
State of Practice

Sarbanes-Oxley and SALT: What Can Auditors Do?

by Peter L. Faber



Companies and practitioners have now had more than a year to live with the Securities and Exchange Commission's final rules relating to auditor independence under the Sarbanes-Oxley Act of 2002 (Public Law 107-204). Unfortunately, the extent to which a company's auditing firm can function in the

state and local tax area is still unclear in a number of important respects.

The Sarbanes-Oxley Act

Among other things, the Sarbanes-Oxley Act addressed a concern that independent accounting firms were not fulfilling their role of acting as independent, objective auditors of their clients' financial statements. The concern was heightened by the Enron situation, in which Arthur Andersen LLP was viewed by many as acting in the best interests of the corporation's management and not in the best interests of its shareholders and the public.

There has always been a tension between the independent role of an outside accounting firm and the business reality that the firm is retained by the company and that there is often a close personal and professional connection between individuals at the accounting firms who are responsible for the engagement and individuals in the company's management. Congress concluded that that inherent conflict of interest made it necessary to prohibit accounting firms from performing certain functions for their audit clients. Congress also concluded, however, that some tax services, particularly the preparation of tax returns, were so linked to the work done traditionally by outside auditors that they should be permitted if approved by appropriate procedures. A number of the provisions of the rules relate to the extent to which different types of tax services should be allowed.

Section 201(a) of the act added a new section 10A(g) to the Securities Exchange Act of 1934 that prohibits an accounting firm from providing eight specified services to an audit client "contemporaneously with the audit." In addition, other non-audit services that the newly established Public Company Accounting Oversight Board determines by regulation are impermissible will not be allowed. The prohibited services are:

(1) bookkeeping or other services relating to the client's accounting records or financial statements; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, and contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit. Nonaudit services other than the eight prohibited ones, including "tax services," can be provided to audit clients if the provision of the service is approved in advance by the client's audit committee.

Neither the statute nor the rules explain what is meant by the phrase "contemporaneously with the audit." Because audit activities occur fairly continuously throughout the year for a large corporation, it is likely that the "contemporaneous" requirement will not provide the accounting firms with much leeway.

Unfortunately, the extent to which a company's auditing firm can function in the state and local tax area is still unclear in a number of important respects.

The report of the Senate Committee on Banking, Housing, and Urban Affairs issued in connection with the act indicates that the purpose of the prohibitions is to bar activities that create a fundamental conflict of interest for the accounting firm. The prohibitions are based on three principles: (1) an auditor cannot audit its own work; (2) an auditor cannot perform management functions; and (3) an auditor cannot act as an advocate for its client. Congress and the SEC view those functions as being inconsistent with the auditor's independent role.

The SEC Rules

On December 2, 2002, the SEC proposed rules relating to auditor independence under the act. Focusing on the three basic principles discussed in the Senate Committee on Banking, Housing, and Urban Affairs report, the proposed rules would have prevented auditing firms from performing many functions that had traditionally been regarded as routine tax services. For example, there was a question under the proposed rules as to whether an auditing firm could represent a client in a routine state tax audit (except, perhaps, to the extent of explaining the

rationale for the preparation of the tax returns), because of the absolute bar against advocating a client's position. The formulation of tax strategies for audit clients would also have been prohibited.

Not surprisingly, the accounting firms, and many of their clients, objected strenuously, and the final rules, which were adopted on January 28, 2003, were considerably more lenient. Many functions that have traditionally been performed by accounting firms, including a company's auditing firm, were expressly allowed. Nevertheless, significant uncertainties remain and it would be a mistake to assume that services such as tax planning and appraisal work can be performed under all circumstances.

'Merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence.'

The SEC's explanation accompanying the final rules acknowledges that the proposed rules had given rise to considerable debate and that tax services were "unique among non-audit services." For one thing, governmental tax authorities have the right to audit tax returns, and that serves as a check against improper practices. Further, the explanation acknowledges that "accounting firms have historically provided a broad range of tax services to their audit clients." The explanation indicates that the SEC "reiterates its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence. Accordingly, accountants may continue to provide tax services such as tax compliance, tax planning and tax advice to audit clients," subject to the approval by the company's audit committee that is required for all nonaudit services.

