Legal And Ethical Implications Of The Foreign Outsourcing Of Tax Return Preparation

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ABSTRACT

In recent years, the outsourcing of tax preparation to foreign service providers has grown substantially. The benefits of outsourcing include lower costs and obtaining additional assistance during the busy tax season. However, some have raised both legal and ethical questions regarding this process. Arguments against the practice include problems related to ensuring confidentially of the information transmitted and the inability to adequately supervise personnel in foreign locations. This paper explores the legal concerns and ethical questions regarding outsourcing in light of the Gramm-Leach-Bliley Act, the Internal Revenue Service requirements, and the American Institute of Certified Public Accountant's Code of Professional Conduct. In addition, the paper summarizes the most recent pronouncement of the AICPA on the subject.

Keywords: foreign outsourcing, tax preparation, confidentiality, ethics, law

INTRODUCTION

When taxpayers retain the services of a tax professional, they assume that the services will be rendered professionally, legally and confidentially. When a CPA firm outsources its tax preparation services to a foreign service provider, these assumptions are often called into question. In the wake of the recent accounting scandals, such as Enron, Worldcom and Arthur Andersen, legal and ethical questions involving accounting firms have taken on added significance.

The foreign outsourcing issue has taken on such importance to the accounting profession that the American Institute of Certified Public Accountants formed a task force to study the issue. The charge to the task force was to determine whether the AICPA's Code of Professional Conduct should be revised to provide guidance for CPAs in this area. The task force has completed its work and new ethics rules that address the outsourcing issue became effective July 1, 2005. The purpose of this paper is to look at the legal and ethical issues that are raised when U.S. CPA firms outsource tax return preparation to service providers in foreign countries. The paper examines the issue in the light of the Gramm-Leach-Bliley Act, the Internal Revenue Service requirements, and the AICPA Code of Professional Conduct.

THE BENEFITS OF OUTSOURCING

The outsourcing of tax return preparation to foreign countries has grown significantly because of a number of potential benefits to U.S. CPA firms. The most commonly cited advantage is cost savings. If a CPA firm uses a foreign tax preparer, especially in an underdeveloped country, the cost to the CPA firm of servicing its tax clients is substantially less than the comparable cost of preparing the return in-house. Some Indian websites claim that tax returns can be processed in India for 50% of the cost in the United States.

Another major advantage of outsourcing tax return preparation is that it addresses the often severe problem of finding competent staff to work during the tax preparation busy-season. Since the ability to prepare a tax return requires a fairly high level of expertise, finding sufficiently trained employees to work only during tax season can be difficult. Every tax season brings the problems of training tax professionals, processing returns, and maintaining files. Since these preparers are only needed during tax season, it is often not financially feasible to keep them employed for the remainder of the year. Consequently, many find other jobs after tax season and are often unavailable for the next tax year. For most CPA firms, this problem is on-going and occurs year after year.

THE OUTSOURCING PROCESS

The Internet and the worldwide web have literally put the entire world's labor pool at the fingertips of U.S. CPA firms. The typical outsourcing process of tax return preparation begins with the U.S. firm conducting an interview with the client and collecting all the information required for preparation of the return. This information, which would include client personal information and source documents such as W-2s, interest and dividend information, charitable contribution information, and brokerage statements, is typically scanned into a computer and encrypted. Encryption has become an important way to protect data and other computer network resources, especially on the internet. Passwords, messages, files, and other data can be transmitted in scrambled form and unscrambled by the computer system of the foreign service provider.

The U.S. CPA firm thus transmits data electronically via the internet to a server in the foreign country. The foreign accountant then accesses the transmitted information using a web browser and prepares the tax return using standard tax preparation software. The completed tax return is then transmitted from the foreign outsourcing service provider back to the U.S. CPA firm. Since the U.S. firm is responsible for the accuracy of the return, it reviews the return, makes any necessary modifications, and then delivers the completed return to the client.

ETHICAL CONCERNS

One major concern in this process is that it is difficult to assess the qualifications of the overseas providers that prepare the returns. The U.S. CPA firm can require a foreign service provider to make certain representations about their qualifications and experience, however, the U.S. firm seldom has the practical means to confirm those representations.

