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# ETHICAL ISSUES IN PROFESSIONAL TAX PRACTICE

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## CASE DESCRIPTION

*The primary subject matter of this case concerns the pressure placed upon today's tax professional by both the client and the firm to minimize tax liabilities through aggressive tax positions. Secondary issues include the competitive environment of professional tax practice, incentives to maximize revenue by retaining old and recruiting new clients, challenges facing the entry-level tax professional, and compliance with Circular 230 and the AICPA's Statement on Standards for Tax Service (SSTS). The case is appropriate for all introductory level tax students at both the undergraduate and graduate level and has a difficulty level of five: appropriate for first year graduate students. The case is designed to be taught in one class period and should require approximately three hours of outside preparation by students.*

## CASE SYNOPSIS

*Students are placed in the role of inexperienced tax practitioners who must deal with aggressive clients wanting to minimize their tax liability. The student must analyze several tax issues, determine the appropriate tax treatment, and address the technical and ethical limits on the tax positions a CPA can take. Students must address numerous sanctions including penalties, malpractice claims, expulsion from the AICPA, loss of a CPA license, and even imprisonment.*

*As a recent college graduate with an accounting degree, a CPA license, and membership in the AICPA, the student, in a role play, is a recent hire at a regional CPA firm, Burst and Packend. The CPA has spent two years mostly in auditing, has obtained the experience necessary for licensing, but has decided to move into the tax department for a trial run. It is March 2009 and the CPA is meeting, for the first time, John and Mary Smith, who are coming in for an appointment to discuss their return. The supervising partner encourages development of an excellent relationship with the Smiths because they have been good clients who have paid high fees over the years. An audit manager, called upon to help during last year's heavy tax season, prepared their 2007 tax return. The Smiths tend to be aggressive in seeking deductions and minimizing their tax liabilities. They have dropped off various tax documents for review prior to their appointment.*

## INSTRUCTORS' NOTES

### RECOMMENDATIONS FOR TEACHING APPROACHES

CPA tax practitioners operate in a highly competitive environment. When employed in aggressive firms, they face strong incentives to maximize professional revenue. They may

confront immense pressure to retain old clients and recruit new ones. At times, these clients may demand that their CPAs utilize aggressive tax positions to minimize tax liabilities. But there are technical and ethical limits on the tax positions a CPA can take. The CPA who oversteps these limits can suffer numerous sanctions including penalties, malpractice claims, expulsion from the AICPA, loss of a CPA license, and even imprisonment.

Recent problems related to aggressive tax shelters illustrate the prevalence of these pressures and sanctions (Kahn, 2003; Halper, 2005.) Large accounting firms have suffered penalties for providing overzealous tax advice. Some tax preparers feel pressured to provide aggressive tax advice because their clients are aware of the low percentage of tax returns subjected to audit. But if tax preparers permit even minor violations of tax law, they can create an atmosphere that is desensitized to unethical conduct.

The market for tax advice is large. Yetmar and Rioux (2004) report estimated expenditures of \$11 billion for professional tax advice in 2002 with 62% of returns receiving professional advice. Their research also reports that approximately one-fourth of all preparers will be assessed a preparer penalty during their careers.

The tax profession has recognized the need for sensitivity to ethics issues. A study of senior level members of the AICPA found that 47% considered their most difficult ethical issue to be “client proposals of tax alteration and tax fraud” (Finn, Chonko & Hunt, 1988.) According to a 1997 survey of members of the AICPA Tax Division, personal moral values and standards, followed by the firm culture and management philosophy, were of greater help to the tax professional in ethical dealings than professional guidelines, although to some extent the fear of losing licensure did affect work-related ethics (Yetmar, Cooper & Frank, 1999.)

