

A BALANCING APPROACH TO THE DISCOVERABILITY OF ACCOUNTANTS' TAX LIABILITY WORKPAPERS UNDER SECTION 7602 OF THE INTERNAL REVENUE CODE

Under section 7602 of the Internal Revenue Code,¹ the Commissioner of Internal Revenue has broad authority to summons material relevant to an investigation of income tax liability.² The Internal Revenue Service (IRS) and taxpayers have frequently litigated the scope of this statutory requirement of relevance, but the courts do not agree on its parameters.³ Although the IRS has an established right of access to factual records of underlying transactions,⁴ it has no such established

1. I.R.C. § 7602 is as follows:

SEC. 7602. EXAMINATION OF BOOKS AND WITNESSES.

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized—

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

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for the tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

2. The summons power is a concomitant to the investigative power granted in I.R.C. § 7601(a). That section provides that:

The Secretary shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed.

3. Compare *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973), and *United States v. Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977) with *United States v. Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979), and *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

4. *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 950 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). General ledger trial balances, bank account reconciliations, accounts receivable, physical inventory listings, and tax returns are factual records. Note, *Government Access to Corporate Documents and Auditor's Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. CORP. LAW 349, 356 (1977).

right to nonfactual material.⁵

A controversy has emerged recently over whether this summons authority extends to an accountant's contingent tax liability workpapers.⁶ These workpapers contain the independent auditor's analysis of the likelihood of an additional corporate tax assessment resulting from an IRS investigation.⁷ The workpapers thus identify specific transactions that are vulnerable to various potential tax treatments.⁸ In 1977 the Tenth Circuit denied the IRS access to such material.⁹ Since then, three district courts have granted access.¹⁰

Part I of this Note presents the problem and explores the interests involved.¹¹ Part II discusses the statutory requirement of relevance,¹² the case law interpreting it,¹³ and the applicability of the attorney-client privilege and the attorney's work product rule.¹⁴ Part III describes the litigation over access to the workpapers.¹⁵ Part IV discusses the elusiveness of the relevancy requirement as applied by the courts.¹⁶ The policies underlying the attorney-client privilege, the work product rule, and the taxation system itself are also analyzed.¹⁷ This Note concludes by proposing that the relevancy requirement calls for a balancing process with presumptions of discoverability based on the categories of documents sought.¹⁸ The attorney-client privilege and the work prod-

5. *See, e.g.*, *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973) (IRS may not summons proposed budgets); *United States v. First Chicago Corp.*, [1979-1] U.S. Tax Cas. (CCH) ¶ 86,034 (N.D. Ill. 1978) (IRS may summons internal audit reports). *See also* Note, *supra* note 4, at 356-58.

6. *See* Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *Legal Times Wash.*, July 28, 1980, at 38, col. 1; Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX. 194 (1979); Note, *supra* note 4.

7. *See* Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 38, col. 1.

8. *Id.* at 38, cols. 1-3.

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

10. *United States v. Price Waterhouse & Co.*, 515 F. Supp. 996 (N.D. Ill. 1981); *United States v. Arthur Young & Co.*, [1980-2] U.S. Tax Cas. (CCH) ¶ 9655 (S.D.N.Y.); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

11. *See* notes 20-48 *infra* and accompanying text.

12. *See* notes 49-75 *infra* and accompanying text.

13. *See* notes 76-108 *infra* and accompanying text.

14. *See* notes 109-21 *infra* and accompanying text.

15. *See* notes 122-53 *infra* and accompanying text.

16. *See* notes 154-82 *infra* and accompanying text.

17. *See* notes 183-205 *infra* and accompanying text.

18. *See* notes 210-13 *infra* and accompanying text.

uct rule are proposed as useful analogies for balancing the policy issues.¹⁹

I. THE PROBLEM

Financial statements are the primary means for shareholders and the public to gain access to corporate information.²⁰ Because the corporation prepares these statements, an independent audit is necessary to verify their accuracy.²¹ The corporation consequently engages an accounting firm to audit the books of the corporation.²² The auditors employ generally accepted professional standards and techniques to test the accuracy of the financial statements and the underlying transactions records.²³ They then issue an opinion as to whether the statements are a fair representation of the financial position of the corporation and an accurate reflection of the results of operations over the reporting period.²⁴

The areas investigated by the auditors include contingent liabilities.²⁵ Contingent liabilities are potential liabilities for the corporation that are dependent upon the occurrence of some future event.²⁶ Accurate reporting of a client's financial position requires ascertaining the existence of an adequate reserve or accrual to cover such liabilities²⁷ and, if

19. See notes 206-09 *infra* and accompanying text.

20. E. SPILLER, FINANCIAL ACCOUNTING: BASIC CONCEPTS 25-27 (3d ed. 1977); Note, *supra* note 4, at 352.

21. W. MEIGS, E. LARSEN & R. MEIGS, PRINCIPLES OF AUDITING 23 (6th ed. 1977) [hereinafter cited as PRINCIPLES OF AUDITING]. The American Institute of Certified Public Accountants [AICPA] requires that "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 220.01 (1978) [hereinafter cited as AICPA AUDIT STANDARDS].

22. PRINCIPLES OF AUDITING, *supra* note 21, at 1-33; E. SPILLER, *supra* note 20, at 27.

23. AICPA AUDIT STANDARDS, *supra* note 21, §§ 320, 330. See PRINCIPLES OF AUDITING, *supra* note 21, at 163-65.

24. AICPA AUDIT STANDARDS, *supra* note 21, § 509.28. Depending on the result of the audit, the auditor may also issue a qualified opinion, *id.* § 509.29, an adverse opinion, *id.* § 509.41, or a disclaimer of opinion, *id.* § 509.45. For a further discussion, see PRINCIPLES OF AUDITING, *supra* note 21, at 686-98.

25. E. SPILLER, *supra* note 20, at 40-41.

26. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT ON ACCOUNTING STANDARDS No. 5: ACCOUNTING FOR CONTINGENCIES §§ 1, 33-39 (1975) [hereinafter cited as FASB No. 5]. See E. SPILLER, *supra* note 20, at 40-41. The author gives as examples disputes over past taxes, debt guarantees, and pending lawsuits.

27. FASB No. 5, *supra* note 26, § 8. The standard requires that the loss be probable and be capable of reasonable estimation.

the amount in question is material,²⁸ disclosing the liability on the financial statements.²⁹ This procedure is required by the standards of the accounting profession³⁰ and for some of the filings mandated by the Securities and Exchange Commission.³¹

The corporate client's liability for income tax is one such contingency.³² Because the IRS has not settled the appropriate tax treatment of many transactions, it may challenge the client's characterization of a given transaction.³³ The corporation's income tax liability may increase if the IRS interpretation is accepted. IRS review of the tax returns of large corporations is a virtual certainty³⁴ and results in a lag of several years between filing and eventual settlement.³⁵ During this interim period the corporation is potentially liable for the additional tax assessment that would result from a successful IRS challenge.³⁶

To assess the adequacy of a corporation's accrual, the auditors and corporate management engage in a worst-case analysis³⁷ of the tax

28. "The materiality of an item may depend on its size, its nature, or a combination of both. An item should be regarded as material if there is reason to believe that knowledge of it would influence the decisions of an informed investor." PRINCIPLES OF AUDITING, *supra* note 21, at 28. *Accord*, Regulation S-X, 17 C.F.R. § 210.1-02(n) (1981).

29. FASB No. 5, *supra* note 26, §§ 9-10.

30. *Id.* The principle of conservatism in accounting "calls for due caution and a careful assessment of risks and uncertainties. When a decision requires judgment, accountants tend to select those procedures which result in smaller measures of resources or income." E. SPILLER, *supra* note 20, at 24-25.

