

Ethics And Tax Education: A Change In Focus Is Needed

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ABSTRACT

The corporate scandals of recent years have highlighted the failure of ethics, not only in corporate management, but also in the big accounting firms. For tax professionals, there is an inherent conflict of interest that makes studying ethics in the context of tax practice problematic. On the one hand, the tax professional is a client advocate with the responsibility of helping the client to legally minimize tax liability. On the other hand, tax professionals who are lawyers or CPAs and who practice before the IRS have both ethical and legal obligations mandated by their professions and the Department of the Treasury. For the tax educator, the problem is finding a way to reinforce the importance of ethical behavior while promoting an understanding of the inherent conflict that anyone in the tax profession faces. In this paper, we look at ethics in tax practice and consider the difficulties faced by faculty in providing an ethical grounding for undergraduate students in taxation. First we will discuss the professional standards already in place for CPAs—the AICPA Statements on Standards for Tax Services and the Treasury Department’s Circular 230. Next we will discuss the need for new guidelines, as demonstrated by the recent wave of lawsuits over tax shelters. Then we will look at ethics as covered in several popular tax textbooks. Finally, we will offer recommendations on improving the coverage of ethics and refining the focus of materials commonly available for educators.

Keywords: Tax Advisor, Tax Educator, Ethics, Scandal, Audit Firms, Accounting Firms, Public Accountant

INTRODUCTION: CONFLICTS OF INTEREST

There is no simple explanation for the corporate scandals of the last few years. Certainly, greed and arrogance at the top—of corporations and of accounting firms—played a major role. But a structural flaw in our systems of investment banking, corporate governance, and accounting oversight contributed to the incredible proliferation of scandals that has shaken investor confidence, destroyed careers, and wiped out years of retirement savings for many Americans. The conflict of interests tolerated in the accounting profession, in large corporate clients, and in the investment banking and securities brokerage business allowed slightly shady practices to grow into full-scale financial disasters.

Public accountants who audit the financial statements of publicly-traded companies are supposed to be independent, to help maintain trust in corporate financial reporting. However, with the rapid expansion of the big accounting firms into the consulting business, maintaining independence became more difficult. Consulting became big business, and accounting professionals on the audit side may have felt the pressure to keep big clients happy and keep both audit and consulting fees coming in.

Financial services firms with both an investment banking arm and a securities brokerage business also earned criticism for conflicts of interest. Supposedly independent financial research analysts found it difficult to honestly evaluate companies involved with the investment banking function of their firms because of the huge fees earned through IPOs and mergers.

In both these instances, the conflict of interest arose in firms which maintained two functional businesses, with one being more profitable than the other. [Brennan] It shouldn’t have come as a great surprise that

independence was compromised. Tax professionals face a different kind of conflict of interest. On the one hand, tax advisors have an obligation to their clients to legally minimize tax liability. On the other hand, tax professionals who are lawyers or CPAs and who practice before the IRS have both ethical and legal obligations mandated by their professions and the Department of the Treasury.

This inherent conflict in tax practice has become more evident in recent months because of well-publicized tax shelter scandals and lawsuits involving large accounting firms which sold tax shelter strategies to their wealthy clients.

Conflicts of interest are only one symptom of the general breakdown of ethics in the accounting profession and corporate America. But the inherent conflict for the tax professional has always made studying ethics in the context of tax practice problematic. There has been much written recently about the failure of business schools to turn out ethical MBAs [Kimm], but what about undergraduates? Some believe that ethics should be integrated into all academic curricula; others favor a separate ethics course. Whatever the approach, we in academia cannot ignore our responsibility to provide the opportunities necessary to help our students learn the difference between ethical and unethical behavior. We cannot guarantee success, but we have a responsibility to try.