In the context in which that language appears, one could infer that the three basic principles underlying auditor independence do not apply to tax services. On the other hand, the explanation goes on to provide that "merely labeling a service as a 'tax service' will not necessarily eliminate its potential to impair independence." Accordingly, it seems prudent to assume that, although most tax services, including "tax planning," can be performed by the company's auditing firm, services that make it difficult for the firm to perform its independent auditing function objectively will not be allowed. The problem is to determine in an individual case whether a particular service would undermine the auditor's independence.

The remainder of this article will discuss particular types of services and conclude with discussions of tax services in general and audit committee approval procedures.

Expert Services

The SEC explanation indicates that accounting firms may not provide expert services to an audit client, including acting as an expert witness in legal, administrative, or regulatory proceedings. That would violate the basic principle against acting as an advocate for an audit client.

The explanation makes clear that an accounting firm cannot perform prohibited expert services indirectly by being retained by the audit client's law firm. Law firms often hire experts rather than having them hired by the company directly so as to

bring the expert's engagement within the attorney-client and attorney-work product privileges. Privilege will be preserved only if the expert's role is to assist the law firm in providing legal advice to the client. Merely placing the expert on the law firm's payroll will not suffice if it is clear under the circumstances that the expert's advice is not pertinent to the legal advice being rendered by the law firm but, rather, is being used directly by the client.

Appraisal and Valuation Services

Appraisal and valuation services are expressly prohibited by the act. The SEC explanation makes clear that the prohibition applies to appraisals of intangible assets such as goodwill, patents, and trademarks, as well as to appraisals of tangible assets. The prohibition would apply to an appraisal of an entire business, as well as of a particular asset. The SEC explanation indicates that in performing its auditing functions an accounting firm would have to evaluate the assumptions and variables used in the appraisal and thus would be auditing its own work if it had done the appraisal in question. On the other hand, a company's auditing firm can review appraisal and valuation work done by the client's own people or others.

In the state tax area, accounting firms are often retained to appraise intangible assets, to determine reasonable royalty rates for patents and trademarks, and to determine reasonable charges for the provision of intercompany management and other services within a group of controlled corporations. Can the company's auditing firm perform those functions under Sarbanes-Oxley? The answer is yes, but it is not clear that that would be a good practice.

The SEC explanation indicates that appraisals done for non-financial-statement purposes, including transfer pricing studies, are permitted. Thus, a company's auditing firm can be engaged in connection with the determination of royalty rates for the licensing of intangible assets and with the provision of goods and services to affiliates. The carve-out for transfer pricing studies is curious. One would think that an auditor in evaluating tax accruals would have to consider the reasonableness of the appraisals on which royalty rates and transfer prices were determined, but the SEC explanation makes clear that those activities are permitted.

Accounting firms may not provide expert services to an audit client, including acting as an expert witness in legal, administrative, or regulatory proceedings.

The problem comes with the next step. What role can the auditor play if a state tax department challenges the royalties of transfer pricing studies? The SEC explanation in other places makes clear that an accounting firm may not act as a public advocate for an audit client. That is one of the basic principles underlying the auditor independence rules. It seems likely, therefore, although this is not entirely clear, that appraisal services that are permissible in a planning context may not be permissible in a litigation context. In other words, although the explanation specifically states that an accounting firm may do transfer pricing studies for an audit client, it is likely that those will be allowed only in the context of establishing or monitor-

ing a transfer pricing arrangement. An accounting firm may not be allowed to do a transfer pricing study in connection with litigation involving combined report issues or the validity of an intangible holding company arrangement. Moreover, the ban on performing expert services and acting as an advocate is likely to prevent an auditing firm representative from testifying in court in support of the firm's transfer pricing study. Although that person might be able to testify as a fact witness in explaining the study, testifying as an expert in rebutting the state's expert witnesses or in advocating the accuracy of the auditing firm's transfer pricing study would probably not be allowed.