Another major concern arises because the U.S. CPA firm cannot directly oversee those operations that are outsourced overseas. Since offshore tax preparation is located outside the United States, the employees of the outsourcing service provider are not employees of the U.S. CPA firm. The foreign preparers are therefore not under the control of nor directly supervised by the U.S. CPA firm. This makes it very difficult to adequately monitor the outsourcing service provider's practices.

Another dilemma in this type of arrangement is that the contractual relationship between the U.S. CPA and the outsourcing service provider is often subject to a legal system outside of the United States. A number of state and federal statutes impose legal obligations on CPAs for controlling and safeguarding a client's financial information. Complying with these laws can be difficult or impossible when the provider is located in a foreign country.

SECURITY CONCERNS

Perhaps the most serious concern regarding the internet transmission of a client's confidential income tax information is that of security. It is difficult to ensure that proper security measures are in place to protect the client's interests. Basic tax information will contain the names, addresses, and social security numbers or federal employer identification numbers of clients and dependents. It might also contain additional information that identifies the location of a client's assets, financial account numbers, and year-end balances. Even when the highest available security measures are used, there is obviously some risk of security being compromised.

In recent years, identity theft has become a serious problem. The types of information disseminated in the outsourcing of tax returns to foreign countries presents major opportunities for identify theft. Consequently, professionals must be concerned about the potential misuse of this information. If a client suffers loss from identity theft, the client will obviously pursue the U.S. CPA for any loss incurred. If the U.S. CPA firm pursues a claim against the foreign outsourcing service provider, a foreign system legal system will be encountered. In this situation, the cost and length of time to prosecute the offender might not justify the potential of recovery.

Another major concern that has been raised is whether or not the client has a right to be informed that his or her tax information is being outsourced overseas. Since the relationship between a CPA and his or her client is a professional relationship, it can be argued that the CPA has an ethical obligation to inform the client that a foreign preparer will have access to the client's information and will be preparing the tax return. It is often further argued that clients of a professional should have the right to decide whether or not to allow their information to be sent overseas.

GRAMM-LEACH-BLILEY ACT

In 1999, Congress enacted the Gramm-Leach-Bliley Act. The act has applicability for CPAs who engage in foreign outsourcing because it provides that accountants who prepare tax returns and/or financial statements must provide written notice of their privacy policy to all individual clients. The law was passed for the purpose of protecting the privacy of recipients of very broadly defined financial services, including tax return preparation.

Beyond these privacy safeguards, the Gramm-Leach-Bliley Act requires other measures to be taken. Under the act, firms must design, implement, and maintain safeguards to protect customer information. In addition, companies must give their customers a privacy notice that explains the firms' information collection and sharing practices. It also requires that the customer have the right to opt-out or limit the sharing of this information.

Accountants are required to provide privacy disclosures to clients. New clients must be provided with an initial privacy notice before they become a client and continuing clients must be sent an annual privacy notice.

The disclosures must provide a clear and conspicuous notice that accurately reflects the firm's practices for protecting the confidentiality and security of personal information. This act has significant legal implications for CPA firms that fail to comply.

INTERNAL REVENUE SERVICE REQUIREMENTS

Internal Revenue Code 7216 prohibits anyone involved in tax return preparation from knowingly or recklessly disclosing income tax return information without the client's consent other than for the purpose of actually preparing or assisting in the preparation of a tax return.

Many CPAs take the position that this section of the code does not create a problem for tax return preparation outsourcing since the outsourcing service provider is considered a tax preparer. In addition, there is no disclosure requirement in Sec. 7216 for a CPA to inform the client that a third party is being used.

When a CPA firm does violate confidentially under this provision, the Internal Revenue code imposes substantial penalties. This includes a criminal tax penalty of $1,000 and possible imprisonment of up to one year. The severity of this punishment reflects the importance that Congress places on the confidentiality of tax return information.

Application of Tax Return Preparer Penalties

The IRS has offered guidance on the implications of using third parties in the tax return preparation process by issuing Revenue Ruling 85-187. In this ruling, an example is used where a practitioner prepares basic information, submits it to a third party, and the third party prepares the tax return. At no time does the third party come into direct contact with the taxpayer.

The revenue ruling emphasizes the point that more than one person or entity can be properly categorized as a preparer. The practitioner furnishing the information is clearly a tax preparer because he or she has the primary responsibility for the overall accuracy of the return.