Our purpose of this paper is to look specifically at ethics and tax practice. First we will discuss the guidelines already in place for CPAs—the Statements on Standards for Tax Services and Circular 230. Next we will discuss the need for new guidelines, as demonstrated by the recent wave of lawsuits over tax shelters. Then we will look at ethics as covered in several popular tax textbooks. Finally, we will offer some recommendations on improving the coverage of ethics and refining the focus of materials commonly available for educators.

CURRENT GUIDELINES FOR TAX ADVISORS

Almost anyone can prepare taxes. With some exceptions, though, only CPAs, attorneys, and enrolled agents may practice before the IRS. “Practice before the IRS” includes any presentation to an IRS employee regarding a taxpayer’s rights, privileges, or liabilities under the Internal Revenue Code and includes preparing and filing documents, communicating with the IRS, and representing a taxpayer at a conference or hearing. [Circular 230]

Circular 230 is part of the Code of Federal Regulations and is published by the Treasury Department. It provides, among other things, rules governing authority to practice before the IRS, duties and restrictions relating to such practice, sanctions for violations, and rules regarding disciplinary proceedings.

Duties relating to practice before the IRS include the following:

- The practitioner must promptly submit information properly requested by the IRS.
- The practitioner who becomes aware of a client’s error or omission must promptly advise the client of that fact.
- The practitioner must exercise due diligence in preparing documents and oral or written representations to the Department of the Treasury

Restrictions relating to practice before the IRS include the following:

- The practitioner may not knowingly accept assistance from any person who has been suspended or disbarred from practice before the IRS.
- The practitioner shall not represent a client if that representation represents a conflict of interest.
- A practitioner may not sign a tax return as preparer if the return contains a position that does not have a realistic possibility of being sustained, unless the position is disclosed and is not frivolous. The reasonable possibility standard requires a one in three likelihood that the position will be sustained on its merits.
- The practitioner also has a duty to advise the client of potential penalties that may apply to the taxpayer with respect with the position.

Sanctions for violation of the regulations may include censure (public reprimand), suspension, or disbarment from practice before the IRS.

Statements on Standards for Tax Services (SSTSs), which are published by the American Institute of Certified Public Accountants (AICPA), set forth ethical tax practice standards for members of that organization. They are part of the AICPA's Code of Professional Conduct and outline the CPA's responsibilities to taxpayers, the public, government, and the profession. [SSTS Preface] The SSTSs are available on the AICPA website and are often included in summary form in tax textbooks.

The Statements cover topics such as the use of estimates, answers to questions on returns, and procedural aspects of preparing returns, but of most interest from the ethics standpoint are Statements 1, 6 and 7.

Statement 1, "Tax Return Positions," discusses the "realistic possibility standard." An AICPA member providing professional tax services should not recommend a tax return position unless that professional believes the position has a realistic possibility of being sustained on its merits. According to Circular 230, a realistic possibility means at least a one in three likelihood. The Statement goes on to suggest that a member may recommend a position that is not frivolous as long as the taxpayer is advised to disclose that position. Playing the audit lottery is not acceptable. A member should also, when relevant, advise the taxpayer about potential penalties. [Statements on Standards for Tax Services, Statement No. 1]

Statements 6 and 7, "Knowledge of Error" discuss the standards for an AICPA member who becomes aware of an error in a tax return (#6) and in an administrative proceeding (#7). The member is to inform the taxpayer of the error and recommend that it be corrected. The member cannot inform the IRS without the taxpayer's permission. If the taxpayer refuses to correct the error, the member must consider whether to continue the professional relationship with that taxpayer.

While these two statements focus on the member's responsibility to his/her client, they briefly discuss the potential for conflict of interest created when a taxpayer refuses to correct an error. The statements suggest that the potential for violating the tax law and regulations and the Code of Professional Conduct relating to confidential client communications, among other considerations, may create a conflict of interest for the tax professional. However, the major focus is on the actions of the tax professional (AICPA member), who must seriously consider whether to continue a relationship with a client who refuses to correct an error, with the unwritten implication that such a client may cause additional problems in the future for the tax professional. To put it bluntly, (in our words), does a tax professional want to risk his/her career for a client who thinks it's OK to cheat on his/her taxes.