It seems likely that appraisal services that are permissible in a planning context may not be permissible in a litigation context.

As a practical matter, the bar against acting as an advocate may prevent accounting firms from performing appraisal services for audit clients even in a planning context. I have always advised clients in selecting an appraiser to be used for planning purposes to pick someone who would be an effective witness in court if the appraisal were challenged. Appraisals are expensive, and it may not be cost-efficient to have to hire a second appraiser to defend the first appraiser's work.

Legal Services

Under current SEC rules an auditor cannot provide legal services to a client. The new rules would expand that prohibition by referring to services that can be provided only by a lawyer. The SEC points out that a lawyer is under an ethical obligation to represent his or her client vigorously to the full extent permitted by the law and that one cannot do that and also objectively and impartially audit the client's financial statements.

The SEC's formulation of prohibited legal services would likely not prevent accounting firms from representing clients before the U.S. Tax Court and many state tax administrative tribunals because the Tax Court and many state tribunals allow clients to be represented by certified public accountants who are not lawyers. Nevertheless, as will be indicated below, the prohibition against acting as an audit client's advocate should prohibit that kind of representation.

The explanation points out that in some countries certain tax services can be performed only by lawyers. The explanation indicates that in those cases accounting firms should be allowed to perform those tax services that would normally be permitted if performed in the United States, even though under the laws of the country in question they can be performed only by lawyers.

Tax Services

Under the proposed rules, many tax services that have traditionally been performed by accounting firms, including representing a client in a routine tax audit before the Internal Revenue Service, might have been barred. The SEC received many critical comments about that aspect of the proposed rules from accounting firms and others. The explanation of the final rules indicates that the SEC will be considerably more generous regarding tax services than the explanation to the proposed rules had suggested. The new explanation points out that tax

services are unique among nonaudit services for several reasons, including that detailed tax laws must be "consistently applied" and that the IRS can audit tax returns. The explanation also points out that "accounting firms have historically provided a broad range of tax services to their audit clients."

The explanation to the proposed rules had indicated that the provision of tax services was governed by the three basic principles underlying the Sarbanes-Oxley Act provisions on auditor independence: (1) an auditor cannot audit its own work; (2) an auditor cannot perform management functions; and (3) an auditor cannot act as an advocate for its client. The explanation to the final rules suggests that those principles should be applied to tax services in light of the historical role that accountants have played in the tax area. The provision of tax services, like other permitted nonaudit services, can be done only if it is preapproved by the company's audit committee, and the explanation indicates that the audit committee should be mindful of the need to preserve independence when it considers particular services.

The explanation states that "accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients."

The explanation cautions that some tax services may nevertheless impair independence. For example, the explanation says that accountants would undermine their independence "by representing an audit client before a tax court, district court, or federal court of claims." The explanation to the proposed rules had identified the U.S. Tax Court, but did not refer to other courts or administrative tribunals. The new language is curious. The reference to "a tax court" suggests that it is not limited to the U.S. Tax Court, but could apply to any court hearing tax cases, including a state or foreign court. The fact that the expression "tax court" is not capitalized may not be meaningful because the reference to the federal court of claims is also not capitalized, but the letter "a" preceding "tax court" suggests that the reference is to any court. Grammatical subtleties aside (and one hesitates to attribute too much precision to the drafters), there seems to be no meaningful distinction between representing a client before a federal court and representing it before a state, local, or foreign court, and it is likely that the prohibition will apply not only to all courts but also to administrative agencies conducting quasi-judicial proceedings the decisions of which are made available to the public.

The independence issues presented regarding state and local tax strategies are identical to those presented regarding federal tax strategies, and the SEC will undoubtedly treat them the same.