31. Regulation S-X, 17 C.F.R. § 210.5-02(25) (1981). The SEC requires the filing of financial statements as part of: (1) registration statements under the Securities Act of 1933, Schedule A (25)-(27), 15 U.S.C. § 77aa (1976); (2) registration statements under the Securities Exchange Act of 1934, §§ 12(b)(1)(J)-(L), 12(g)(1), 15 U.S.C. §§ 78j(b)(1)(J)-(L), 78j(g)(1) (1976); (3) proxy and information statements under the Securities Exchange Act of 1934, § 14, 15 U.S.C. § 78n (1976); Schedule 14A, Item 15, 17 C.F.R. § 240.14a-101 (1981); and (4) annual reports under the Securities Exchange Act of 1934, §§ 13, 15(d), 15 U.S.C. §§ 78m(a)(2), 78o(d) (1976); 17 C.F.R. §§ 249.310, 249.460 (1981).

32. PRINCIPLES OF AUDITING, *supra* note 21, at 605-06.

33. *Id.*

34. *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 949 (D. Colo. 1975) (IRS had audited every corporate tax return since 1913), *aff'd*, 550 F.2d 615 (10th Cir. 1977); *United States v. Acker*, 325 F. Supp. 857, 859 (S.D.N.Y. 1971) (four IRS agents on full time assignment); Kurtz & Panel, *Discussion on "Questionable Positions,"* 32 TAX LAW. 13, 15 (1978) [hereinafter cited as Kurtz].

35. Kurtz, *supra* note 34.

36. PRINCIPLES OF AUDITING, *supra* note 21, at 605-06.

37. AICPA AUDIT STANDARDS, *supra* note 21, § 337.05. This analysis is an attempt to uncover "what the worst possible nightmare is the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation.

"He may think up contingencies even more lurid than the worst contingencies a revenue agent

treatment of selected items on the corporation's return. A worst-case tax assessment is then computed and a portion of this amount is accrued or reserved.³⁸ This process takes place separately from the preparation of the actual tax return, regardless of whether the corporation also has engaged the auditing firm to prepare the corporation's tax return.³⁹ The transactions that are the basis of this process are available to the IRS separately in the form of the corporate accounting records.⁴⁰ The product, which is the property of the auditor,⁴¹ is known as the tax accrual workpapers.⁴² Access to these workpapers is the source of controversy among the IRS, the auditors, and their corporate clients.⁴³

The interests at stake are substantial. Access to the workpapers would provide the IRS with a "roadmap" to those "soft spots" in the return where additional probing might prove profitable.⁴⁴ The IRS maintains that such information is necessary in a taxation system based on self assessment. The large corporate taxpayer may knowingly bury questionable positions among thousands of transactions, gambling against the possibility of discovery upon an IRS audit.⁴⁵ For the tax-

comes up with . . ." *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953 (D. Colo. 1975) (testimony of M. Stone, past president, American Institute of Certified Public Accountants), *aff'd*, 550 F.2d 615 (10th Cir. 1977). See also Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6; Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, *supra* note 6; Note, *supra* note 4.

38. FASB No. 5, *supra* note 26, § 8. See Brief for Appellant-Respondent at 4-5, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

39. Brief for Appellant-Respondent at 4, 35-37, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

Taxpayers use this separation of procedures to bolster the argument that the workpapers are not relevant within the meaning of the summons authority of § 7602. See note 139 *infra* and accompanying text. In *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 952 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), the court found the argument persuasive. In *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 329 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980), the court rejected this approach.

40. Brief for Appellant-Respondent at 5, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

41. AICPA AUDIT STANDARDS, *supra* note 21, § 338.06. See PRINCIPLES OF AUDITING, *supra* note 21, at 287; Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 39, col. 1.

42. Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 39, col. 2. The workpapers are also referred to as the tax pool analysis, tax liability contingency analysis, tax cushion, or tax contingency reserve. *Id.*

43. See note 6 *supra* and accompanying text.

44. Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 39, col. 3.

45. Kurtz, *supra* note 34, at 16.

We now have situations in which the taxpayer well knows which items he would like

payer, release of this information means that he acquires the burden of administrative proceedings, litigation, and possible additional tax liability. The taxpayer contends that it is inequitable for the IRS to require him, in effect, to furnish the IRS with the case against him.⁴⁶ The auditor is concerned that release of the desired information will threaten the confidential relationship with the client that facilitates the free flow of information.⁴⁷ If the client knows that the IRS can gain access to any information in his auditor's hands, he will not communicate much useful and important information. The end result is less accurate reporting of the corporate taxpayer's financial position and consequent injury to the public which relies on that information.⁴⁸

II. BACKGROUND

A. *The Statutory Requirement of Relevance*

The statutory authority for the IRS's summons power is contained in section 7602 of the Internal Revenue Code.⁴⁹ The summons is not self-executing.⁵⁰ Upon challenge, the IRS must seek enforcement⁵¹ in an

the agent not to find. He may have sought legal opinions about them and may have, in fact, reserved against them on his balance sheet. Yet disclosure of those reserves has been resisted by taxpayers and by their professional advisors It is difficult to improve relations between agents and taxpayers when taxpayers have the information and, in effect, say to the agent, here is the haystack, the needle is in there somewhere, and it's your problem to find it.

Id.

46. Brief for Appellant-Respondent at 10, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

47. *United States v. Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). The court quoted from the expert opinion testimony of a certified public accountant:

If we were hampered in any audit situation by the fact that the client knows that if he gives us any data . . . it's going to be readily available to the Government, I cannot imagine how we would be able to render audit opinions for that client for very long. It would just absolutely cut off our communication, and if I were the client, I would be the first to admit that that is the way I would feel.

Id. at 954.

48. *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 326-27 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 958 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). See notes 20-31 *supra* and accompanying text.

49. See notes 1-2 *supra* and accompanying text.

50. *Reisman v. Caplin*, 375 U.S. 440, 445-46 (1964).

51. I.R.C. § 7402(b) provides:

(b) To Enforce Summons—If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides or may be found shall have

adversarial proceeding in the federal courts.⁵² The proceeding affords the taxpayer complete protection⁵³ and the taxpayer may also appeal the decision.⁵⁴

The Supreme Court enunciated a four-part standard for judicial enforcement of an IRS summons in *United States v. Powell*.⁵⁵ The IRS must show: (1) that a legitimate purpose exists for conducting the investigation,⁵⁶ (2) that the inquiry is relevant to that purpose,⁵⁷ (3) that the Commissioner does not already possess the information sought,⁵⁸

jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

52. I.R.C. § 7604(b) provides:

(b) Enforcement—Whenever any person summoned under section 6420(e)(2), 6421(f)(2), 6424(d)(2), 6427(h)(2), or 7602 neglects or refuses to obey such summons, or to produce books, papers, records, or other data, or to give testimony, as required, the Secretary may apply to the judge of the district court or to a United States commissioner for the district within which the person so summoned resides or is to be found for an attachment against him as for a contempt. It shall be the duty of the judge or commissioner to hear the application, and, if satisfactory proof is made, to issue an attachment directed to some proper officer, for the arrest of such person, and upon his being brought before him to proceed to a hearing of the case; and upon such hearing the judge or United States commissioner shall have power to make such order as he shall deem proper, not inconsistent with the law for the punishment of contempts, to enforce obedience to the requirements of the summons and to punish such person for his default or disobedience.

In *Reisman v. Caplin*, 375 U.S. 440, 448 (1964), the Court stated that “[§ 7604(b)] was intended only to cover persons who were summoned and wholly made default or contumaciously refused to comply.”

53. *Reisman v. Caplin*, 375 U.S. 440, 446 (1964).

54. *Id.* at 449.

55. 379 U.S. 48 (1964). In *Powell*, the IRS summoned the president of the corporate taxpayer. Thus the decision arguably was addressed to a third party summons and the lower courts have indeed applied the *Powell* criteria to third party summons. See, e.g., *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 945 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). See generally 7 ARIZ. L. REV. 143 (1965); 63 MICH. L. REV. 939 (1965); 38 TEMP. L.Q. 462 (1965).

