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Via E-Mail: Comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006

Attention: William J. McDonough
Chairman, PCAOB

**Re: PCAOB Release No. 2004-015; PCAOB Rulemaking Docket Matter No. 017
Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees**

Ladies and Gentlemen:

I am enclosing comments on PCAOB Rulemaking Docket Matter No. 017, "Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees," dated December 14, 2004. The views expressed in these comments represent the position of the Section of Taxation of the American Bar Association, as approved by a majority vote of its Council, and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association or of any American Bar Association entity other than the Section of Taxation. The Section of Taxation is the principal organization of tax lawyers in the United States, with more than 18,000 members nationwide.

These comments are limited to certain technical aspects of Proposed Rule 3522 - Tax Transactions. Proposed Rule 3522 includes several cross references to specific regulations promulgated under provisions of the Internal Revenue Code directed to tax shelter transactions, and incorporates in several significant instances standards utilized in the tax shelter regulations. The Tax Section has particular expertise concerning this area of the law. It has spoken out regularly and consistently about the dangers to the tax system inherent in abusive corporate tax shelter transactions. In addition, the Tax Section has worked with Congress, the Treasury Department and the Internal Revenue Service as they have responded to these transactions through legislation, regulations and revisions of professional standards.

We appreciate the opportunity to submit these comments, and are available to meet with the Board or its Staff to respond to any questions. Please contact the undersigned at (214) 969-4850 (dbdrapkin@jonesday.com), or Stuart J. Offer at (415) 268-7052 (soffer@mofo.com), if that might be helpful.

Respectfully submitted,

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**COMMENTS ON PROPOSED ETHICS AND INDEPENDENCE RULES CONCERNING
INDEPENDENCE, TAX SERVICES, AND CONTINGENT FEES
PCAOB RELEASE NO. 2004-015, DECEMBER 14, 2004
PCAOB RULEMAKING DOCKET MATTER NO. 017
PREPARED BY THE SECTION OF TAXATION
OF THE AMERICAN BAR ASSOCIATION**

The following comments on PCAOB Rulemaking Docket Matter No. 017 represent the position of the Section of Taxation of the American Bar Association (the “Tax Section”), and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association or of any American Bar Association entity other than the Tax Section.

The Tax Section is the principal organization of tax lawyers in the United States, with more than 18,000 members nationwide. The Tax Section has spoken out regularly and consistently about the dangers to the tax system inherent in abusive corporate tax shelter transactions. The Tax Section has worked with Congress, the Treasury Department and the Internal Revenue Service as they have responded to these transactions through legislation, regulations and revisions of professional standards.

The Tax Section provided comments to the Securities and Exchange Commission with respect to the auditor independence rules adopted by the Commission on February 5, 2003.¹ The Tax Section urged the SEC to adopt rules relating to tax shelter product activity by audit firms. In its comments, the Tax Section noted the difficulty in differentiating between tax shelter products and general tax planning, and proposed a definition. *See* Tax Section SEC Comments, at 11-13.

The Tax Section commends the Public Company Accounting Oversight Board (the “Board”) for re-examining certain issues arising out of the provision of tax services that could be viewed as affecting auditor independence. Although the Board, in its proposed rules, addresses several issues, the Tax Section’s comments are limited to Proposed Rule 3522, relating to tax transactions (the “Proposed Rule”). In addition, our comments are limited to certain technical aspects of Proposed Rule 3522 including the incorporation of standards found in the tax law and regulations with respect to which the Tax Section has particular expertise.

1. Proposed Rule 3522--Introductory Language

Proposed Rule 3522 applies when a registered public accounting firm, or an affiliate of the firm, provides any non-audit service to the audit client relating to “planning, or opining on the tax treatment of, a transaction” of the type described in subsection (a), (b) or (c) of the Proposed Rule.