NEW GUIDELINES NEEDED

The current version of the SSTSs have been in place since 2000, but the need for new guidance has become increasingly evident in the wake of numerous lawsuits filed over tax shelters sold by accounting firms. In November, 2002 the AICPA recognized the controversy and issued an exposure draft on a proposed interpretation for SSTS #1 to provide guidance on tax planning, which may include tax shelters.

The large accounting firms which provide tax, as well as audit and consulting services, are not immune to the culture of corporate greed so common in the US. The boom of the 1990's produced many very wealthy potential tax clients for the large accounting firms. Selling tax shelter strategies to these clients proved extremely lucrative for the tax teams at Deloitte, Ernst and Young, KPMG, Pricewaterhouse Coopers, and other firms. [*Wall Street Journal*, 2/7/2003, page A6] For some firms, selling tax shelters generated more than half of the firm's tax revenue. Some of the tax shelters created paper losses to offset capital gains; others used complicated transactions to increase the cost basis of assets to reduce the profits on paper. The IRS has attacked many of the transactions because most had no business purpose, other than to reduce tax liability, and thus were sham transactions. [*Wall Street Journal*, 2/7/2003, page A3]

When audit firms also provide tax advice to executives of the firms they audit, a particularly risky conflict of interest can arise. This situation occurred at Sprint, where the top executives were required to use Ernst and

Young, Sprint's auditor, to prepare their tax returns. [*Wall Street Journal*, 2/10/2003] The two executives, the CEO and the President of the Board, bought into a tax shelter sold by Ernst to save millions on stock option gains, but when this very shelter came under investigation by the IRS, it left the executives at odds with the company's auditor. Sprint's board finally concluded that it was better to get rid of the executives than the auditor, but the whole fiasco certainly raises conflict of interest issues for the accounting firm as well as the corporation.

Now the bubble is beginning to burst. As the IRS has stepped up its enforcement efforts against abusive tax shelters, more and more clients being audited by the IRS are filing lawsuits against the accounting firms for bad tax advice. The potential cost to the accounting firms is measured not just in millions of dollars to settle or fight lawsuits, but also in lost credibility with clients. Clearly, the quest for profits overwhelmed ethical concerns in some of these accounting firms. Whether an expansion of the interpretation of SSTS #1 to include a discussion of tax shelters will provide the self-regulation that the profession desires remains to be seen. Looking at recent events suggests that a third dimension has been added to the fundamental conflict between being an advocate for your client and following professional ethical guidelines. Some accountants appear to have placed greed and personal gain above both the client's interests and the profession's interests.

THE TEXTBOOK APPROACH TO PROFESSIONAL ETHICS

In the tax textbooks we surveyed, coverage of professional ethics was minimal at best. [List of texts in the Appendix] The discussion usually consisted of 2-3 pages at the end of a chapter on tax research or tax administration. For example, after a 34-page discussion of tax research, the Pope, Anderson, & Kramer comprehensive *Federal Taxation* spent 3 pages summarizing the SSTSs. The CCH *Federal Taxation Comprehensive Topics (Smith, Harmelink, and Hasselback)* covers ethics rules for practitioners in 3 pages at the end of a 73-page chapter on tax research, practice, and procedure. In the Hoffman, Smith and Willis *Individual Income Taxes*, less than a page in Chapter 1 is spent on ethical guidelines, while in the Hoffman, et. al., *Corporations, Partnerships, Estates & Trusts*, coverage is better with a 6-page discussion of Circular 230, the SSTSs, and privileged communications.

