine[148] and by the Supreme Court's recognition that the scope of the work product immunity must include nonlawyers as well as lawyers.[149]

F. Internal Revenue Manual

The IRS has, arguably, provided some assistance in resolving the controversy over tax accrual workpapers. In a speech delivered on May 5, 1981,[150] Commissioner Roscoe L. Egger, Jr., announced changes to the Internal Revenue Manual that examiners must follow in requesting tax accrual workpapers. These changes, now embodied in section 4024.4,[151] were designed to

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148. *Cf.* Special Project, *The Work Product Doctrine*, 68 CORNELL L. REV. 760, 868 (1983).

149. 422 U.S. 225, 238 ("[A]ttorneys often must rely on the assistance of investigators and other agents in compilation of materials in preparation for trial. It is therefore necessary that the [work product] doctrine protect material prepared by agents for the attorney . . . .").

150. Roscoe L. Egger, Jr., Commissioner of Internal Revenue, remarks made at the Joint Meeting of San Francisco Chapter, California Society of Certified Public Accountants and Tax Section, San Francisco Bar Association (May 5, 1981), *reported in* [May-June] DAILY REPORT FOR EXECUTIVES (BNA) No. 86, at J-1 (May 5, 1981)[hereinafter cited as Egger Speech].

151. This section provides:

> (1) In unusual circumstances, access may be had to the audit or tax accrual workpapers. However, examiners should keep in mind that the taxpayer's records are the primary source of factual data to support the tax return. Accountants' audit or tax accrual workpapers should normally be used only when such factual data cannot be obtained from the taxpayer's records and then only as a collateral source for factual data, access to which should be requested with discretion and not as a matter of standard examining procedure. For example, after the examiner has audited the taxpayer's records regarding the reserve for bad debts, he/she may request the audit workpapers relating to the reserve for bad debts if those workpapers are determined to be necessary. Such a request should be made first to the taxpayer.
>
> (2) Unusual circumstances, for this purpose exist under the following conditions:
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> (a) a specific issue or issues has been identified by the examiner for which there exists a need for additional facts; and
>
> (b) the examiner has sought from the taxpayer all facts known to the taxpayer relating to the identified issue(s); and
>
> (c) the examiner has sought from the taxpayer's accountant supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue(s).
>
> (3) In any case where the unusual circumstances in (2) above furnish a basis for requesting audit or tax accrual workpapers, the examiner should limit the request only to the portion of the workpapers believed to be material and relevant to the examination. Whether an item is considered to be "material" is

"eliminate routine requests for tax accrual workpapers by examiners when they first walk in the door."[152]

Since the revision of the Internal Revenue Manual, the Service's summonses of independent auditors' tax accrual workpapers have decreased substantially, in large part because the restrictions in section 4024.4 are so difficult to satisfy.[153] Because of its narrow scope, however, section 4024.4 provides only limited relief for the taxpayer. For example, section 4024.4 does not apply to criminal or joint IRS investigations. Thus, a special agent in a particular case apparently has discretion to demand the production of tax accrual workpapers at any time.[154] In addition, section 4024.4 provides guidelines only for requesting tax reconciliation workpapers, as defined in section 4024.2(1).

A further problem lies in the possibility that the Internal Revenue Manual could be changed. It is somewhat reassuring, however, that after its victory in *Arthur Young*, the IRS moved quickly to allay fears of any policy change by announcing that it had no plans to alter the guidelines set forth in section 4024.4.[155]

Representatives from Big Eight accounting firms have recently expressed mixed feelings about the continuing usefulness of section 4024.4.[156] Moreover, should the IRS not require strict

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based on the examiner's judgment and an evaluation of the facts and circumstances in the case. However, materiality does not depend entirely on amount. The concept involves qualitative as well as quantitative judgments. For example, the significance of an item or its impact on the tax liability could be some of the factors to be considered in making a judgment regarding materiality.

(4) The reconciliation of Schedule M-1 must be made before considering whether it is necessary to request tax accrual workpapers. Guidelines for the reconciliation are contained in text 232.8 of IRM 4233, Tax Audit Guidelines, Partnerships, Estates and Trusts, and Corporations.

(5) In situations where it is deemed necessary to request tax accrual workpapers in corporate examinations, the prior written approval of the Chief, Examination Division is required. When requesting information pertaining to the tax accrual workpapers, the examiner should first take all reasonable means to secure this information from the corporate officer before looking to the independent auditor to provide the information. This will require the examiner to question and where that is not successful to summon a financial officer or the tax manager of the corporation.

IRM § 4024.4 (1981).

152. Egger Speech, *supra* note 150, at J-1.

153. Matson, *Tax Accrual Workpapers—Does the Service Have a Right of Access?*, 42 INST. ON FED. TAX'N PROC. 4-1, 4-10 (1984).

154. Caplin, *supra* note 7, at 377.

155. IR-84-45, [1986] 9 STAND. FED. TAX REP. (CCH) ¶ 5924.501 (March 29, 1984).

156. James F. Strother, firm counsel of Alexander Grant & Co., expects that in the

adherence by its examiners to the guidelines of section 4024.4, the taxpayer would have little recourse. Courts generally view the IRS' procedural rules as directory, not mandatory, and, thus, unenforceable by the taxpayer.[157]

IV. CONCLUSION

The *Arthur Young* decision probably signals the end of any judicial attempt to create a pure accountant-client privilege. In light of the recent trend requiring more disclosure and discouraging use of the audit lottery, it is unlikely that Congress will act to create such a privilege any time in the near future.This does not mean, however, that documents prepared by accountants are necessarily devoid of protection. The accountant may come within the ambit of the attorney-client privilege if the accountant prepares documents at an attorney's direction in order to assist the attorney in giving legal advice. In addition, the work product immunity doctrine may apply to an accountant acting as a taxpayer's representative or agent while performing legal services in anticipation of litigation.

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long run, the IRS will routinely ask for tax accrual workpapers. "Now that they have access to tax accrual workpapers, I wouldn't be surprised to see the Internal Revenue Manual amended to make it easier for an agent to get clearance to have access to them. It's unnatural to expect forebearance for so abstract a notion as fairness." Sheppard, *No Work Product Immunity for Accountants, Says Supreme Court*, 22 TAX NOTES 1277, 1277-78 (1984). On the other hand, Allan Kramer, General Counsel of Deloitte, Haskins & Sells, does not expect the *Arthur Young* decision to affect many cases. "The likelihood of the IRS going after tax accrual workpapers is remote now, but that policy could change under another Commissioner." *Id.* at 1277.

157. Luhring v. Glotzbach, 304 F.2d 560 (4th Cir. 1962). *See* United States v. Caceres, 440 U.S. 741 (1979)(refusing to exclude evidence obtained in violation of the IRM's procedures because the violation implicated no constitutional or statutory rights).