(a) Opining. Neither the Proposed Rule nor the Release elaborates on when the accounting firm will be considered to be “opining” on a transaction for purposes of the Proposed

¹ Comments on Proposed Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence, File No. S7-49-02, prepared by the Sarbanes-Oxley Task Force of the Section of Taxation of the American Bar Association, Jan. 6, 2003 (the “Tax Section SEC Comments”).

Rule. Thus, it is not clear, for example, whether “opining” covers both oral and written advice, or whether “opining” is intended only to describe advice intended to be relied upon by the audit client in preparing its tax returns or for other purposes.

Recently adopted regulations governing practice before the Internal Revenue Service² establish standards with respect to certain tax opinions. For purposes of these regulations, a “covered opinion” is limited to “written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues” 31 C.F.R. §10.35(b)(2)(i).

We recommend that the Board, either in the final Rule or in its adopting release, consider the classification of tax opinions established by the Circular 230 Regulations in regard to providing guidance on when an audit firm is “opining” for purposes of the Proposed Rule. The Board should clarify whether the term “opining” is intended to cover both oral and written advice. If the Board determines to limit “opining” to written advice, the treatment of electronic communications (such as email) should be addressed. We also recommend that the Board consider whether, and to what extent, the presence or absence of reliance disclaimers (as described in the Circular 230 Regulations³) should affect whether an audit firm will be considered as “opining” for purposes of the Rule.

(b) Transactions. Neither the Proposed Rule nor the Release defines the term “transaction.” We recommend that the Board, either in the final Rule or in its adopting release, clarify the scope of the term. We believe that the term should include a “partnership or other entity, or an investment plan or arrangement.”⁴ At the same time, we believe that it would be appropriate to confirm that the term “transaction,” as it applies to Proposed Rule 3522(c) (applicable to a transaction “a significant purpose of which is tax avoidance”) should be interpreted to apply to a business transaction taken as a whole, and not limited only to the tax planning for the transaction. For example, in the context of a business acquisition where tax advice is provided with respect to the form of the consideration used in the acquisition, the term “transaction” should encompass all aspects of the acquisition, and the issuance of consideration to the target company and the related tax planning should not be viewed as a separate transaction. A definition of “transaction” that results in focusing on tax planning in isolation would have the effect of rendering the phrase “a significant purpose of which is tax avoidance” in Proposed Regulation 3522(c) meaningless as almost all tax planning has the minimization of taxes as a significant purpose.

2. Proposed Rule 3522(a)--Listed Transactions

Proposed Rule 3522(a) would treat a registered public accounting firm as not independent of its audit client if the firm, or any affiliate of the firm, provides non-audit services relating to

² T.D. 9165, 69 Fed. Reg. 75839, December 20, 2004, amending 31 C.F.R. part 10 (the “Circular 230 Regulations”).

³ See 31 C.F.R. §10.35(b)(4)(ii).

⁴ The Circular 230 Regulations, in identifying the scope of covered opinions, refer to opinions concerning one or more Federal tax issues “arising from”: (a) a “transaction that is the same as or substantially similar to” a listed transaction; (b) a “partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code”; or (c) any “partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code” 31 C.F.R. §10.35(b)(2)(i).

the planning, or opining on the tax treatment of, a “listed transaction” as defined in regulations under section 6011 of the Internal Revenue Code (“IRC”). The proposing Release notes that the Proposed Rule does not address situations in which a transaction planned or opined upon by the registered public accounting firm becomes listed after it is executed, and requests comments on how to address this situation. The Proposed Rule would apply whether or not the audit firm would be considered a “material advisor” with respect to the transaction under the tax regulations.