The explanation to the proposed rules had indicated that an accounting firm could not bring tax strategies such as "tax shelters" to audit clients because that would require them to audit their own work. The explanation to the final rules softens this discussion. It indicates that "audit committees also should scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment

of which may be not supported in the Internal Revenue Code and related regulations." This suggests that an audit committee would have to review specific proposals brought to the company by its auditors and conduct a rather sophisticated analysis involving not only literal compliance with the tax laws and regulations but also the application of doctrines that have been applied by the courts, including substance-over-form, step transaction, economic substance, and business purpose. The language describing tax plans that are clearly prohibited is quite narrow. Not many strategies recommended by accountants or, for that matter, the most egregious tax shelter promoters, will fit within it. For example, even the most aggressive tax shelters typically have *some* nontax business purpose, even though the proposal's tax aspects may dwarf it.

It appears that accountants will be permitted to request rulings from federal and state tax authorities on behalf of audit clients for both future and past transactions.

But it would be dangerous to view this language as a license for the audit committee to approve all other tax planning work that does not fall within the four corners of this narrow tax shelter description. The language preceding the quoted language in the same paragraph provides that:

Nonetheless, merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence under Rule 2-01(b). Audit Committees and accountants should understand that providing certain tax services would, as described below, or could, in certain circumstances, impair the independence of the accountant.

The "would, as described below" can be read to refer to the narrow circumstances described in the "should scrutinize carefully" language quoted above. However, the "could, in certain circumstances" language indicates that the prohibition is not restricted to proprietary tax shelter schemes. The independence of an auditor who in connection with the audit and certification of a company's financial statements signs off on the tax provisions for the amounts of the tax accruals, or even on whether related tax accruals are required under GAAP, can be impaired by promoting aggressive tax mechanisms that may technically not be considered abusive tax shelters. It seems likely that the SEC would expect audit committees to be particularly vigilant about any tax-oriented transaction proposed by the auditors. Moreover, although some people have suggested that the reference to the Internal Revenue Code suggests that the ban on aggressive strategies would not apply to strategies aimed at saving state and local taxes, that can only be described as wishful thinking. The independence issues presented regarding state and local tax strategies are identical to those presented regarding federal tax strategies, and the SEC will undoubtedly treat them the same.

Accounting firms have often conducted "tax minimization" studies for audit and other clients in which they review a company's tax profile and suggest strategies for reducing its tax burden. Those strategies have often been attacked by federal and state tax authorities on the ground that although

they literally complied with the laws and regulations, in substance they represented artificial schemes that lacked business purpose or economic substance. Those strategies invariably purport to have both a business purpose and economic substance, and the issues in litigation have revolved around whether they were what they purported to be. Making those determinations may be difficult for audit committees, and many companies will conclude that they should use advisers other than their auditing firms for tax minimization projects.

Can an accounting firm represent an audit client in a routine state, local, or federal tax audit? Doing so would seem to involve acting as an advocate for the client, which would violate one of the three basic principles underlying the auditor independence provisions. Nevertheless, the explanation discussing the advocacy issue mentions only court proceedings and representing clients in tax audits, a role that accounting firms have traditionally played. The discussion of the requirement that "tax fees" must be reported indicates that "tax planning" and "tax advice" include "a diverse range of services, including assistance with tax audits and appeals." The footnote accompanying that passage cautions that representation in court proceedings is not permitted. Thus, tax-audit work appears to be permitted.

Accountants have often represented audit clients in getting rulings from tax authorities regarding the taxation of future transactions. Getting a ruling is a private proceeding and, although private letter rulings issued by the IRS are published, identifying information is deleted. The IRS's file relating to a ruling request is also made available to the public but, once again, identifying information is not. On the other hand, rulings issued by the tax authorities in some states are made public with no deletion of identifying information. Nevertheless, it appears that accountants will be permitted to request rulings from federal and state tax authorities on behalf of audit clients for both future and past transactions. The explanation's discussion of tax fees that must be reported indicates that tax planning includes filing "requests for rulings or technical advice from taxing authorities." "Rulings" generally refer to future transactions and requests for technical advice generally involve past transactions.

