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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 017
Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees

Dear Mr. Secretary:

McGladrey & Pullen, LLP is pleased to submit written comments on the proposed ethics and independence rules concerning independence, tax services, and contingent fees. McGladrey & Pullen, LLP is a registered public accounting firm serving middle-market issuers.

General Comments

We agree with the Board's conclusion that neither routine tax return preparation and tax compliance services nor general tax planning and advice in connection with business transactions initiated by the audit client raise independence concerns. Furthermore, we see no conceptual basis why these same types of services would raise independence concerns when performed for senior officers.

We agree that auditors should not be permitted to recommend potentially abusive tax positions to their audit clients. However, we are concerned that Proposed Rule 3522, as drafted, poses an extremely difficult standard that, in many cases, will have an unintended consequence – that is, we are concerned that audit committees and auditors will conclude that the risk of violating the rule is simply too great to permit an issuer to utilize the auditor for general tax planning and advice.

Similarly, where the Board has concluded that tax services do not raise independence concerns, we believe that is unnecessary to specify audit committee preapproval requirements in excess of those required by the current rules. We are concerned that the requirements of Proposed Rule 3524 will also have an unintended consequence – it will send a message to audit committees that even permitted tax services should be viewed with extreme skepticism. We are concerned that management and audit committees will simply decide that it's not worth the effort to use the auditor to provide any tax services.

If our fears materialize, issuers will incur substantially greater costs for tax compliance and advisory services, which could have an adverse effect on job creation and competitiveness of the issuers. In addition, we believe separation of audit and tax services would result in decreased competition among the

providers of both services. This may be another example of over-regulation of mid-sized issuers, who are struggling to understand and comply with the existing requirements of the Sarbanes-Oxley Act and the host of existing rules that have been promulgated thereunder.

Proposed Rule 3502

We are concerned that under the proposed rule, an associated person could *cause* the registered firm to violate the Act, the Rules of the Board, or the provisions of the securities laws due to an act or omission the person knew or should have known would *contribute to* such violation. It seems to us that *contributing to* a violation is a far cry from *causing* a violation, especially in the case of an omission. In addition, we are not sure that this rule is necessary, or the best approach, to subjecting associated persons to the Rules of the Board.

Proposed Rule 3520

We are concerned that, as drafted, this rule is overly broad and may conflict with the existing SEC rules. For example, Rule 2-01(c)(1)(iii)(B) provides an exception to the general rule on accountant's financial relationships with respect to a new audit engagement. Accordingly, we suggest that "as required by applicable independence rules" or "subject to exceptions set forth in applicable independence rules" be added to the end of this rule.

Proposed Rule 3522 (a)

Treas. Reg. §1.6011-4 requires taxpayers to disclose transactions meeting one of six categories of "reportable transactions," including transactions that are substantially similar to "listed transactions." The regulations provide that the term "substantially similar" is to be broadly construed in favor of disclosure. Much of the current authority identifying listed transactions is so broadly worded that it captures both transactions having potential for tax abuse and legitimate business transactions. Some of the listed transaction authority also requires disclosure of transactions by parties that receive no tax benefit from the transaction. Requiring disclosure from multiple parties increases the likelihood that the IRS will be able to review a transaction.

The purpose of Treas. Reg. §1.6011-4 is to elicit disclosure of transactions that enables the Treasury and the Internal Revenue Service (IRS) to evaluate whether an individual transaction is in fact abusive. The reporting of a transaction under Treas. Reg. §1.6011-4 (as a listed transaction or otherwise) does not affect the legal determination of whether the Federal income tax reporting of the transaction is proper. This expansive approach to requiring disclosure is entirely appropriate when the purpose is to identify transactions that the IRS believes merit review. An expansive approach is not appropriate when, without further review of a transaction's merits, it is presumed to be abusive.

In the situation in which a transaction bears some similarity to a listed transaction, but where it is unclear whether the transaction is "substantially similar" within the meaning of Treas. Reg. §1.6011-4(c)(4), a registered firm might wish to advise a client to make a "protective disclosure" in its tax return to avoid even a remote chance of incurring a penalty for failure to disclose a listed transaction. However, under the proposed rule, the protective disclosure would be evidence that the transaction was in fact a listed transaction impairing the firm's independence. In this situation, the proposed Rule creates a disincentive for a client to make a protective disclosure or for the registered public accounting firm to recommend protective disclosure. Such a disincentive does not advance public confidence in the registered firm's report on the client's financial statements, nor does it advance the true purpose of the "listed transaction" definition to encourage broad transaction disclosure to facilitate further IRS review.