56. The IRS may not use summons power to gather information for an exclusively criminal investigation. The investigation is solely for a criminal purpose when the case is referred to the Department of Justice, and the IRS has institutionally abandoned the pursuit of a civil tax determination or collection. *United States v. La Salle Nat'l Bank*, 437 U.S. 298 (1978) (IRS special agent summoned bank files relating to taxpayer). See also Stroud, *The Criminal Prosecution Defense: A Defense to a § 7602 Summons*, 4 AM. J. CRIM. LAW 152 (1976); Comment, *The Improper Purpose Challenge to a § 7602 Summons*, 31 TAX LAW. 226 (1977).

57. See notes 76-108 *infra* and accompanying text.

58. The court rejected the taxpayer's argument in *United States v. Coopers & Lybrand* that because the IRS had seen the records which served as the basis for the workpapers, it had, in effect, also seen the workpapers. 413 F. Supp. at 949. See *United States v. Pritchard*, 438 F.2d 969 (5th Cir. 1971).

One commentator suggests that this requirement is intended to protect the taxpayer against harassment by the IRS. Note, *supra* note 4, at 367 & n. 111.

and (4) that the IRS has followed the administrative steps required by the Code.⁵⁹

The Internal Revenue Manual sets out guidelines for issuance of the summons.⁶⁰ In 1980 the revised manual directly addressed tax contingency workpapers for the first time.⁶¹ Officers of the Service have indicated their intent to vigorously pursue access to the workpapers.⁶² The 1981 manual revisions, however, tighten the summons issuance procedure⁶³ and significantly restrict the circumstances in which the IRS may seek workpapers.⁶⁴ The courts, on the other hand, have held that failure to follow these guidelines does not run afoul of the fourth part of the *Powell* standard.⁶⁵ Furthermore, the Supreme Court, in *United States v. Caceres*,⁶⁶ refused to order exclusion of evidence obtained in violation of the manual's procedures because the violation implicated no constitutional or statutory rights. The manual thus may indicate the Service's policy,⁶⁷ but it provides scant protection for the taxpayer.⁶⁸

The Code provides additional requirements for the issuance of summonses to third-party record keepers.⁶⁹ The IRS must notify the tax-

59. See notes 60-68 *infra* and accompanying text.

60. I INTERNAL REVENUE MANUAL (Audit) (CCH) §§ 4020-4026 (1981) [hereinafter cited as IRM].

61. IRM, *supra* note 60, § 4024.3. See Diss & Hanson, *Tax Contingency Audit Workpapers: Current Developments, Observations, and Proposals*, 12 TAX ADVISOR 104, 105 (1981); Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 39, cols. 1-3. "Obviously, the IRS has rejected a policy of forbearance and restraint in using its summons authority." *Id.*

62. Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 39, col. 1.

63. IRM, *supra* note 60, § 4024. The agent must seek written approval of the Examination Section Chief before seeking a summons for the workpapers. *Id.*

64. *Id.* The agent must have substantially completed the examination, exhausted other sources of information, and identified specific issues. See *IRS Revises Agents Manual to Limit Probes of Workpapers*, J. ACCOUNTANCY, July 1981, at 10.

65. *United States v. Price Waterhouse & Co.*, 515 F. Supp. 996, 999 (N.D. Ill. 1981); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 331 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

66. 440 U.S. 741 (1979). See Parnell, *The Internal Revenue Manual: Its Utility and Legal Effect*, 32 TAX LAW. 687 (1979); *Postscript—The Internal Revenue Manual: Its Utility and Legal Effect*, 33 TAX LAW. 341 (1979).

67. See Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 39, cols. 1-3.

68. Auditing firms report that fear of the IRS summons of workpapers has made corporate clients reluctant to discuss sensitive tax issues with the auditors. *IRS to Clarify Rules Limiting Agents Probe of Tax Workpapers*, J. ACCOUNTANCY, May 1981, at 8.

69. I.R.C. § 7609. Before this amendment to the Code, intervention by the taxpayer in a third party summons proceeding was within the discretion of the judge as measured by the magni-

payer whose records are sought.⁷⁰ The taxpayer may then instruct the third party not to comply and may also intervene in the proceeding.⁷¹ The courts have held that a higher level of scrutiny is necessary when third-party summonses are challenged.⁷²

The Supreme Court has held that the person summoned may challenge the summons on any appropriate ground.⁷³ Taxpayers frequently challenge the relevance of the records sought by the IRS⁷⁴ and may also contend that the summoned material is protected by a testimonial privilege.⁷⁵

B. Case Law Interpretation of Relevance

The requirement of relevance in section 7602 invites the divergent views of its meaning that have emerged in litigation. Lacking guidance from the legislative history,⁷⁶ courts have turned to the language of the statute,⁷⁷ analogies to other instances of compulsory process,⁷⁸ and the policy of the tax system⁷⁹ to support their various articulations of the

tude of the interest sought to be protected. See Note, *Challenging the Tax Summons: Procedures and Defenses*, 19 WM. & MARY L. REV. 771 (1978).

70. I.R.C. § 7609(a).

71. I.R.C. § 7609(b).

72. *United States v. Humble Oil & Ref. Co.*, 488 F.2d 953, 960 (5th Cir. 1974), *vacated and remanded*, 421 U.S. 943, *aff'd*, 518 F.2d 747 (5th Cir. 1975); *Venn v. United States*, 400 F.2d 207, 211-12 (5th Cir. 1968); *United States v. Harrington*, 388 F.2d 520, 523 (2d Cir. 1968).

73. *Reisman v. Caplin*, 375 U.S. 440, 449 (1964).

74. See notes 76-108 *infra* and accompanying text.

75. See notes 109-21 *infra* and accompanying text.

76. The summons authority in the original legislation creating the income tax system extended to "any objects liable to tax or the returns thereof." Act of Oct. 3, 1913, ch. 16, § I, 38 Stat. 114, 178-79.

In 1918 Congress changed the language to read: "[T]o examine any books, papers, records or memoranda bearing upon the matters required to be included in the return . . ." Act of Feb. 24, 1919, Ch. 18, § 1305, 40 Stat. 1057, 1142. The committee report stated that "[t]he remainder of the general provisions carry forward into this bill the general administrative provisions of the revenue acts of 1916 and 1917, which are repealed by this bill." H.R. REP. NO. 767, 65th Cong., 2d Sess. 58 (1918).

Congress enacted the present language in the Internal Revenue Code of 1954. The final committee report states: "§ 7602 *Examination of books and witnesses*. This section contains no material change from existing law." H.R. REP. NO. 1337, 83d Cong., 2d Sess. A436 (1954), *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4584.

Congress has not indicated the original intent as to the scope of the summons power, nor has Congress ever changed it.

77. See notes 144-46 *infra* and accompanying text.

78. See notes 86-89 *infra* and accompanying text.

79. See notes 199-205 *infra* and accompanying text.

concept. The results, which form a spectrum between a requirement of probable cause⁸⁰ and a license for a fishing expedition,⁸¹ are confusing and difficult to apply.⁸²

Although the Supreme Court's opinion in *Powell*⁸³ is a promising starting point, relevance was not an issue in that case.⁸⁴ Litigants have argued the *Powell* relevancy requirement, and courts have ruled on that basis,⁸⁵ but the content of the various relevancy standards has not come from courts' application of *Powell*.

The *Powell* Court compared the IRS summons power to the inquisitorial power of the grand jury.⁸⁶ Some courts subsequently have used this characterization of the IRS summons power to support an expansive concept of relevance.⁸⁷ Litigants may challenge the compulsory process of both the grand jury and administrative agencies on the basis of overbreadth.⁸⁸ This prohibition requires only that the summons is

80. *United States v. Powell*, 379 U.S. 48, 57 (1964) (probable cause not required).