Some of the above texts include short ethics vignettes in most of the chapters in the text. The problem is, most of these are fairly simplistic and it is hard to put them in context without a foundation in the ethics of the profession. The best ethics discussion we found was in a book designed for the AICPA Model Tax Curriculum—*Taxation for Decision Makers* by Dennis-Escoffier and Fortin. In the second chapter of this text, the authors briefly discussed Circular 230, summarized the SSTSs, and considered the inherent conflict resulting from the tax professional's dual responsibilities to the client and the tax system. They also mentioned the other moral issue which both tax professors and tax students come up against: the idea that it's OK to cheat on your taxes because "everybody does it." This is an attitude we have all encountered, but most textbook authors avoid mentioning it. After this good beginning, though, we could find no other examples of ethics issues in this textbook. Overall, we can only conclude that current tax textbooks do not provide a strong foundation for classroom discussions of ethics for the future tax professional.

RECOMMENDATIONS

CPAs are advised to protect their professional standing by adhering to the "realistic possibility" standard when taking a tax return position, by adhering to confidentiality rules, and by considering carefully whether to continue a relationship with a client who refuses to correct an error on a return. Scenarios used in education often relate to the professional's responsibility when a client appears to be doing something shady. Obviously, it is important that tax professionals understand the implications of maintaining a relationship with a dishonest client. At one time or another, many professionals have to decide if the big fees are worth the risk to their careers.

We can no longer focus only on careful client screening. Events of the last few years have shown us that we have to watch out for accountants that cross the line, also. In the past, the conflict for the tax professional was between the duties of a client advocate and the ethical obligations to the profession and the tax system. Now we also have to consider the push for profits in the accounting firm with the resulting pressure to sell tax strategies, no matter what.

We have three recommendations regarding the treatment of ethics in tax textbooks and other educational materials.

- Increase the prominence and expand the coverage of ethics.
Devote a whole chapter to this issue and put it at the front of the book, not the end. Don't bury it in three pages at the end of the research or administrative practice chapter. It's more important than that. Develop ethical scenarios and put them in context, using Circular 230 and the SSTs. Discuss uncomfortable issues. Don't be afraid to say: cheating on taxes is wrong.
- Look at the costs of unethical behavior.
The costs of unethical behavior are both personal and professional for the tax accountant who ignores ethical considerations. A tax practitioner can be suspended from practice before the IRS if they engage in disreputable behavior. Are the big fees from a dishonest client worth a career? A firm has to be profitable to continue to exist, but the tax professional has to be ready to accept the consequences for decisions made. At the firm level, weigh the costs of lawsuits from unhappy clients with the big revenues from tax shelter schemes. Discuss actual cases of firms that settled lawsuits relating to abusive tax shelters.
- Use current events to discuss the inherent conflict of interest that the tax professional faces.
The pressure for profits has complicated the conflict that tax professionals face. Most of the big accounting firms bought into the aggressive marketing of tax shelters in the 90's and most are now facing lawsuits relating to potentially abusive tax shelters. Since tax textbooks are revised annually, including current events in ethics coverage should not be an issue.

Although it's doubtful the entry-level accountant would be associated with tax shelter marketing, the ethical atmosphere of the firm affects employees at all levels. If integrity loses out to greed at the top, that type of behavior will soon be acceptable throughout the firm.

Tax students need to be exposed to ethical problems during their education, so that when they get out into practice they have some foundation for evaluating alternative actions in an ethical framework.

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APPENDIX: List of textbooks reviewed

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2. Hoffman, William H., Jr., James E. Smith, William A. Raabe, and David M. Maloney, *Corporations, Partnerships, Estates, and Trusts, 2003 edition*, Southwestern Publishing, 2003.
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4. Pope, Thomas R., Kenneth E. Anderson, and John L. Kramer, *Federal Taxation 2003 Comprehensive*, Prentice Hall, 2003.
5. Smith, Ephraim P., Philip J. Harmelink, and James R. Hasselback, *CCH Federal Taxation Comprehensive Topics*, CCH, 2003.