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Is Your Company's Auditor Independent? Proposed New Rules Address Tax Services PCAOB Release No. 2004-015 (July 26, 2005)

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Securities and Exchange Commission rules and the professional standards of the American Institute of Certified Public Accountants require auditors to be independent of their audit clients. A new rule-making body for public company accounting firms has created new rules that put that standard into practice; however, these rules must be approved by the Securities and Exchange Commission ("SEC") to become effective.

The Public Company Accounting Oversight Board ("PCAOB") was created by the Sarbanes-Oxley Act of 2002 and charged with overseeing auditors of U.S. public companies and creating rules governing public company auditors. The establishment of the PCAOB was Congress' response to Enron- and Worldcom-type scandals and the tax shelter and accounting abuses of the 1990s.

On July 26, the PCAOB adopted proposed rules addressing the promotion of tax shelters and other activities that could impinge upon auditors' independence. The proposed rules will become effective upon approval by the SEC.

The PCAOB's proposed rules ("Rules") establish the fundamental ethical standard that a registered public accounting firm and its related companies must be independent of the firm's audit client throughout the audit and professional engagement period.¹ The independence obligation encompasses PCAOB rules and SEC rules and regulations but does not extend to associated persons that are not required by the SEC to be independent.²

The Rules establish three major types of transactions that prevent an audit firm from being independent of its audit client:

¹ PCAOB Proposed Rule 3520, PCAOB Release No. 2004-015 (July 26, 2005).

² PCAOB Proposed Rule 3520, n. 1, 2, PCAOB Release No. 2004-015 (July 26, 2005).

- 1) Contingent fees—If the firm or an affiliate³ provides any service on a contingent fee or commission or receive a contingent fee or commission from the audit client.
- 2) Tax transactions—If the firm or an affiliate provides an audit client with any non-audit service related to the marketing, planning, or opining in favor of the tax treatment of confidential transactions or aggressive tax position transactions.
- 3) Tax services to certain persons—If the firm or an affiliate provides any tax service to a person in a financial reporting oversight role at the audit client or an immediate family member of such a person.⁴

Confidential Transactions

The PCAOB believes that requiring clients to maintain the confidentiality of tax products marketed, planned, or opined in favor of so that those tax products may be marketed to multiple clients erodes public confidence in the ethics and integrity of public accounting firms.⁵ "A reasonable investor easily could infer that the auditor has a vested interest in advocating to the IRS the tax treatment it promoted, or helped to promote, to multiple clients and perpetuating that treatment in the audit client's financial statements."⁶

The Treasury has identified confidential transactions as potentially abusive, and tax regulations require taxpayers to disclose to the IRS transactions in which a tax advisor "places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies."⁷

"A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor fee."⁸ A transaction is offered to a taxpayer "under conditions of confidentiality" if the advisor being paid the fee "places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that tax advisor's tax strategies."⁹ A transaction is still a confidential transaction even if the conditions of confidentiality are not legally binding on the taxpayer.

³ "Affiliate of the accounting firm" includes the accounting firm's parents; subsidiaries; pension, retirement, investment and similar plans; and any associated entities as defined by SEC regulations. PCAOB Proposed Rule 3501(a)(i), PCAOB Release No. 2004-015 (July 26, 2005).

⁴ "Immediate family member" means a person's spouse, spousal equivalent, and dependants. Rule 3501(g)(i), PCAOB Release No. 2004-015 (July 26, 2005).

⁵ PCAOB Release No. 2004-015, part II(B)(3)(b) (July 26, 2005).

⁶ PCAOB Release No. 2004-015, part II(B)(3)(b) (July 26, 2005).

⁷ 26 C.F.R. § 1.6011-4(b)(3)(ii).

⁸ PCAOB Proposed Rule 3501(c)(i)(1), PCAOB Release No. 2004-015 (July 26, 2005).

⁹ PCAOB Proposed Rule 3501(c)(i)(2), PCAOB Release No. 2004-015 (July 26, 2005).

Registered public accounting firms may not market, plan, or opine in favor of the tax treatment of a confidential transaction whether or not the accounting firm imposed the conditions of confidentiality or whether another tax advisor did so.¹⁰

A transaction is not offered "under conditions of confidentiality" just because the promoter or advisor claims that a transaction is proprietary or exclusive if the advisor "confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction."¹¹

Aggressive Tax Positions

Under Rule 3522, an accounting firm is not independent of its audit client if the accounting firm or an affiliate provides services related to the marketing, planning or opining in favor of the tax treatment of an aggressive tax position transaction. An aggressive tax position transaction is a transaction initially recommended, directly or indirectly, by the accounting firm or an affiliate when a significant purpose of the transaction is tax avoidance.¹² An accounting firm indirectly recommends a transaction when another tax adviser recommends the client engage in the transaction and the other tax adviser has a formal agreement or other arrangement with the accounting firm related to the promotion of the transactions.

However, Rule 3522 will allow the auditor to provide services related to the marketing, planning or opining in favor of a transaction that is "at least more likely than not to be allowable under applicable tax laws."¹³ This is the standard taxpayers must meet to avoid penalties for substantial understatement of income tax due in connection with a tax shelter.¹⁴ "The proposed rules also use this standard, as opposed to a higher standard, in recognition of the fact that tax laws may often be complex and subject to differing good faith interpretations."¹⁵

All transactions listed by the IRS are considered aggressive tax position transactions. The PCAOB warned that accounting firms should be cautious in participating in transactions that the firm believes could become listed because the firm could find its independence impaired by its mutuality of interest with the audit client.¹⁶ If a transaction

¹⁰ PCAOB Proposed Rule 3522(a), PCAOB Release No. 2004-015 (July 26, 2005).