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

82. *See, e.g.*, *United States v. Harrington*, 388 F.2d 520, 524 (2d Cir. 1968) (the question of relevance is not easily resolved).

83. 379 U.S. at 57-58.

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

85. *See, e.g.*, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 329-30 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

86. 379 U.S. at 57.

"[The grand jury] does not depend on a case or controversy for power to get evidence but can investigate merely on suspicion that the law is being violated or even just because it wants assurance that it is not." *United States v. Morton Salt Co.*, 338 U.S. 632, 642-43 (1950).

87. *See, e.g.*, *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States v. Turner*, 480 F.2d 272, 279 (7th Cir. 1973); *United States v. Harrington*, 388 F.2d 520, 523 (2d Cir. 1968).

88. *United States v. Morton Salt Co.*, 338 U.S. 632, 651-53 (1950); *Hale v. Henkel*, 201 U.S. 43, 76-77 (1906).

The fourth amendment's prohibition against unreasonable searches and seizures arguably applies to an administrative summons. The amendment protects against an overly broad grand jury subpoena *duces tecum*. *United States v. Dionisio*, 410 U.S. 1, 10-12 (1973). In *Powell*, the Court compared the § 7602 summons power to the inquisitorial power of the grand jury. *United States v. Powell*, 379 U.S. 48, 57 (1964). The inference that fourth amendment protections apply as well to a § 7602 summons is thus logical.

The fourth amendment, however, affords limited additional protection. The compulsion to appear is not a fourth amendment seizure. *United States v. Dionisio*, 410 U.S. 1, 9 (1973). If the production of records is a search, *id.* at 11-12, the summoned taxpayer or accountant can assert

“reasonable” and that the requested materials are relevant.⁸⁹ The courts’ analogical reasoning thus leads back to a relevance standard without meaningful content.

The courts have proffered varying formulations of a standard of relevance. One of the most frequently cited tests is whether the summoned materials “might have thrown light upon” the correctness of the taxpayer’s return.⁹⁰ *United States v. Harrington* further refined “might” to require a “realistic expectation rather than an idle hope.”⁹¹ The meaning of this standard in a given instance, however, is dependent on the facts of the case. Most of the courts construing relevance have dealt with records of the actual transactions that formed the basis of the income tax liability.⁹² The few cases in which the IRS has sought background materials that were either conjectural or only tangentially

possible defenses related to privacy and overbreadth. A protectable privacy interest, however, is dependent upon a showing of a reasonable expectation of privacy. *Katz v. United States*, 389 U.S. 347, 351 (1967). That is a difficult burden to sustain with respect to the records that form the factual basis of the tax return. *Hale v. Henkel*, 201 U.S. 43, 75 (1906).

Cases that involve a corporation include an additional factor. Corporations are creatures of the state, recipients of certain privileges as enumerated in the state-granted charter because of a perceived public interest in the existence of this form of business organization. The state, and by extension the federal government, may thus inquire into the corporate records to flush out abuses of the privilege of doing business. *United States v. Morton Salt Co.*, 338 U.S. 632, 651-52 (1950); *Hale v. Henkel*, 201 U.S. 43, 74-75 (1906).

A corporation is not similarly disqualified from asserting the unenforceability of the summons on the basis of overbreadth. *United States v. Morton Salt Co.*, 338 U.S. 632, 652 (1950); *Oklahoma Press Pub. Co. v. Walling*, 327 U.S. 186, 209 (1946); *Hale v. Henkel*, 201 U.S. 43, 76 (1906). See Note, *supra* note 9, at 366. A challenge on these grounds is resolved by ascertaining the reasonableness of the summons, a standard similar to relevance and thus of little additional assistance. *United States v. Morton Salt Co.*, 338 U.S. 632, 652-53 (1950).

89. *United States v. Morton Salt Co.*, 338 U.S. 632, 652-53 (1950).

90. *Foster v. United States*, 265 F.2d 183, 187 (2d Cir. 1959), *cert. denied*, 360 U.S. 912 (1960).

91. 388 F.2d 520, 524 (2d Cir. 1968).

92. In *United States v. Bisceglia*, 420 U.S. 141 (1975), the Court enforced a John Doe summons issued to a bank in order to discover the identity of a person making deposits of large numbers of deteriorated \$100 bills. The Court found that the deposits suggested the possibility of liability for unpaid taxes and that the IRS had a legitimate interest in large or unusual financial transactions. *Id.* at 149. The following summonses of similar type have been enforced: summons for bank records of customers’ deposits and cancelled checks, *United States v. Continental Bank & Trust Co.*, 503 F.2d 45 (10th Cir. 1974); summons to tax preparer for records of clients’ names and social security numbers, *United States v. Turner*, 480 F.2d 272 (7th Cir. 1973); IRS summons for alimony payment records held by an attorney in connection with an investigation of the client’s former spouse, *United States v. Harrington*, 388 F.2d 520 (2d Cir. 1968); summons for a London bank’s records that provided the only opportunity for the Government to determine the validity of a taxpayer’s claimed earned income, *Foster v. United States*, 265 F.2d 183 (2d Cir. 1959), *cert. denied*, 360 U.S. 912 (1960).

related to records of actual transactions have produced widely divergent results.⁹³

In *United States v. Matras*⁹⁴ the court considered whether proposed company-wide budgets summoned by the IRS were relevant to the tax investigation of the Northern Natural Gas Company. The company had already provided all records of actual, taxable transactions. The investigation was closed, subject to the outcome of the request for the budgets.⁹⁵ The IRS claimed that the documents would provide a "roadmap" for the investigation.⁹⁶ The court agreed with the corporation's contention that only actual transactions, not proposed budgets, were relevant to a tax investigation. The court acknowledged both the inquisitorial power of the IRS⁹⁷ and the *Harrington* court's relevancy standard.⁹⁸ It concluded, however, that convenience for the government in the form of its need for a "roadmap" did not satisfy the relevancy requirement, and it therefore denied production.⁹⁹

In *United States v. Noall*¹⁰⁰ the IRS sought internal audit reports prepared by the Bunge Corporation. The audit reports resulted from Bunge monitoring its adherence to established accounting and financial procedures within its operating divisions.¹⁰¹ The contents included "hearsay, rumors, opinions and other evidence" pertaining to book-keeping practices.¹⁰² Bunge resisted the summons, claiming the records were neither used for, nor prepared in connection with, the company's income tax returns.¹⁰³ The court ordered production, relying on the "might have thrown light upon"¹⁰⁴ articulation of relevance, and stated that the standard was particularly low when the taxpayer's papers were

93. See, e.g., *United States v. Smith*, 373 F. Supp. 14 (S.D. Miss. 1974) (summons limited to those records held by accountant that actually were used in preparation of the client's tax return); *United States v. Williams*, 337 F. Supp. 1114 (S.D.N.Y. 1971) (denied summons seeking answering service records of psychologist suspected of understating income receipts), *appeal vacated and dismissed*, 486 F.2d 1397 (2d Cir. 1972); *United States v. Acker*, 325 F. Supp. 857 (S.D.N.Y. 1971) (summons for minutes of board of directors meeting enforced).

94. 487 F.2d 1271 (8th Cir. 1973).

95. *Id.* at 1273-74 n.2.

96. *Id.* at 1273.

97. *Id.* at 1274. See notes 86-89 *supra* and accompanying text.

98. 487 F.2d at 1274. See notes 90-92 *supra* and accompanying text.

99. 487 F.2d at 1275.

100. 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

101. *Id.* at 125.