The IRS may identify a transaction as a listed transaction at any time. The Release accompanying the proposed Rule acknowledges that a firm's independence could be intact when a transaction is implemented, even if the transaction is later listed by the IRS. We believe that the Rule should specifically state that independence would only be impaired if the transaction is listed at the time that the services are performed. In addition, a transaction may become listed during the course of the auditor's services with respect to such transaction. We believe that, so long as the services would have been permitted under proposed Rule 3522(c), this rule should make it clear that the auditor would be permitted to cooperate in transitioning the service to a successor tax advisor without impacting the firm's independence.

Finally, the proposed rule should permit an auditor to provide negative tax advice (*i.e.*, a recommendation not to proceed with a listed transaction) to an audit client concerning a listed transaction proposed by the client or a third party.

Proposed Rule 3522 (b)

Treas. Reg. §1.6011-4(b) provides that a transaction is reportable as a "confidential transaction" if any tax advisor who receives a minimum fee provides tax advice to a client under conditions of confidentiality. The proposed rule fails to consider a situation in which an audit client receives tax advice from more than one advisor. For example, if an audit client seeks tax advice from an independent law firm and from the auditor, if the law firm imposes confidentiality conditions on the audit client, the proposed rule would treat the auditor as not independent.

We do not believe that the actions of an independent third party should determine whether or not the auditor is independent. We believe that the rule should be revised to limit any impact upon independence to situations in which the auditor imposes confidentiality conditions upon the audit client. We believe that Rule 3522 (b) should be revised to read as follows:

> **(b) Confidential Transactions** – **in which the registered public accounting firm imposes conditions of confidentiality** ~~that is a confidential transaction~~ within the meaning of 26 C.F.R. § **1.**6011~~.1~~-4(b)(3)**(ii)**~~, or that would be within the meaning of 26.C.F.R. § 6011.1 4(b)(3) if the fee for the transaction were equal to or more than the minimum fee described in 26.C.F.R. § 6011.1 4(b) (3)~~; or

Proposed Rule 3522 (c)

The proposed rule refers to transactions having a "significant purpose" of tax avoidance and requires a registered public accounting firm to reach a conclusion of "more likely than not" in order to provide any tax advice without impairing its independence. This approach mirrors the approach to "tax shelters" and penalties in IRC §6662(d)(2)(C) and §6664. The problem with the "significant purpose" test is that it provides virtually no guidance to distinguish between abusive transactions that may impair a firm's independence and routine tax planning.

What is a "significant purpose" of tax avoidance? Whenever a client seeks tax advice before implementing a tax strategy or transaction, is not the avoidance or minimization of taxes a "significant purpose" of seeking advice? N. Jerold Cohen, former Chief Counsel to the IRS and former chair of the American Bar Association Section of Taxation, recently stated that applying the significant purpose test literally would mean that all tax planning that he has done during his 40-year career would have met this test.[1]

[1] Comments of N. Jerold Cohen at the Tax Shelter Enforcement Conference, sponsored by BNA Tax Management, October 15, 2004.

The IRS and Treasury have recognized the difficulty of applying "significant purpose" as the sole test to identify a potentially abusive tax shelter transaction. When Treasury proposed using a stand-alone "significant purpose" test to define a "tax shelter" for purposes of Circular 230, practitioners decried the lack of specificity of this definition. Treasury ultimately abandoned "significant purpose" as a stand-alone test.

The proposed rule's use of "significant purpose" as an imprecise stand-alone test would essentially require that a registered public accounting firm render no tax advice to an audit client at less than a "more likely than not" standard for the firm to have any assurance of maintaining independence. The rule would therefore have an impact far beyond the abusive transactions that might potentially impact a firm's independence.

The proposed Rule also does not distinguish between advice rendered in tax planning or transactions initially recommended by the registered public accounting firm and those initially recommended by a third party. Consider a situation in which a client is approached by a third party tax advisor with a tax planning strategy. The third party tax advisor will deliver or will assist the client in obtaining a tax opinion concerning the transaction. In deciding whether to implement the strategy, the client asks its auditor, a registered public accounting firm, for an assessment of the merits of the strategy and whether the tax reporting of the transaction as proposed by the third party would raise financial reporting considerations. The proposed rule would prevent the registered public accounting firm from providing any advice at less than a "more likely than not" level of assurance concerning the merits of the transaction. Because of the cost of due diligence to reach that level of assurance (if in fact it can be reached), an audit client would be discouraged from seeking a "second opinion" from its registered public accounting firm.