The Board’s proposal reflects in many aspects the recommendations of the Tax Section in the Tax Section SEC Comments. As indicated in those comments, we believe that the auditor independence principles enunciated by the SEC are necessarily implicated when the audit firm or its affiliates actively assists an audit client in implementing a listed transaction or a transaction substantially similar to a listed transaction and then is required to evaluate the transaction (including the likelihood of penalties) in the audit of the client’s financial statements. The Tax Section SEC Comments were predicated, however, on the audit firm being a material advisor to the client. *See* Tax Section SEC Comments at p.13.⁵

IRC §6111(b), as recently amended by the American Jobs Creation Act of 2004, defines “material advisor” as any person “who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction” and “who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary of the Treasury) for such advice or assistance.” The statute establishes \$250,000 as the threshold amount in the case of a reportable transaction involving a corporation. Existing Treasury Regulations promulgated under IRC §6111 prior to the 2004 amendment established dual thresholds: \$250,000 for reportable transactions involving corporations, other than listed transactions, and \$25,000 for listed transactions involving corporations.⁶

The applicable tax law provisions reflect the fact that advisors covered by the law who participate in reportable transactions and fail to promptly notify the tax authorities are liable for substantial penalties. *See* IRC §6707. The minimum fee threshold provides some balance to the broad scope of activities that may be subject to penalties.

In the proposing Release, the Board does not comment on the failure to include a requirement in the Proposed Rule that the audit firm be a “material advisor” for the Proposed Rule to apply, but does comment on the “minimum fee” requirement in the Treasury Regulations governing confidential transactions.⁷ In rejecting a minimum fee requirement for Proposed Rule 3522(b), the Board states that it “does not believe that the amount paid in connection with an auditor’s provision of a confidential transaction bears on an auditor’s independence, in fact or appearance.” The Tax Section fully understands the Board’s reasoning as it applies to Proposed

⁵ The Tax Section SEC Comments recommended that an audit firm be considered a “material advisor” if it had received a fee of \$250,000 or more from any person in connection with the offering of the tax strategy to any corporation (not limited to the audit client) and made or provided any statement, oral or written, to any person as to the potential tax consequences of the transaction.

⁶ 26 CFR §301.6112-1(c)(3).

⁷ Release at p. 30 fn.62.

Rule 3522(b) where the conditions of confidentiality are imposed by the audit firm.⁸ We do not believe, however, that the Board's comment addresses the broader question whether it is generally appropriate to impose disqualification on an audit firm whose participation in a particular transaction is neither material to the transaction nor of sufficient magnitude to attract some minimum fee.

As the terms "planning, or opining on the tax treatment of, a transaction" may be broadly construed, we recommend that the Board consider adopting some financial threshold before the activities of the audit firm or its affiliates result in loss of independence. Whether the Board opts for one of the financial thresholds in the IRC or tax regulations, or some other *de minimis* standard, is a policy judgment for the Board.

Regardless of whether the Board elects to adopt a financial threshold, we believe that the Board should clarify that a registered public accounting firm does not lose independent status simply by advising an audit client *not* to engage in a listed transaction or a transaction substantially similar to a listed transaction, or in advising a client that a proposed transaction is such a transaction. It would be unfortunate if rules that have been proposed in response to the potential adverse impact on audit firms of participation in tax shelter activities⁹ were interpreted to preclude one of the audit client's usual tax advisors from counseling against participation in such transactions.

In response to the Board's request for comments concerning the circumstance where an audit firm plans or opines with respect to a transaction that subsequently becomes a listed transaction, we note the likelihood that such transactions would be described in Proposed Rule 3522(c). We recognize that Proposed Rule 3522(a) applies whether or not the transaction is initially recommended by a tax advisor to the audit client, while Proposed Rule 3522(c) applies only when the transaction is initially recommended by outside advisors. If the Board believes, however, that it is necessary to deal with the situation where a transaction (i) is initiated by the audit client, and (ii) becomes listed after implementation, we believe it is better to deal with it through a change in Proposed Rule 3522(c), which incorporates a "more likely than not" standard that can be applied by the audit firm in screening transactions, than through a retroactive application of Proposed Rule 3522(a), which contains no such standard.

3. Proposed Rule 3522(b)--Confidential Transactions

Proposed Rule 3522(b) would find a registered public accounting firm not independent if it provides any non-audit service with respect to planning, or opining on the tax treatment of, a confidential transaction within the meaning of 26 CFR §1.6011-4(b)(3), determined without regard to the minimum fee requirement of 26 CFR §1.6011-4(b)(3).