102. *Id.*

103. *Id.*

104. See note 90 *supra* and accompanying text.

at issue and no third parties were involved.¹⁰⁵ It found no significance in Bunge's contention that the records were not prepared for income tax purposes. If the records revealed overstatements or understatements of income or expense or identified accounting practices leading to such errors, then they were clearly relevant.¹⁰⁶ The court flatly rejected Bunge's public policy argument that production would hamper full and frank disclosure in internal audits. The court stated that the language of section 7602 was the congressional response to such concerns and that the courts should not act in contradiction.¹⁰⁷ Finally, the court rejected the taxpayer's request for an *in camera* inspection of the requested documents to ascertain relevancy. The court concluded that Congress could not have intended to impose such a burdensome task on the courts.¹⁰⁸

C. *The Attorney-Client Privilege and the Work Product Rule*

The testimonial privileges act to exclude relevant evidence because of a superior public interest in maintaining the confidentiality of the affected relationship.¹⁰⁹ The attorney-client privilege is one of the oldest privileges recognized at common law. When a client seeks legal advice from an attorney, the confidential communications of the client relating to that purpose are, at the client's insistence, permanently protected from disclosure by himself or the attorney unless the protection

105. 587 F.2d at 126.

106. *Id.*

The court in *United States v. Acker*, 325 F. Supp. 857 (S.D.N.Y. 1971), engaged in similar reasoning. In *Acker*, the IRS sought minutes from meetings of the board of directors and executive committee. The court noted the analogy between the functions of the IRS agent and the auditor:

The accountants, to be sure they see what is germane to their task, look at minutes that turn out not to be germane. They do not accept the views of others as to what they ought to examine, and the company does not expect them to do so. This makes sense for them. It makes equally good sense, *mutatis mutandis*, for the agents of the IRS.

Id. at 861-62 (footnotes omitted).

107. 587 F.2d at 126.

108. *Id.* at 127.

In *United States v. First Chicago Corp.*, [1979-1] U.S. Tax Cas. (CCH) ¶ 86,034 (N.D. Ill. 1978), the IRS sought internal audit reports prepared by the corporation. The corporation submitted 23 of the reports of a relevancy determination *in camera*. The eight relevant reports were records of actual transactions with tax consequences. The other 15, which failed to satisfy the relevance standard, contained discussions of internal operating procedures, reports of spot checks on various departments, and references to "de minimis" transactions. *Id.*

109. 8 J. WIGMORE, EVIDENCE § 2285 (rev. ed. J. McNaughton 1961). See generally Lipton, *Privileged Communications*, 13 N.Y.U. INST. FED. TAX. 955, 961 (1955).

is waived.¹¹⁰ The privilege extends to corporate clients as well as individuals.¹¹¹ The courts generally have accepted its applicability to IRS summons enforcement proceedings.¹¹²

Federal law does not recognize an accountant-client privilege.¹¹³ Under the federal rule, communications to an accountant fall within the attorney-client privilege to the extent that the accountant's work is in aid of the attorney's legal services.¹¹⁴ The privilege, however, does not protect communications to the accountant prior to the establish-

110. 8 J. WIGMORE, *supra* note 109, § 2292.

111. Until recently, the courts used two competing formulations and one modification of the scope of the attorney-client privilege in the corporate setting. The "subject matter" test, formulated in *Harper & Row Publishers, Inc. v. Decker*, 423 F.2d 487 (7th Cir. 1970), *aff'd by an equally divided court*, 400 U.S. 348 (1971), sustains the privilege for the corporation when the employee's communication is made "at the direction of his superiors in the corporation and where the subject matter upon which the attorney's advice is sought by the corporation and dealt with in the communication is the performance by the employee of the duties of his employment." *Id.* at 491-92. The "control group" test holds the privilege applicable only when the corporate employee who communicates with the attorney has the power to act on the basis of the advice given. *City of Philadelphia v. Westinghouse Elec. Corp.*, 210 F. Supp. 483, 485-86 (E.D. Pa.), *petition for mandamus and prohibition denied sub nom. General Elec. Co. v. Kirkpatrick*, 312 F.2d 742 (3d Cir. 1962), *cert. denied*, 372 U.S. 943 (1963). The "subject matter" test was modified in *Diversified Indus. Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1978) (*en banc*), such that a claim to the privilege would be sustained when the communication directed by the corporate superior was made for the purpose of securing legal advice and was not disseminated beyond those persons with a need to know its content.

Most recently, the Supreme Court has signaled the probable demise of the "control group" test. In *Upjohn Co. v. United States*, 449 U.S. 383 (1981), the Court held that the attorney-client privilege protected from an IRS summons questionnaires circulated by Upjohn's attorney in the course of an internal investigation of illegal foreign payments. Although the Court refused to endorse a single test, opting instead for resolution on a "case-by-case" basis, it maintained that "the narrow 'control group test' . . . cannot . . . govern the development of the law in this area." *Id.* at 686. The Court stressed that the control group test "overlooks the fact that the privilege exists to protect not only the giving of professional advice to those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice." *Id.* at 683. *See generally* 58 WASH. U.L.Q. 1041 (1980).

112. *See Upjohn v. United States*, 449 U.S. 383 (1981); Note, *Privileged Communications Before Federal Administrative Agencies: The Law Applied in the District Courts*, 31 U. CHI. L. REV. 395, 397, 398 n.7 (1964), and cases cited therein. *But see United States v. Summe*, 208 F. Supp. 925, 928 (E.D. Ky. 1962) (application of privilege "must be kept in the narrow confines of its own reason for being"). *See generally Orkin, Attorney-Client Privileges in Tax Matters*, 49 A.B.A.J. 794 (1963).

113. *Couch v. United States*, 409 U.S. 322, 335 (1972). Some states have enacted statutory accountant-client privileges. *See generally* Note, *Privileged Communications—Accountants and Accounting—A Critical Analysis of Accountant-Client Privilege Statutes*, 66 MICH. L. REV. 1246 (1968).

114. *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961). "Accounting concepts are a foreign language to some lawyers in almost all cases and to almost all lawyers in some cases. Hence, the

ment of the attorney-client relationship.¹¹⁵

Although it is not, strictly speaking, a privilege, the closely allied attorney's work product rule may also provide protection from an IRS summons.¹¹⁶ The work product rule shields materials prepared by an attorney in anticipation of litigation.¹¹⁷ It supports the public policy interest in the efficient adjudication of claims.¹¹⁸ A showing of particularized need may overcome the rule, but the attorney's legal theories and thought processes are still held inviolate.¹¹⁹ The work product rule extends to materials prepared by agents of the attorney or other representatives of the party.¹²⁰ It does not, however, protect materials prepared for business purposes or public requirements unrelated to litigation.¹²¹

presence of an accountant . . . ought not destroy the privilege" *Id.* at 922. *See generally* Garbis, *Discovery and Defenses in Tax Fraud Investigations*, 10 CUM. L. REV. 655, 662 (1980).

In tax practice, the roles of the attorney and the accountant are, at times, indistinguishable. Some commentators have argued that this functional overlap is not a sufficient reason to extend the privilege to accountants. *See Note, Functional Overlap Between the Lawyer and Other Professionals: Its Implications for the Privileged Communications Doctrines*, 71 YALE L.J. 1226, 1246-49 (1962). Other commentators have urged that the public policy interest, which is furthered by recognition of the attorney-client privilege in tax matters, does not suffer because an accountant, rather than an attorney, is rendering the service. Katsoris, *Confidential Communications—The Accountant's Dilemma*, 35 FORDHAM L. REV. 51, 67-68 (1966). Wigmore has argued for extension of the privilege to specialists practicing before administrative agencies. 8 J. WIGMORE, *supra* note 109, § 2300a, at 581-82. *See also* Comment, *Accountants, Privileged Communications and Section 7602 of the Internal Revenue Code*, 10 ST. LOUIS U.L.J. 252 (1965).