Although an accounting firm cannot represent an audit client in a court case, it may be able to work with the company's attorneys in negotiating with the tax authorities to settle a case that is in litigation. Those negotiations might involve a case that had been formally docketed before a court, but they would be private. On the other hand, one can argue that acting as an advocate in a court case is barred by the rationale reflected in the explanation without regard to whether it is done publicly or privately. Moreover, it is likely that any prohibition of that type of activity could not be avoided by having the company's lawyers retain the accounting firm to assist them in providing legal advice. This type of engagement should be specifically approved by the audit committee, and if it is to be done, the committee should condition its approval on the accounting firm working with and under the direction of the law firm and only in a nonpublic capacity. More conservative audit committees might conclude that it is best for accountants not to engage in that type of activity unless and until the SEC makes clear that it is permitted.

Tax planning on corporate transactions seems to be permitted. The explanation specifically mentions tax planning as

being a permitted activity, and there should be no problem with accounting firms advising audit clients about the tax consequences of transactions that are being undertaken for business reasons.

Drawing the line will not always be easy.

Drawing the line will not always be easy, however. It seems clear that a company should not do a transaction that it would not otherwise have done if the auditors bring it to the managers' attention and suggest that it would save taxes. Even though some such transactions and strategies may be noncontroversial, the company's audit committee would have no way of evaluating that. Although the audit committee could look to the corporation's tax staff or another outside firm for confirmation, there will always be a risk that the SEC would take a different view of the strategy. To illustrate the problem, consider the common strategy of having an operating company transfer its patents and trademarks to a separate holding company located in a low- or no-tax state and license them back with the intention of saving state income taxes by deducting the royalties. Courts in several states have upheld that technique, but courts in others have rejected it. Some people (including this writer) think that it is a perfectly legitimate tax-planning technique when properly done, but other people think that it is an egregious abuse that does not work. It would be unwise to put a company's audit committee in the position of having to decide whether the strategy is legitimate tax planning or could put the auditing firm in a position of auditing its own work and, hence, be viewed by the SEC as destroying auditor independence.

It is easy to say that a company should not use its auditing firm to suggest to it tax-saving transactions that it would not otherwise engage in. It is harder to deal with tax planning regarding transactions that the company was going to do anyway. That would seem at first blush to fit within accepted notions of tax planning that the SEC seems to be prepared to permit, but what if a strategy could be viewed as aggressive? Assume that a company plans to start a manufacturing operation in State X. It consults with its auditing firm as to the most tax-efficient way to do that. The company would like to avoid being taxed in State X if possible. The auditing firm suggests that it form a limited partnership in State X and have the limited partnership own the manufacturing plant and employ the workers. The company takes back a 99 percent limited partner interest in the partnership, and an affiliate takes back a 1 percent general partner interest. The affiliate nominally makes the management decisions for the limited partnership. The company takes the position that it does not have taxable nexus in State X because its only contact there is the ownership of a passive limited partnership interest with no management rights, even though through that interest it owns almost all of the value of the manufacturing operation. This strategy may work. Under prior law the Tennessee Department of Revenue held that it did.¹ On the other hand, it could be attacked on the ground that the arrangement's form does not reflect its substance or that the partnership is a sham that should be disregarded or the limited partner's agent. Would an accounting firm that had recom-

mended that strategy and received a hefty fee for recommending and implementing it be able to pass judgment on the company's tax reserves? The firm would have an incentive to take the position that the company should not reserve for the strategy or that the reserve should be lower than might otherwise be the case. The auditing firm would be auditing its own work, which is flatly inconsistent with the principle of auditor independence.

Sales of assets present other issues. Tax planning for the sale of property is a function that tax practitioners perform every day. Nevertheless, routine tax planning in the context of a sale may raise independence issues. Let me draw on one example from the federal tax area and then discuss two from the state tax area.