The Section of Taxation, in the Tax Section SEC Comments, identified audit firm participation in transactions marketed under conditions of confidentiality as transactions likely to erode confidence in the results reflected in a registrant's audited financial statements.¹⁰ As

⁸ As discussed below, it does not appear that Proposed Rule 3522(b) is limited to circumstances where the conditions of confidentiality are imposed by the audit firm.

⁹ See, e.g., Release at pp. 25-27.

¹⁰ Tax Section SEC Comments at p. 12.

drafted, however, the Proposed Rule would apply even when the condition of confidentiality is not imposed by the registered public accounting firm or its affiliate, or for the benefit of either. We note that this represents a policy judgment by the Board which differs from that reached in the incorporated tax regulations, as they affect advisors.

Assuming that the Board believes that auditor independence issues are raised by auditor participation in planning, or opining on the tax consequences of, a transaction where neither the auditor nor an affiliate of the auditor imposes the confidentiality requirement (either because the Board believes that it is too easy to manipulate which advisor requires confidentiality or because of concern with such transactions generally), we reiterate our recommendation above that some *de minimis* fee threshold should apply before the Proposed Rule is applied. Similarly, we believe that an exception for negative advice should be added.

Under the tax regulations, as a result of the minimum fee requirement that is expressly carved out of the Proposed Rule, it is highly unlikely that an advisor could participate in a transaction at a level in which it earns the minimum fee without knowledge of the existence of the confidentiality requirement. In the absence of a minimum fee requirement, it seems possible that an advisor with only a nominal role in implementing the transaction might not know or have reason to know of the confidentiality condition. This suggests to us that, absent a minimum fee requirement, the Proposed Rule should be clarified to apply only when the audit firm knows, or has reason to know, of the confidentiality condition at the time of its participation in the transaction.

4. Other Reportable Transactions

The Release requests comments on whether other provisions of the Treasury Regulations on reportable transactions should be incorporated by reference in the Board's rules on tax-oriented transactions that impair independence. These currently include: (i) transactions with contractual protection; (ii) certain loss transactions exceeding a threshold; (iii) certain book-tax differences exceeding a threshold; and (iv) assets with a brief holding period.¹¹

We do not believe that the policies underlying the reportable transactions tax regulations (to the extent that they apply to transactions other than listed transactions or transactions with confidentiality restrictions) have the same direct correlation to issues of auditor independence as would be the case where the auditor participates in a listed transaction or a transaction offered under conditions of confidentiality. The transactions reported under these other provisions are likely to include a far greater percentage of entirely legitimate transactions than those that are captured by the listed transaction or confidentiality rules.

5. Proposed Rule 3522(c)--Aggressive Tax Positions

Proposed Rule 3522(c) would find a registered public accounting firm not independent if it provides any non-audit service with respect to "aggressive tax positions." An aggressive tax position is defined as one "that was initially recommended by the registered public accounting firm or another tax advisor and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws."

¹¹ See 26 CFR §1.6011-4(b).

The Release states that the “more likely than not” standard refers to the standard that, under 26 CFR §1.6664-4(f), is required to avoid penalties for substantial understatement of income tax due in connection with tax shelter items of a corporation.¹²

In the proposing Release, the Board asks for comments on whether the term “initially recommended by the registered public accounting firm or another tax advisor” is sufficiently clear. It also asks for comments on whether the “more likely than not” standard is the appropriate standard. Finally, the Board requests comments on whether the registered public accounting firm should be required to obtain a third-party tax opinion in support of the tax treatment if the potential effect of the treatment could have a material effect on the audit client’s financial statements.