For a general discussion of accountants and tax practice, see Gray, *Lawyers and Accountants in Tax Practice—A Challenge to the Bar*, 15 J. TAX. 100 (1961).

115. *See* Garbis, *supra* note 114, at 662.

116. *Upjohn Co. v. United States*, 449 U.S. 383, 397-402 (1981); *United States v. Brown*, 478 F.2d 1038, 1041 (7th Cir. 1973).

117. *Hickman v. Taylor*, 329 U.S. 495, 513 (1947).

118. *Id.* at 510.

119. *See* FED. R. CIV. P. 26(b)(3). The rule provides:

A party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including his attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

120. *Id.*

121. FED. R. CIV. P. 26 advisory committee note, 48 F.R.D. 487, 501 (1970).

In the wake of the *Upjohn* decision, *see* note 111 *supra* and accompanying text, commentators

III. THE CASES

In *United States v. Coopers & Lybrand*¹²² the IRS, pursuant to its investigation of the Johns-Manville Corporation, issued a summons to the public accounting firm of Coopers & Lybrand for production of the tax accrual work papers pertaining to the firm's audit of Johns-Manville.¹²³ The taxpayer intervened¹²⁴ and objected, *inter alia*, on the grounds of relevance as contained in the *Powell* criteria¹²⁵ and in the statute.¹²⁶

The District Court for Colorado acknowledged the elusiveness of the concept of relevance and the lack of judicial standards for its determination.¹²⁷ It set up two categories of potentially relevant documents. The first category included documents, such as records of actual taxable transactions, that were ordinarily relevant and reachable whether sought from the taxpayer or a third party.¹²⁸ The second category encompassed all data not falling within the first category, including documents not prepared for nor used in connection with the determination of tax liability¹²⁹ and documents that contained the private thoughts of the taxpayer.¹³⁰ The court concluded that the IRS must satisfy a higher standard of relevance to obtain disclosure of materials, such as the workpapers, in this second category.¹³¹ The government's testimony that the documents "might shed some light"¹³² on unidentified, additional tax liabilities was not sufficient to sustain its burden of establish-

have speculated on the reach of the "in anticipation of litigation" requirement. "In one sense at least, preparation for tax litigation commences with the structuring of the transaction, its documentation, perhaps even the way in which the tax return . . . is prepared." Nat'l L.J., Feb. 9, 1981, at 3, col. 4. The contrary view is:

Using the attorney in this audit role will not cloak the detail underlying the total tax provision figure with some form of privilege. The work involved is not being done for the purpose of providing legal advice to the client nor in preparation for litigation, but rather as support for financial statements intended to go to third parties.

Id., Mar. 2, 1981, at 3, col. 6.

122. 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977).

123. *Id.* at 944.

124. See note 69 *supra* and accompanying text.

125. See notes 55-59 *supra* and accompanying text.

126. See notes 1 & 76-77 *supra*.

127. 413 F. Supp. at 950.

128. *Id.*

129. *Id.*

130. *Id.* at 952.

131. *Id.*

132. *Id.* at 951.

ing relevance.¹³³ The court consequently refused to order production of the workpapers.¹³⁴

The court also considered the taxpayer's public policy arguments. It quoted extensively from expert witness testimony that disclosure to the IRS of the conjectural workpapers would cut off the frank communications between accountant and client that are necessary to assure adequate reporting of financial position.¹³⁵ The additional time and expense burdens of producing the workpapers were also a significant factor in the court's decision.¹³⁶ Although these public policy concerns alone were not sufficient to justify nondisclosure of the requested documents, they did carry considerable weight in the balancing process that the court implicitly adopted to measure relevance.¹³⁷

In *United States v. Arthur Andersen & Co.*¹³⁸ the District Court for Massachusetts, under a substantially similar fact situation,¹³⁹ ordered production of the workpapers. The respondents relied on the *Coopers*

133. *Id.* at 954.

134. *Id.*

135. *Id.* at 953-54. See note 47 *supra* and accompanying text.

136. 413 F. Supp. at 954.

137. *Id.*

138. 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

After the court denied a motion for a stay of the district court's enforcement order, Arthur Andersen & Co. turned over the summoned documents and appealed that part of the order requiring production of the tax liability contingency analysis. The First Circuit dismissed the appeal as moot, holding that the firm could have refused production and risked contempt to preserve the appeal. 623 F.2d 720, 722 (1980). A second appeal on the issue of whether bankruptcy proceedings foreclosed the IRS's investigatory authority resulted in the affirmance of the district court's determination that it did not. 623 F.2d 725 (1980). The mootness issue was the basis of the petition for certiorari.

United States v. Arthur Young & Co., [1980-2] U.S. Tax Cas. (CCH) ¶ 9655 (S.D.N.Y.) was another workpapers case decided shortly after *Arthur Andersen*. The court, relying on the *Arthur Andersen* decision and *United States v. Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979), see notes 100-08 *supra* and accompanying text, ordered production of the workpapers.

United States v. Price Waterhouse & Co., 515 F. Supp. 996 (N.D. Ill. 1981), is the most recent case addressing the workpapers issue. The auditors in *Price Waterhouse* refused to turn over only that portion of the workpapers containing opinions "on issues not specifically identified by the IRS." *Id.* at 998. The court concluded that the auditor's objection did not involve the judgmental nature of the workpapers. The issue was whether the IRS's failure to identify the specific issues addressed in the portion of the workpapers withheld rendered those portions irrelevant. The court concluded that it did not and ordered enforcement. The court acknowledged the importance of the policy arguments asserted by the auditors but found it unnecessary to address them in deciding the narrow issue before it.

139. In *Coopers & Lybrand* the auditing firm was not responsible for preparation of the firm's income tax returns. In *Arthur Andersen* it was. The *Arthur Andersen* court did not distinguish the

& *Lybrand* court's interpretation of relevancy, but the court refused to adopt that standard¹⁴⁰ and turned instead to the statutory language for guidance.¹⁴¹ It found no support in the statute for restricting relevant information to information that formed the basis of the tax return.¹⁴² The relevancy standard also reached material that involved characterization of the transactions that were the basis of the income tax liability.¹⁴³ The statutory use of the words "any"¹⁴⁴ and "may be relevant or material"¹⁴⁵ was evidence to the court of this expansive scope.¹⁴⁶

The court maintained that "the collective familiarity"¹⁴⁷ of the investigating agents was sufficient to satisfy the government's burden of establishing relevance.¹⁴⁸ The IRS could not and was not required to guarantee relevancy prior to production. It could make that determination only after the summoned documents were produced and analyzed.¹⁴⁹

The *Arthur Andersen* court relied on precedent to reject the accountant-client privilege urged by the corporation,¹⁵⁰ but did, however, ac-

cases on this basis, but the factor was stressed in *Noall v. United States*, 587 F.2d 123, 127 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

140. 474 F. Supp. at 329.

141. *Id.*

142. *Id.* at 329-30.

143. *Id.* at 330.

144. *See* note 1 *supra*.

145. *Id.*

146. 474 F. Supp. at 329.

The court in *United States v. Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979), suggested that Congress used "may" advisedly and in recognition of the fact that because the IRS could not determine relevancy in fact prior to inspection of the documents, the threshold standard of relevance was low. *Id.* at 125-26. In its brief, *Arthur Andersen & Co.* suggested that "may" was merely indicative of congressional recognition of the broader, but not limitless, scope of inquiry in an investigatory context. Brief of Appellant-Respondent at 40, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980). *See United States v. Acker*, 325 F. Supp. 857, 862 (S.D.N.Y. 1971).

In *United States v. Arthur Young & Co.*, [1980-2] U.S. Tax Cas. (CCH) ¶ 9655 (S.D.N.Y.), the parties argued the meaning of the word "data" in the statute, *see* note 1 *supra*. The court rejected the taxpayer's contention that the term "data" was restricted to records of actual transactions. *See Caplin, Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, *supra* note 6, at 199.