One of the IRS's requirements for a sale of the business to qualify as a tax-free reorganization under section 368 of the IRC is that a "substantial" portion of the purchase price be paid in the form of stock of the acquiring company or the acquiring company's parent. The word "substantial" in this context has never been definitively defined. The IRS will give a favorable ruling if the stock constitutes at least 50 percent of the purchase price. Most lawyers (including my firm) will give a favorable opinion at 40 percent. The U.S. Supreme Court has approved a transaction involving 38 percent continuity, and one lower court has approved a transaction involving 25 percent continuity. What if the shareholder continuity that is expected will be only 33 percent? Some tax professionals would approve that transaction, whereas others would not. Could a company's auditing firm advise that a purported reorganization involving 33 percent stock continuity would qualify as a reorganization and later audit the company's financial statements with any degree of independence? I doubt it. It might be appropriate in that kind of situation for the company, once the issue is identified, to look to other advisers for guidance and to make it clear that it is not interested in the auditing firm's advice on that issue.

Routine tax planning in the context of a sale of assets may raise independence issues.

Let me now consider two related strategies that are often used in the state and local tax area. One involves avoiding sales tax on a proposed sale of assets by dropping the assets into a limited liability company and selling the LLC interest to the buyer. The dropdown to the LLC will normally be exempt from sales tax, and the sale of the LLC interest, being the sale of an intangible asset, would not be subject to sales tax. Is there a danger that state tax authorities will collapse the transaction and treat it as a direct sale of assets (particularly if the buyer liquidates the LLC soon after acquiring it)? The New York authorities indicate that this technique works.² On the other hand, authorities in California and Oklahoma suggest that it does not.³ The DOR in most states have not passed on the issue. Can an auditing firm recommend this strategy and still objec-

² TSB-A-98(2) S (1998); TSB-A-94(25) S (1994); *The TJX Companies Inc.*, NYS Division of Tax Appeals (1995), affirmed on other grounds, NYS Tax Appeals Tribunal (1997). (For the full text of the New York State Tax Tribunal's decision in *TJX*, see *Doc 97-5482 (15 pages)* or *97 STN 41-43*.)

³ California Administrative Ruling SUTA Series 395.0074; Oklahoma Tax Commission Ruling ID No. P8900153 (1991).

¹ Tennessee Letter Ruling 97-49.

tively evaluate the company's tax reserves in the context of preparing its financial statements?

Similarly, in New York State, a corporation is not subject to income tax on gain from the sale of a subsidiary's stock. If a New York corporation is planning on selling assets, can it avoid income tax on its gain by transferring the assets to a subsidiary and then selling the subsidiary's stock to the buyer? Under section 351 of the IRC, the dropdown of assets to a new corporation in exchange for its stock qualifies for tax-free treatment only if the transferor remains in control of the transferee corporation immediately after the transfer. If a sale of that corporation's stock is contemplated but not fixed, will the step transaction doctrine prevent the dropdown from being tax-free? Or could the New York tax authorities successfully maintain that the exemption for sales of subsidiaries should not apply to a subsidiary that is created for the purpose of qualifying for the exemption? Here, too, reasonable people could differ. The SEC might well conclude that an auditing firm could not recommend that kind of strategy and preserve its independence.

Some professional firms have developed model preapproval policies for their clients. A company should be wary of using standardized forms.

It is apparent that there are many tax-planning situations in which advice given by an auditing firm could compromise its independence. Some companies have concluded that the audit committee cannot be put in the position of evaluating when tax-planning advice is so aggressive as to present independence issues and when it is not. They have decided not to use their auditing firms for tax planning, even when the planning appears at first blush to be routine.

Audit Committee Approval Process

The final rules provide that an engagement to provide non-audit services must be approved by the company's audit committee in advance. That can be done regarding specific engagements or under preapproval policies and procedures established by the audit committee, provided that the policies and procedures are detailed as to the particular service, the audit committee is informed of each service, and the policies and procedures do not amount to a delegation of the committee's responsibilities to management. Thus, it appears that an audit committee can authorize the retention of the accounting firm for all tax audits and ruling requests for the next year as long as each specific engagement is later reported to the audit committee. The rules do not indicate a time limit on such a blanket approval, but it might be desirable to impose a one-year limit.