(a) “Initially Recommended.” In the Tax Section SEC Comments, the Section of Taxation proposed to define “tax shelter product” to include a transaction that “has a principal purpose of tax avoidance and the audit firm actively participates in the promotion or marketing of the transaction to potential corporate consumers.”¹³ The Tax Section SEC Comments also noted that it was common for more than one tax shelter promoter to offer similar products and that it was unreasonable to expect an audit firm to provide an unbiased, frank evaluation of another promoter’s similar tax shelter product to an audit client.¹⁴

The Board’s proposal differs somewhat from the Tax Section SEC Comments in that it distinguishes between transactions initially recommended by the audit firm (or another tax advisor) to the audit client and transactions initiated by the audit client. It is possible that the audit client could independently develop an aggressive transaction without input from a tax advisor. It is more likely, however, that an audit client would learn of an aggressive transaction from the audit firm or another tax advisor (such as through an educational program or seminar for selected firm clients, or a “clients and friends” newsletter). The Board may wish to clarify whether a transaction will be considered “initially recommended by the registered public accounting firm or other tax advisor” when the transaction is first brought to the attention of the audit client in this fashion.

We also are uncertain how the Board intends to apply the “initially recommended” standard when the audit client approaches a tax advisor with a problem, and the solution recommended by the tax advisor is a transaction a significant purpose of which is tax avoidance and that does not satisfy the more likely than not standard. We assume that the Board would intend Proposed Rule 3522(c) to apply in this circumstance, even though the consultation had been initiated by the audit client.

We note that the Proposed Rule refers to “the registered public accounting firm” and not “the registered public accounting firm or any affiliate of the firm.” We assume that the Board intends that affiliates of registered firms be included in the term “another tax advisor.”

(b) “More Likely Than Not.” We believe that the selection of the “more likely than not” standard is a reasonable policy judgment of the Board. As the concern addressed in the

¹² Release at p. 33.

¹³ Tax Section SEC Comments at pp. 12-13.

¹⁴ *Id.* at p. 12.

Proposed Rules is participation in aggressive tax transactions with potential exposure to penalties, the “more likely than not” standard most closely reflects the level of tax certainty required to avoid penalties. We are aware that consideration is being given by the Financial Accounting Standards Board to the adoption of a higher standard for purposes of recognition of tax assets on financial statements as a proposed Interpretation to Statement 109, but we believe that the concern addressed in that proposal differs from the concerns underlying the Proposed Rules.

We recommend that the Board consider expanding the description of the “more likely than not” standard to make clear both the required scope of the opinion and the diligence required to reach the conclusion. For example, the Circular 230 Regulations, which were finalized after the date the Release was published, establish requirements for “covered opinions.” The Circular 230 Regulations require that the practitioner: (i) use reasonable efforts to identify and ascertain the facts on which the opinion is based; (ii) relate the law to the facts; and (iii) evaluate and conclude as to all significant Federal tax issues. *See* 31 CFR §10.35(c).

At present, neither the Release nor the federal income tax law defines “significant purpose.” Now-repealed regulations under IRC §6111 provided a general definition (“structured to produce tax benefits that constitute an important part of the intended results of the arrangement”), and excluded transactions entered into in the “ordinary course of business” consistent with “customary commercial practice.” The Board should consider providing further guidance indicating how the term “significant purpose” is to be defined.

The definition of “tax advisor” could create uncertainty because a superficial reading of the term would suggest an advisor that has professional tax expertise, whereas the Release (at footnote 65) clearly indicates that any advisor, regardless of expertise, could be implicated. The Board, therefore, may want to refine its terminology.

It is clear that the Proposed Rule requires the audit firm to form its own judgment whether the proposed tax treatment of a transaction is at least more likely than not to be allowable under applicable tax law, whether or not the audit firm actually opines on the proposed transaction. Thus, auditor independence apparently would require the audit firm, or an affiliate of the audit firm, providing non-audit services relating to the planning of a transaction to reach a conclusion with respect to both the issue of tax avoidance purpose and the issue of the likelihood of success prior to performing any services, since it would be too late to avoid disqualification if the audit firm reached an adverse conclusion and withdrew from the transaction after it had performed some services. (We note that, again, there is no *de minimis* fee threshold with respect to the Proposed Rule.)