147. 474 F. Supp. at 329. The term apparently refers to the agents' investigation of the affairs of the taxpayer for a considerable period of time.

148. *Id.* at 329-30.

149. *Id.* at 330. One commentator has referred to this holding as a "catch 22." Caplin, *IRS Maintains Tough Stance on Accrual Workpapers*, *supra* note 6, at 38, col. 3.

150. 474 F. Supp. at 326-27.

knowledge the significance of the public policy concerns underlying the privilege.¹⁵¹ Neither Arthur Andersen & Co. nor Coopers & Lybrand asserted an attorney-client privilege or the work product rule.¹⁵² The workpapers were neither the product of an attorney's work nor the result of confidential communications to an attorney.¹⁵³

IV. ANALYSIS

Although the *Coopers & Lybrand* and *Arthur Andersen* courts tested the same concept against the same standard, their respective resolutions of the question are at opposite poles. This exceedingly malleable standard offers little guidance or predictability. Relevancy is inherently a balancing concept¹⁵⁴ such that the courts must weigh the variables in each case on an ad hoc basis.¹⁵⁵ When the IRS summons workpapers, the relevant variables include (1) the nature of the information sought,¹⁵⁶ (2) the party from whom it is sought,¹⁵⁷ (3) the public interest in preserving confidentiality in that particular relationship,¹⁵⁸ and (4) the IRS's need for that particular information to perform its statu-

151. *Id.*

152. See notes 109-21 *supra* and accompanying text.

153. See *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980); *United States v. Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). See also notes 183-98 *infra* and accompanying text.

154. Brief for Respondent-Appellant at 19-25, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980). See C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE § 77, at 159-60 (2d ed. E. Cleary 1972).

Reconciling interests in privacy and confidentiality with the needs of litigants is not readily achieved in terms of broad categories; it calls for the finer touch of the specific solution. A tool already at hand, though perhaps largely unrecognized, consists of recognizing standing on the part of the possessor of information to question the legitimacy of need for it in litigation, i.e., to raise issues of relevancy in the broad sense. . . . A similar thread runs through the Federal Rules of Civil Procedure limitation of discovery to matter "relevant to the subject matter involved in the pending action." Relevancy itself, of course, contemplates a process of weighing, and inevitably the judge must be accorded a substantial measure of discretion.

Id. (footnotes omitted).

155. *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973).

156. *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 945 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977) ("the character of the material and documents summoned is the pivotal element in our consideration").

157. *United States v. Harrington*, 388 F.2d 520, 523 (2d Cir. 1968) (judicial scrutiny of summons particularly appropriate when records summoned are those of a third party).

158. *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 948 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977) (policy considerations are relevant in a judicial enforcement proceeding).

tory mandate to collect taxes.¹⁵⁹ Balancing these factors reveals the divergent and competing interests that are affected by the decision. In contrast, the application of phraseology and conclusory analysis to support a decision provides no indication of what factors prompted the result or whether the evidence was weighed at all.

The *Coopers & Lybrand* court balanced these various interests to a greater degree than did the *Arthur Andersen* court.¹⁶⁰ The *Coopers & Lybrand* court considered the nature of the documents sought and a certified public accountant's expert testimony both on the methods employed to compile the documents and the damage that would result from their disclosure.¹⁶¹ The government sought the workpapers to assist it in identifying additional tax liabilities.¹⁶² On further questioning, however, the government admitted that the books and records already in its possession were adequate to complete the investigation.¹⁶³ In contrast, the *Arthur Andersen* court summarily accepted an affidavit attesting to "the collective familiarity"¹⁶⁴ of the agents as a sufficient showing of need for the summoned materials.¹⁶⁵

The *Coopers & Lybrand* court relied heavily on *Matras*,¹⁶⁶ while the *Arthur Andersen* court relied on *Noall*.¹⁶⁷ The same contrast between balancing the affected interests and a summary procedure is apparent in those two earlier opinions. Although the *Matras* court weighed the taxpayer's policy arguments,¹⁶⁸ the *Noall* court dismissed such considerations.¹⁶⁹ In *Matras* the government's testimony concerning its need revealed nothing more than the desire for a roadmap as a convenience, and the summons thus was denied.¹⁷⁰ In *Noall* the government demon-

159. *United States v. Bisceglia*, 420 U.S. 141, 145 (1975) ("[i]t would be naive to ignore the reality that some persons attempt to outwit the [tax] system and tax evaders are not readily identifiable").

160. See notes 122-49 *supra* and accompanying text.

161. 413 F. Supp. at 953-54. See note 47 *supra* and accompanying text.

162. 413 F. Supp. at 951.

163. *Id.* at 952.

164. 474 F. Supp. at 329.

165. In *United States v. Harrington*, 388 F.2d 520 (2d Cir. 1968), the court rejected the notion that it should order production of summoned records because "some chance of relevance exists . . ." *Id.* at 524. The court stated that "[t]he question . . . is whether from what the Government already knows there exists the requisite nexus . . ." *Id.*

166. See notes 94-99 *supra* and accompanying text.

167. See notes 100-08 *supra* and accompanying text.

168. 487 F.2d at 1275.

169. See note 107 *supra* and accompanying text.

170. See note 96 *supra* and accompanying text.

strated its need by alleging that the documents were potentially relevant and that a determination of actual relevancy was possible only after inspection.¹⁷¹ The court rejected the taxpayer's request for an evidentiary hearing.¹⁷²

The balancing approach adopted by the *Coopers & Lybrand* and *Matras* courts, however, still fails to provide judges and litigants with a relevance standard that assures consistent results and a degree of certainty.¹⁷³ The *Coopers & Lybrand* court suggested a logical first step in the development of a more workable standard. It divided potentially relevant documents into two categories: factual and nonfactual documents.¹⁷⁴ The first category includes actual records of taxable transactions. These records are unquestionably relevant and, barring other prohibitions,¹⁷⁵ are ordinarily subject to summons enforcement.¹⁷⁶ The second category includes the proposed budget in *Matras*,¹⁷⁷ the internal audit reports in *Noall*,¹⁷⁸ and the workpapers in *Coopers & Lybrand*¹⁷⁹ and *Arthur Andersen*.¹⁸⁰ documents that consist of plans, investigations, speculations, and thought processes.¹⁸¹ This latter category is not available without a more specialized showing of need balanced against the grounds for resistance.¹⁸²

The attorney-client testimonial privilege¹⁸³ is not directly applicable

171. 587 F.2d at 125.

172. See note 108 *supra* and accompanying text.

173. The *Matras* court recognized that without some limitation, all corporate documents are relevant and thus discoverable. *United States v. Matras*, 487 F.2d 1271, 1275 (8th Cir. 1973). The courts, however, are unable to agree upon the limits of relevancy. See, e.g., *United States v. First Chicago Corp.*, [1979-1] U.S. Tax Cas. (CCH) ¶ 86,034 (N.D. Ill. 1978) (summons of internal audit reports).

174. See notes 128-29 *supra* and accompanying text.

175. Other prohibitions would include the *Powell* criteria, see notes 55-59 *supra* and accompanying text, and the work product rule, see notes 116-21 *supra* and accompanying text.

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

177. 487 F.2d at 1275.

178. 587 F.2d at 125-26.

179. 413 F. Supp. at 945.

180. 474 F. Supp. at 327 n.6.

181. In *United States v. First Chicago Corp.*, [1979-1] U.S. Tax Cas. (CCH) ¶ 86,034 (N.D. Ill. 1978), the court rejected the claimed relevance of spot checks of individual departments "which make passing references to individual, *de minimus* transactions." *Id.* at ¶ 86,037.