In the case of third party advice, a registered firm's independence is not likely to be impaired unless the registered firm both endorses the transaction and the client relies primarily on that endorsement (as opposed to the third party advice) in implementing the transaction. If a client ultimately relies on the third party advice (as opposed to the registered firm's advice) in deciding whether to pursue a transaction, it should not be necessary for the registered firm to reach a conclusion of "more likely than not" to avoid independence issues.

To address the issues identified above, we believe that Rule 3522 (c) should be revised to read as follows:

> **(c) Aggressive Tax Positions** –that was initially recommended by the registered public accounting firm or ~~another tax advisor~~ **its affiliates** 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. **For purposes of this Rule, a transaction will not be deemed to have a significant purpose of tax avoidance if the audit client has a predominant non-tax business purpose for the transaction. The fact that an audit client would elect not to proceed with a transaction absent certain tax treatment or tax consequences will not be deemed a significant purpose of tax avoidance.**

Proposed Rule 3523

As indicated in our general comments, we do not see any conceptual basis for limiting tax services to senior officers beyond the limitations that would apply to the audit client itself. In fact, if only those limitations were applied, we believe they should be extended to outside directors as well. However, if the final rule completely prohibits tax services for senior officers, we do not believe it would be either practical or necessary to extend a complete prohibition to outside directors.

The release makes it clear that the proposed rule would extend only to *officers in a financial reporting oversight role*, and not to outside directors. The term "officer" is not defined, however, and the release states, "Whether someone is an officer would depend on the person's function rather than title or designation in the company's bylaws." Proposed rule 3501(f)(i) would define the term "financial reporting oversight role" in a manner that is consistent with the definition in Rule 2-01 of Regulation S-X. However, that term includes persons who would not normally be considered officers (e.g., controller, director of internal audit and director of financial reporting), and it is unclear whether such persons would be considered "officers" for purposes of this rule. In addition, the proposing release and the title of the proposed rule refer to *Senior Officers*, which implies that the Board intended to apply the restrictions to only certain officers rather than all officers (or persons) in a financial reporting oversight role.

Finally, we believe that certain transitional provisions are necessary to address situations in which clients of the auditor are promoted or hired into such a position, when an issuer first becomes an audit client, when an issuer first becomes subject to the rule (e.g., as a result of an IPO), and for certain follow-up services (e.g., assistance with an examination of tax returns) relating to tax services that were provided by the auditor before the effective date. Such transition provisions are particularly important if the complete prohibition on providing tax services to senior officers is retained in the final rule.

Proposed Rule 3524

As indicated in our general comments, for permitted tax services, we do not believe it is either necessary or appropriate to specify audit committee preapproval requirements in excess of current requirements.

In addition, we are concerned with the implication in the proposing release that an audit client must employ a competent tax director in order for the auditor to independently provide permitted tax services. Most small and mid-sized issuers do not employ tax directors; however, the chief financial officer of the issuer is normally competent to oversee the tax services, make all decisions with respect to tax positions taken, and accept responsibility for the results of the services. Accordingly, there is no risk that the auditor would be placed in a position of making management decisions on behalf of the audit client.

We are concerned that the proposing release unreasonably elevates the extent of documentation that an audit committee would be required to consider in approving permitted tax services. For example, in some cases, it would not be practicable to completely and accurately specify in advance *each* type of return to be filed in *each* jurisdiction at the time of audit committee preapproval.

We are also confused by the implications of paragraph (a)(ii) of the proposed rule, which appears to imply that an auditor could promote, market or recommend a transaction or pay a commission in connection with such a transaction. We thought the purpose of proposed rule 3522 was to prohibit the auditor from having any involvement in such activities.

While paragraphs (b) and (c) of the proposed rule appear reasonable on the surface, those provisions in combination with the requirements of rule 3522, will result in significantly more involvement of tax professionals in much lengthier discussions with the audit committee, which will result in significant additional costs to the issuer. Overall, we believe the benefit to be derived from this rule does not justify its cost.

Closing Comments

Because of the likelihood that State Legislatures and State Boards of Accountancy will consider extending these requirements beyond issuers subject to the rules of the SEC and PCAOB, we urge the Board to carefully consider the potential "trickle down" effect of its rulemaking activities on private companies and

their auditors. In most private companies, the interests of the company and management are aligned and the potential for conflicts of interest is virtually nonexistent. Accordingly, for private companies and their auditors, restrictions such as those included in the proposed rules are not necessary to protect the public interest.

Thank you for the opportunity to comment on this proposed standard. Questions concerning our comments should be directed to Leroy Dennis, Executive Partner – Assurance Services (952.921.7627) or Kimpa Moss, Executive Partner – Tax Services (952.921.7616).

Very truly yours,