¹¹ PCAOB Proposed Rule 3501(c)(i)(2), PCAOB Release No. 2004-015 (July 26, 2005).

¹² PCAOB Proposed Rule 3522, PCAOB Release No. 2004-015 (July 26, 2005).

¹³ PCAOB Proposed Rule 3522(c), PCAOB Release No. 2004-015 (July 26, 2005).

¹⁴ Treas. Reg. § 1.6664-4(f)(2)(i)(B) (stating that one requirement for establishing that a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item is that the corporation reasonably believed that the tax treatment was more likely than not the proper treatment, which requires that either (a) the corporation concluded from its own analysis that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the I.R.S. or (b) the corporation relied on the opinion of a professional tax advisor that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the I.R.S.).

¹⁵ PCAOB Release No. 2004-015, part II(B)(3)(c) (July 26, 2005).

¹⁶ PCAOB Release No. 2004-015, part II(B)(3)(a) (July 26, 2005).

planned on or opined by the firm, or a similar transaction, becomes listed, the firm should discuss the potential impairment of its independence with the client's audit committee.¹⁷

Auditors are permitted to advise against executing an aggressive tax transaction. However, an auditor may not issue "an opinion that a transaction does not satisfy the more-likely-than-not standard but does satisfy a lower standard of confidence" or offer "advice that an audit client will 'probably' lose an argument in favor of a tax treatment, because such advice can imply up to a 49-percent chance of success."¹⁸

According to the PCAOB, aggressive tax positions undermine investor confidence in the "judgment, objectivity, and ethics" of accounting firms that engage in such transactions.¹⁹ Also, participating in these transactions increases the likelihood that an accounting firm will not be independent of its audit client because the transactions carry a high risk that tax authorities will disallow the transaction and such a challenge increases the mutuality of interest between the firm and its client.²⁰

Relevant Time Period

The restrictions on confidential or aggressive tax position transactions only apply to services provided during the audit and professional engagement period, which is the period covered by any financial statements audited and the period of engagement to audit and review the client's financial statements or to prepare a report filed with the SEC.²¹ This period will always apply to ongoing, regular clients of audit firms but not necessarily to new audit clients, former audit clients and one-time, special-circumstances audit clients.

Tax Services To Individuals

The PCAOB is concerned that "performing tax services for certain individuals involved in the financial reporting processes of an audit client creates an appearance of a mutual interest between the auditor and those individuals."²²

There are three exceptions in which an accounting firm may offer tax services to a person in a financial reporting oversight role:

1) Board of director members—if the person is only considered to be in a financial reporting oversight role because he or she is on the client's board of directors.

¹⁷ PCAOB Release No. 2004-015, part II(B)(3) (July 26, 2005).

¹⁸ PCAOB Release No. 2004-015, part II(B)(3) (July 26, 2005).

¹⁹ PCAOB Release No. 2004-015, part II(B)(3) (July 26, 2005).

²⁰ PCAOB Release No. 2004-015, part II(B)(3) (July 26, 2005).

²¹ PCAOB Proposed Rule 3501(a)(iii)(2), PCAOB Release No. 2004-015 (July 26, 2005).

²² PCAOB Release No. 2004-015, part II(B)(4) (July 26, 2005).

2) Role with affiliate—if the person is only considered to be in a financial reporting oversight role because of that person's relationship to an affiliate of the audit client. One of two conditions must be met for this exception:

A) The affiliate's financial statements must not be material to the consolidated financial statements of the audit client; or

B) The affiliate's financial statements must be audited by an auditor other than the audit firm or an associated person of the audit firm.

3) New in oversight role—if the person was not in a financial oversight role before a hiring, promotion, or change in employment and the engagement for the tax services was in process before that event and is completed within 180 days of that event.²³

Audit Committee Pre-Approval

In order to obtain pre-approval from the client's audit committee to perform permissible tax services, the audit firm must take the following actions:

1) The audit firm must provide the following information to the committee in writing:

a) The scope of the service, the fee structure, and any side letters or amendments to the engagement letter related to the service, and

b) Any compensation arrangement or other agreement (such as referral agreements, referral fees, or fee-sharing agreements) with any third party related to promoting, marketing, or recommending transactions involved in the service;

2) Discuss with the committee how the services could potentially affect the audit firm's independence; and

3) Document the substance of the discussion.²⁴

Conclusion

The PCAOB's proposed rules create a greater burden for public company audit committees, which must approve in advance all non-audit services provided by audit firms. However, the rules also help audit committees obtain a better grasp over the tax services provided by their auditors and the potential conflicts those services create. The rules require auditors to inform the audit committee when their non-audit services might create a conflict of interest and to justify services that could create potential conflicts.

The rules will prevent audit firms from providing some services that companies and directors may find beneficial or convenient, such as certain types of tax planning products for the company and individual tax planning services for management and

²³PCAOB Proposed Rule 3523, PCAOB Release No. 2004-015 (July 26, 2005).

²⁴ PCAOB Proposed Rule 3524, PCAOB Release No. 2004-015 (July 26, 2005).

directors. However, these provisions also protect the company. The rules ensure that auditors are not compromised and can provide objective audits of a public company's financial records. This protects shareholders and helps the board better supervise the company and its management. The rules also ensure that accounting firms—at least the one auditing the company—do not sell potentially abusive tax products to the company.

Although the proposed rules explicitly prohibit certain transactions, the true effect of the rules (if approved by the SEC) will be decided largely in the board room as audit committees decide on a case-by-case basis whether or not to approve tax services that potentially create conflicts of interest. The rules give the audit committee more tools and information to make these decisions, but it is yet to be seen whether the audit committees will use those tools to ensure auditor independence or will rubber stamp the plans of management and audit firms.■



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