The Proposed Rule could also be read to apply to transactions that are abandoned before completion because the audit firm, or some other tax advisor, concludes that it is not able to provide a more likely than not opinion.¹⁵ If the concern underlying the Proposed Rule arises out of the potential conflict of interest in advising on a transaction and evaluating how the

¹⁵ Consistent with our prior recommendations in these comments, we recommend that the Board specifically provide that negative advice by the audit firm not give rise to auditor independence concerns under Proposed Rule 3522(c).

transaction is reported on the audit client's financial statements, it may be advisable to limit the scope of the Proposed Rule to implemented transactions.

(c) "Third Party Opinions." We are uncertain of what the Board is proposing with respect to third-party opinions in the context of Proposed Rule 3522(c). In the Tax Section SEC Comments, we recommended that if the SEC did not adopt rules regulating the tax shelter practices of audit firms with respect to audit clients, that *audit committees* consider seeking independent review of either the proposed transaction or the audit client's tax reserves to assure that the reserves appropriately reflected the level of the potential risks.¹⁶ The purpose of this recommendation was to protect the audit client, not the auditor, and was limited to tax shelter transactions (as defined).

We are not aware of current circumstances in which an audit firm would obtain a tax opinion with respect to an audit client's transaction for the benefit of the audit firm. We could foresee circumstances, if the Proposed Rule is adopted, where it might be in the interest of the audit firm to obtain such an opinion to support its position that it did not forfeit independence by participating in or opining on a transaction. It may not be in the interest of the audit client to share with a third person the information necessary to prepare such an opinion. Moreover, the standard suggested by the Board on when such an opinion might be required (*i.e.*, "if the potential effect of the treatment could have a material effect on the audit client's financial statements") appears to mix the personal interests of the auditor in avoiding disqualification with a standard relating to the accuracy of the audit client's financial statements. If the issue of concern to the Board is the accuracy of the *audit client's* financial statements, it is not clear whether it is appropriate for the auditing firm, rather than the audit client, to obtain an opinion, if a third-party opinion is to be obtained. Moreover, as it is entirely possible that the standard for reporting a transaction on financial statements could differ from the standard applicable to tax penalties, it is not clear that a third-party opinion addressing the tax treatment of the transaction under the more-likely-than-not standard would necessarily resolve any financial statement issue. For these reasons, we question whether a third-party opinion of the type described in the proposing Release would advance the purposes of the Proposed Rules.

6. General Comment--References to Tax Regulations

The Proposed Rule adopts specific tax regulations by reference. The Board may wish to clarify in the final Rule whether Rule 3522 will be applied with reference to the tax regulations in effect when the final Rule becomes effective, or as they subsequently may be amended. More broadly, we note that the tax law and underlying tax regulations relating to listed transactions, reportable transactions, and "reportable avoidance transactions" (a reportable transaction, other than a listed transaction, "if a significant purpose of such transaction is the avoidance or evasion of Federal income tax")¹⁷ are in a state of constant development and revision. Moreover, the statutory and regulatory provisions are subject to administrative interpretation by the IRS as well as possible judicial review. It is possible that revisions could be given retroactive effect. The Board's decision to implement auditor independence standards by incorporating substantive provisions of the tax laws should be made with an awareness of this state of affairs. The Board

¹⁶ Tax Section SEC Comments at p. 12.

¹⁷ IRC §6662A(b)(2)(B), as added by the American Jobs Creation Act of 2004.

should consider the extent to which the standards it adopts should be subject to subsequent interpretations or revisions of the underlying tax rules by Congress, the Treasury Department (including the IRS) and the courts, as well as the implicit burden imposed on the Board to monitor these developments.

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We appreciate the opportunity to submit these comments, and are available to meet with the Board or its Staff to respond to any questions you have. Please contact Dennis B. Drapkin, the Chair-Elect of the Section of Taxation ((214) 969-4850; dbdrapkin@jonesday.com) or Stuart J. Offer ((415) 268-7052; soffer@mofocom), if that might be helpful.