Some professional firms have developed model preapproval policies for their clients. A company should be wary of using standardized forms. A preapproval policy should be tailored to the company's needs. The model policies that I have seen typically include a list of preapproved tax services in an appendix. They include different types of tax planning. It would be advisable for the policy to make clear that the tax planning that is preapproved does not include proposing new transactions

that the company was not already considering. I know of several companies that have decided that they will use their auditors for tax advice regarding transactions that the company was planning to do but that they will engage another accounting or law firm for other tax work and for the initiation of tax strategies when appropriate.

Several of the model policies that I have seen include as preapproved services valuation services, including transfer pricing studies. Those are specifically mentioned as approved services in the SEC's explanation of the final auditor independence rules. Here, too, a caveat is in order. As indicated above, it seems likely that a member of an auditing firm would not be allowed to testify as an expert witness in tax litigation regarding valuation. That would violate the proscription against acting as the company's advocate in a public proceeding. Any policy should provide that the general preapproval of valuation services does not extend to providing testimony as an expert witness. It may be permissible for a representative of a firm conducting a valuation study to testify as a fact witness to explain the study, but acting as an expert witness is different and may be questionable.

As indicated above, the SEC's explanation makes clear that an accounting firm can represent an audit client in a tax audit before the IRS or any other government agency. I have seen model preapproval policies that authorize the auditors to assist with tax audits and appeals before governmental tax agencies generally. This type of formulation is too broad. In many jurisdictions, including New York State and New York City, the "courts" in which tax cases are tried are technically administrative agencies of the government and not part of the formal court system. Their decisions are published, with taxpayers identified, and appearing before them would seem to be as inconsistent with auditor independence as appearing before the U.S. Tax Court and other federal courts, which is clearly prohibited by the final rules. Auditing firms should not represent audit clients in those proceedings, and preapproval policies should make clear that the authorization to represent the company in tax audits and appeals does not extend to representation in any forum that is judicial or quasi-judicial in nature and the decisions of which are made public.

Preapproval policies and procedures should do more than merely parrot the language of the SEC explanation. It is important that companies analyze the types of tax services that their particular auditors are likely to perform and consider carefully which ones should be preapproved and which ones should be subject to special approval on an engagement-by-engagement basis.

Conclusion

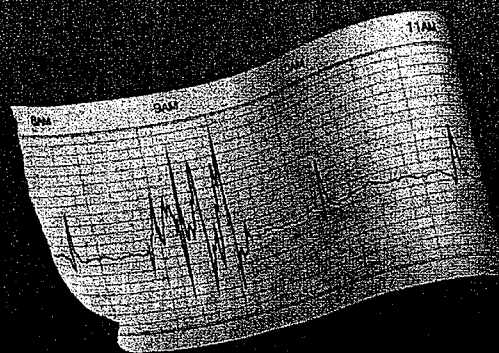
The act has presented some significant practical problems for companies and their auditors in the state and local tax field. Many companies have a long-standing relationship with the state and local tax people at their auditing firm. The auditors know the company, its business, and, as important, its culture and risk-averseness. Nevertheless, using the auditing firm for certain types of tax advice can be dangerous under Sarbanes-Oxley.

Many audit committees will conclude that there are so many uncertainties as to what their auditing firms can do that the safest course of action will be not to use them for any tax services other than the preparation or approval of tax returns and routine tax compliance. If the independence requirements

are violated, the company will have to retain a new auditing firm, which can be time-consuming and expensive. Even when the nature of services is such that they can best be provided by an accounting firm, many companies will conclude that the uncertainties of using their auditing firm and the inconvenience of having the audit committee constantly making decisions as to what can and cannot be done are such that it is not worth the trouble and that an accounting firm other than their auditing firm should be retained for tax services. ☆

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