In response to a need for effective ethical guidelines, the AICPA adopted new tax practice standards in 2000. The Statements on Standards for Tax Services (SSTS) replaced the more advisory Statement on Responsibilities in Tax Practice. Preface #1 of the SSTS states:

“Practice standards are the hallmark of calling one’s self a professional. Members should fulfill their responsibilities as professionals by instituting and maintaining standards against which their professional performance can be measured. Compliance with professional standards of tax practice also confirms the public’s awareness of the professionalism that is associated with CPAs as well as the AICPA.”

Ethics instruction should be an essential component of today’s tax curriculum, yet it is often overlooked (Grasso & Kaplan, 1998; Finn et al 1988.) Ethics cases are common in the audit and assurance services area, but there is a strong need for ethics cases in tax (Grasso and Kaplan, 1998; Hite & Hasseldine, 2001.)

In addition to the prevalence of ethical issues in the tax setting, ethics issues are commonplace in the general business setting, leading to a call for better ethics education in business schools. The AACSB has gathered numerous articles on ethics education at its ethics education resource center with many of these articles containing relevance for the taxation classroom. The report of the Ethics Education Task Force of AACSB International (2004) stresses this ideal in their introduction: “This report is based on the premise that the time has come for business schools – supported by AACSB – to renew and revitalize their commitment to the centrality of ethical responsibility at both the individual and corporate levels in preparing business leaders for the twenty-first century.” (p.9) The Task Force emphasizes that business

schools must encourage students to develop a better understanding of ethical issues, provide them with tools for recognizing ethical issues, and engage them through analyses of business examples. They further write, “Students especially need to be exposed to cases and types of ethical issues that they are likely to face in the business world.” (p.13)

This teaching case responds to this AACSB recommendation. In this case, students are placed in the role of inexperienced tax practitioners who must deal with two aggressive clients wanting to minimize their tax liability. The students must analyze several tax issues, determine the appropriate tax treatment, and address the ethical ramifications given the most recent IRS and AICPA rulings. The purpose of the case is to improve the student’s ability to deal with technical and ethical issues that can typically arise early in the career of a tax professional and to understand the often tenuous client-practitioner relationship. Educators can use the case in the middle or late stages of an introductory taxation course.

### DISCUSSION QUESTIONS

1. **What are the individual tax issues in this case? List each issue individually, state your position on each issue, and indicate, by general citation, the law that addresses the issue.**

The Smiths have presented numerous tax issues. For 2007, they have neglected to report income from gambling and bartering and they have inappropriately taken several deductions. Several of the issues are repeating in 2008.

For 2007, the Smiths deducted Mary’s tuition as an itemized deduction. Because their adjusted gross income exceeded the limits for the limited education deduction under IRC Section 222 or for any education credits, the only possible deduction for education expenses was under Section 162.

Generally, under section 162, an employee can deduct expenses incurred for education as ordinary and necessary business expenses provided the expenses are for either of two reasons: 1) to maintain or improve existing skills required in the present job; or 2) to meet the express requirements of the employer or the requirements imposed by law to retain his or her employment status. Education expenses are not deductible if they are to meet the minimum educational standards for qualification in the taxpayer’s existing job or to qualify the taxpayer for a new trade or business. Because Mary’s completion of a law degree qualifies her for a new trade or business, her law school tuition was not deductible even if she can demonstrate the courses improve her skills as a marketing executive.

As an AICPA member who is now aware of an error in the 2007 return, you must advise the taxpayers promptly that an error has occurred. (SSTS No. 6) A similar obligation exists under IRS Circular 230. Your advice should include a recommendation for appropriate measures the taxpayer should take regarding their prior year return. In this instance the taxpayers should notify the IRS, file an amended return, and pay any tax liability. However, you are not obligated to inform the IRS of the situation nor may you do so without the permission of the taxpayers, except as provided by law. If the Smiths want you to prepare the 2008 return but have not taken action to correct the 2007 return, you should consider whether to continue your

professional relationship or withdraw from the engagement. If you prepare the 2008 return, you should ensure that the error is not repeated.