182. A showing that the original records of account are unavailable may meet the specialized showing of need. See Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, *supra* note 6, at 199. In *In re Co-Build Co.*, [1977-2] U.S. Tax Cas. (CCH) ¶ 9735 (E.D. Pa.), the corporation's internal records were destroyed by fire.

183. See note 110 *supra* and accompanying text.

to a summons for workpapers because it is an accountant, rather than an attorney, who has provided the service.¹⁸⁴ The attorney's work product rule¹⁸⁵ is not applicable because it is an accountant's, not an attorney's, work product that is involved.¹⁸⁶ The work is not done strictly in preparation for trial because it is required independently of anticipated litigation.¹⁸⁷ Nevertheless, the policy interests that underlie these two privileges are applicable in the workpapers situation.¹⁸⁸

The Supreme Court recently addressed both the attorney-client privilege and the attorney's work product rule in *Upjohn Co. v. United States*.¹⁸⁹ The Court stressed that the attorney-client privilege protects not only the giving of advice by the attorney but also his receipt of information forming the basis of that advice. Free access to the latter is critical to informed and effective counsel.¹⁹⁰ In the auditor-corporation relationship, confidence similarly is necessary if the auditor is to fulfill his duty to issue an informed opinion on the accuracy of the corporate client's financial statements.¹⁹¹

The *Upjohn* Court also strongly reaffirmed the attorney's work product rule as enunciated in *Hickman v. Taylor*.¹⁹² The rule, said the Court, provides special protection for the mental processes and legal theories "of an attorney or other representative."¹⁹³ The interests of both the clients and the judicial system require that an attorney have a degree of privacy in the preparation of a case for trial.¹⁹⁴

The analogy to the workpapers situation is strong. The workpapers

184. See notes 113-15 & 150-53 *supra* and accompanying text.

Recent commentary suggests that auditors, acting as agents of the corporation, submit the workpapers to either corporate in-house counsel or outside counsel to obtain counsel's advice on the financial statement provision for contingent income tax liability. This practice might bring the workpapers within the protection of the attorney-client privilege. Diss & Hanson, *supra* note 61, at 106-07. Whether such communications are made for the purpose of obtaining business or legal advice, however, is not clear. See note 114 *supra* and accompanying text.

185. See note 117 *supra* and accompanying text.

186. See notes 152-53 *supra* and accompanying text.

187. See note 121 *supra* and accompanying text.

188. Compare notes 109-21 *supra* and accompanying text with notes 47-48 *supra* and accompanying text.

189. 449 U.S. 383 (1981).

190. *Id.* at 390.

191. See notes 48 & 135 *supra* and accompanying text.

192. 329 U.S. 495 (1947).

193. *Upjohn Co. v. United States*, 449 U.S. 383, 398 n.7 (1981) (quoting FED. R. CIV. P. 26(b)(3)). See note 119 *supra*.

194. 449 U.S. at 397-98. Without the protection of the rule, "much of what's now put down in writing would remain unwritten. . . . Inefficiency, unfairness and sharp practices would inevita-

are a collection of possibly adverse legal theories compiled by the accountant.¹⁹⁵ If they are available to the IRS for the asking,¹⁹⁶ the accountant will perform the required work in his head,¹⁹⁷ and less accurate reporting of financial position will result.¹⁹⁸

The general objective of fair play in the tax system¹⁹⁹ provides an additional ground for resistance to the IRS summons of an accountant's workpapers. Preparation of the workpapers is necessary for compliance with SEC regulations and with acceptable standards of practice in the accounting profession.²⁰⁰ The IRS does not require preparation of such documents. Congress has not seriously considered suggestions that taxpayers append to their tax returns a disclosure of questionable positions.²⁰¹ A corporation has a legal right to decrease its taxes by means that it determines are in conformance with the law.²⁰² Requiring disclosure of the arguments the taxpayer conjures up against this position is untenable. The self assessment system is buttressed by the broad investigatory powers of the IRS, but it is also grounded in an assumption of fair play by both sides.²⁰³ A requirement that the taxpayer, in effect, prepare the IRS's case against his position is beyond the bounds of fair play and is thus disruptive to the self assessment system.²⁰⁴ The IRS has successfully rebuffed taxpayers who have sought discovery of the IRS's legal position in litigation on the ground that the information sought was neither factual nor relevant.²⁰⁵ The

bly develop in the giving of legal advice and the preparation of cases for trial." *Id.* at 398. (quoting *Hickman v. Taylor*, 329 U.S. 495, 511 (1947)).

195. See note 37 *supra* and accompanying text.

196. See *Hickman v. Taylor*, 329 U.S. 495, 516 (1947) (Jackson, J., concurring) ("[d]iscovery was hardly intended to enable a learned profession to perform its functions on wits borrowed from the adversary").

197. Brief for Appellant-Respondent at 6, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

198. See notes 47-48 *supra* and accompanying text.

199. See Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, *supra* note 6, at 200.

200. See notes 30-31 *supra* and accompanying text.

201. See Kurtz, *supra* note 34, at 13.

202. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). See ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 314 (1967).

203. See note 199 *supra* and accompanying text.

204. Brief for Appellant-Respondent at 10, *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *aff'd*, 623 F.2d 725 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

205. See, e.g., *P.T. & L. Constr. Co. v. Commissioner*, 63 T.C. 404, 414 (1974), in which the court said that "[w]hat is relevant is the *factual information* Mental impressions, legal analysis, conclusions, and recommendations are generally not relevant."

taxpayer should have the benefit of the same argument interpreted in the same way.

V. CONCLUSION

The current uncertain status of the workpapers vis á vis the summons authority of the IRS is unacceptable. The relevance requirement provides no inherent limits on the types of documents that the IRS may summon.²⁰⁶ The varying interpretations of the courts²⁰⁷ give corporate taxpayers, accountants, and attorneys no basis for predicting outcomes or protecting their interests. The attorney-client privilege is facially inapplicable and judicial extension is unlikely.²⁰⁸ The attorney work product doctrine serves as a useful analogy for the purposes of developing the policy considerations but can do little more.²⁰⁹ Whether accomplished statutorily or judicially, a workable, predictable standard is necessary that will protect the workpapers from the summons absent an extraordinary showing of need. The division of potentially relevant documents according to their factual or nonfactual content is a logical first step.²¹⁰ Documents in the first category are ordinarily discoverable.²¹¹ Discovery of documents in the second category should require a showing of particularized need balanced against the policy interests in nonproduction.²¹² If the IRS meets this burden, the order to produce should limit production to those portions of the documents containing the facts for which the IRS has established need. The order should, if possible, protect materials consisting of the mental processes and opinions of the accountant.²¹³ This standard would help ensure access to the information the IRS needs to carry out its mandate to collect the

206. See note 173 *supra* and accompanying text.

207. See notes 90-108 *supra* and accompanying text.

208. See notes 183-84 *supra* and accompanying text.

209. See notes 185-88 *supra* and accompanying text.

210. See notes 128-29 & 174-76 *supra* and accompanying text.

211. See notes 128 & 175-76 *supra* and accompanying text.

212. See notes 130 & 177-82 *supra* and accompanying text.

213. The *Coopers & Lybrand* court did not suggest that materials reflecting the accountant's thought process were absolutely privileged. 413 F. Supp. at 950. The Supreme Court, in *Upjohn Co. v. United States*, reserved judgment on the question of absolute privilege as applied to the thought process revealed in the attorney's work product. 449 U.S. at 401. If the IRS shows both necessity and unavailability from any other source, *e.g.*, destruction of the transactions records, see note 182 *supra*, the court may use an *in camera* inspection to excise material reflecting opinions from the workpapers. The court in *United States v. Noall* rejected this possibility. 587 F.2d at 127.

taxes. In addition, this standard would serve the equally important purposes of protecting the taxpayer's legitimate expectation in the confidentiality of his and his accountant's thought processes and of preserving the balance critical to the successful operation of the tax system.

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