The ruling also takes the position that the third-party entity to which the taxpayer's information was outsourced also fits the IRS definition of an income tax return preparer. The rationale is that the outsourcing entity is in the business of preparing income tax returns for compensation and the scope of its work extends beyond mere clerical assistance. As a result, both the practitioner and the outsourcing entity face the possibility that certain Internal Revenue Code penalties may apply.

The IRS position is clear regarding CPA firms that outsource tax preparation services to foreign service providers. The U.S. CPA firm is still subject to preparation penalties and has the responsibility to check the accuracy of outsourced income tax returns. The IRS also classifies the overseas outsourcing entity as an income tax preparer and could subject the foreign service provider to the income tax return preparer penalties. Thus, both the Gramm-Leach-Bliley Act and the IRS are particularly relevant for CPAs engaged in foreign outsourcing of tax services.

CURRENT GUIDANCE FROM THE AICPA

The American Institute of Certified Public Accountants (AICPA) is the premiere professional organization for Certified Public Accountants in the United States. Even though membership in the AICPA is voluntary, a CPA who becomes a member automatically becomes subject to the AICPA Code of Professional Conduct. Courts have also held that even CPAs who are not members of the AICPA are subject to the Code. The Code of Professional Conduct essentially guides CPAs in the performance of their professional responsibilities. Several rules in the Code are of particular relevance to tax outsourcing.

Rule 102 provides that "in the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others." The Code goes on to state that a member should be "honest and candid within the constraints of client confidentiality."

If the CPA is to be "honest and candid," with the client, it seems clear that the client has a right to know that his or her return will be processed overseas. It seems reasonable that in most cases the client would want to be informed that his or her personal information and records are being outsourced to a foreign service provider. From an ethical perspective, the client should be informed that personal and tax information is being transmitted electronically overseas for processing. The client then has the right to decide whether he or she wants to allow the off-shore preparation. The CPA firm could then make the case to the client that the information is secure and that the client will benefit from lower fees because of decreasing processing costs.

Rule 201 states that CPAs must exercise professional competence and due care while performing professional services. It further states that CPAs should adequately plan and supervise the performance of professional services. Rule 201 also indicates that a member remains responsible for ensuring the accuracy and completeness of the services provided by the third-party provider. This means that the U.S. CPA should review all work performed by the third-party provider since he or she will remain fully responsible for the accuracy and completeness of the services provided.

Some have argued that it is difficult to meet these ethical obligations when tax processing takes place overseas and without the direct supervision of the U.S. CPA. Some may also argue that if the U.S. CPA carefully reviews and approves the final product, this requirement is met. The Code's interpretation of Rule 201 is stated in Interpretation 201-1. It points out that competence includes the ability to adequately supervise staff and ensure that the quality of the work is acceptable. This includes evaluating those working on the product to be sure that they have "knowledge of the profession's standards, techniques, and the technical subject matter involved. The CPA should also have the capability to exercise sound judgment in applying such knowledge in the performance of professional services." Since the U.S. CPA must rely on the foreign provider for assurances that the competence standard is met, it is often difficult for the U.S. CPA to effectively supervise the overseas preparer.

Another rule in the code that has application to foreign outsourcing of accounting services is Rule 202. This rule requires a CPA to comply with the technical standards of the services performed. Those that process tax information must follow the Statements of Standards for Tax Services. These statements primarily apply to taking tax positions with respect to the IRS Code. However, there are tax preparation issues that could arise in foreign outsourcing. For example, there might be an instance where the foreign service provider receives transmitted information that is incomplete or incorrect. In this situation, it becomes even more important that the U.S. CPA make sure that the tax information is clear, correct, and complete before it is transmitted to the outsourcer for processing overseas.

Confidentiality

Rule 301 of the code also provides guidance regarding the confidentially and privacy of personal information. Rule 301 states that "a member in public practice shall not disclose any confidential client information without the specific consent of the client." The implications for CPAs that outsource tax information are significant, especially if the client is unaware that Social Security numbers and financial data, including bank and brokerage account numbers, have been transmitted overseas. The argument that confidential data is encrypted and that the CPA controls the source documents seems insufficient to satisfy the requirements of this rule.

In addition to the above guidance, the AICPA's professional ethics division did address the use of third-party providers in Ethics Ruling No. 1. Although this ruling was made many years before overseas outsourcing of tax returns became an issue, it provides relevant guidance on the matter. The ruling specifically deals with computer processing of client returns. It states that members "must take all necessary precautions to be sure that the use of outside services does not result in the release of confidential information".

This ruling was originally issued to provide guidance to U.S. CPA firms that use domestic service bureaus to process client information. It is, however, clearly applicable to situations that involve the foreign outsourcing of client tax returns. Under the Code, a member has an obligation to ensure that the client's information remains confidential by exercising due care. The U.S. CPA has an ethical responsibility to be sure that the controls are adequate. Some have taken the position that the U.S. CPA firm should discuss the specific controls that the foreign provider has in place to safeguard the client's information. This would include inquiring as to what specific security measures and encryption techniques are being used. This may necessitate that the U.S. CPA firm hire consultants with the technical ability to evaluate whether the foreign provider has adequate controls. The ruling also states that controls should be "in place to ensure that those with access to the client's information are bound by nondisclosure agreements and cannot misuse the clients' financial information." There should perhaps be security measures in place to prevent the unauthorized printing or copying of the clients' financial data.

Even if the U.S. CPA is satisfied that there are sufficient procedures in place to ensure the security of information that is transmitted electronically, the U.S. firm has a duty to satisfy itself that controls are in place to ensure the information remains confidential. There are several ways by which third-party providers might satisfy a practitioner in this regard. For example, they may use nondisclosure agreements with their employees. They may also implement certain computer protections that prohibit downloading, printing, scanning or copying a client's financial information. They could also incorporate firewall security to prevent outsiders from hacking into the system. Periodic testing of these security measures could also provide more comfort to the practitioner. Whatever the measures used by the third-party provider, the member should be satisfied that reasonable efforts are undertaken to assure the confidentiality of the information to which the provider has access. The issue has taken on such significance that the AICPA issued outsourcing guidance in a March 2004 Journal of Accountancy article, reiterating its Code of Professional Conduct's position that practitioners are ultimately responsible for maintaining the security and confidentiality of client information. A confidentiality breach by the outsourcer, even if all of the above steps were taken, will still be the responsibility of the CPA.

AICPA NEW ETHICS REQUIREMENTS REGARDING OUTSOURCING

The AICPA adopted new ethics rules that affect CPA firms that outsource tax preparation services to foreign service providers. These rules apply whether the CPA outsources to domestic or foreign providers. The rules

require that if a CPA uses a third party provider for accounting services, discloser must to be made to the client whose information is being outsourced. These new rulings have several effects on the disclosures CPA's make to clients.

The new rules define a third party provider as any external organization or individual who the firm is not paying as an employee. Firms must inform their clients that the firm will be using a third-party's services. The AICPA has clarified that CPAs are responsible for all work performed by any service provider.

CPAs using third parties must enter into an official agreement with the third-party to maintain client confidentiality. In addition, the CPA must be reasonably assured that the third-party has procedures in place to protect against the unauthorized release of client information. The new rules are effective for professional services performed on or after July 1, 2005.

CONCLUSION

In view of the Gramm-Leach-Bliley Act, the IRS requirements, and the AICPA Code of Professional Conduct, CPAs now have clear guidance regarding their obligations when using foreign service providers. They should satisfy themselves regarding the competence, practices and procedures of any foreign service provider. At a minimum, it seems advisable to discuss with the overseas provider the specific controls in place to safeguard the client's information. The U.S. CPA firm should ensure that controls are adequate before transmitting data overseas.

In terms of the electronic transmission, it is important that the U.S. CPA assures that only the intended party is able to access the information. The data should be transmitted in such a manner that it protects against other parties gaining access to that information. There are sophisticated authentication methods available to certify that both the sender and receiver of the information are legitimate.

The CPA should also ensure that services are performed with professional competence and due care, including the adequate supervision and review of all work performed by the outsourcing provider.

One method to standardize the process of adequately informing the client would be to institute the practice of issuing engagement letters to all tax clients. Accountants frequently use engagement letters to summarize the terms of an engagement. They inform the client of each party's responsibility and serve the same purpose as a contract. Although engagement letters are not required for tax engagements, they could serve a useful function by disclosing the practitioner's use of outsourcing.

The practice of outsourcing accounting services is not new. The new factors involved are the speed of the information being transferred, the ability to protect confidentiality, and the extensive use of service providers in foreign countries. Outsourcing is likely to continue to grow and it is important for U.S. CPA firms that engage in the practice to adhere to both the spirit and stated legal and ethical standards of conduct that apply in this area.

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