The Smiths have taken a deduction for John's home office. Under IRC Section 280A, employees and self-employed individuals are not allowed a deduction for a home office unless the office is used exclusively on a regular basis as either of the following: 1) the principal place of business for the taxpayer; or 2) a place of business used by clients, patients, or customers. Employees must also show that the use is for the convenience of the employer rather than being merely helpful. The principal place of business must be used to conduct administrative or management activities and there must be no other fixed location of the trade or business where the taxpayer conducts these activities.

John cannot take deductions for home office expenses. As an employee, he cannot show that the home office is for the convenience of the employer. In addition, he has a campus office available for preparing his academic research. Also, the personal items such as the home computer and the pullout sofa violate the rule requiring exclusive business use of the office. As discussed above with respect to the law school tuition, you must now take action to alert the taxpayers to the error in the 2007 return and ensure that the error does not repeat on the 2008 return.

John can deduct the cost of paints and other supplies as ordinary and necessary business expenses under Section 162. He can allocate the cost of the camera between business and personal use and deduct the business portion. If John can verify that the travel to study abroad was necessary for his business and any pleasure associated with the trip was incidental, then he can deduct the business travel costs as ordinary and necessary under Section 162.

On the 2007 return, Mary has taken a deduction for mileage in connection with her work. An employee like Mary may deduct unreimbursed employment-related transportation expenses as an itemized deduction from AGI. The burden is on the taxpayer to keep records to support the deduction. (IRC Section 162, 274, and the Cohan rule)

In this instance, Mary is not keeping contemporaneous records of her business mileage and is instead making a year-end estimate. The deduction is therefore invalid.

John Smith has delivered paintings to his neighbor, Brian Westbrook, in return for free daycare services. John believes he has no income from the transactions. But such barter transactions trigger income recognition despite the absence of cash payment. John should be recognizing income equal to the fair market value of the service provided. The Smiths had gambling winnings in 2007 and gambling losses in 2008. Under IRC Section 61, the winnings in 2007 are income and should have been reported on the 2007 tax return. Again, you must alert the taxpayers to the error.

As for the gambling losses in 2008, they can be itemized deductions up to the amount of gambling winnings. (IRC Section 165) The conference cost of \$1,800 is not taxable since John attended an academic conference while in Las Vegas.

The CPA firm has placed an ad saying, "We win when the IRS audits our clients. For peace of mind, come to Burst and Packend." This ad is an ethics violation. A CPA must not seek clients through false, misleading, or deceptive advertising (Rule 502 of the AICPA Code of Professional Conduct).

John Smith would like to arrange for a contingent fee equal to 20% of the refund for 2008. Such an arrangement would be an ethics violation. Tax practitioners are prohibited from charging contingent fees on an original tax return. (Section 10.27 of Circular 230 and Rule 302 of the AICPA Code of Professional Conduct)

The CPA firm's ethics policy should be examined. If an ethics policy is not established at the firm, one should be developed to ensure that firm members are aware of the ethical responsibilities associated with their practice. Undoubtedly, the prior year's return should be amended. The client should be notified, preferably in writing, of the firm's policy for amending returns.

You should inform your supervisor of the errors in 2007 so that the prior year preparer, if still employed with the firm, can be advised and given the opportunity to make appropriate corrections. The possibility exists that the prior year's preparer was not given full information in 2007 or did not ask the appropriate questions regarding income and deductions. Should your supervisor take the position that a 2007 amended return is not necessary due to the possibility of losing the Smiths as a client, you need to examine your personal ethical responsibilities and whether you should continue your employment at the firm.

## 2. What ethics regulations apply to the tax preparers in this case?

Tax preparers are subject to various statutes, rules, and codes of professional conduct. Raabe, Whittenburg and Sanders (2003) summarize a complex regulatory environment for tax preparers.

All tax practitioners are subject to IRS Circular 230: Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service, updated in April 2008 to address ethical practice guidelines for practitioners. The Internal Revenue Code specifies numerous penalties and rules that apply to all tax practitioners. In addition, CPAs who are members of the American Institute of Certified Public Accountants (AICPA) must comply with its Code of Professional Conduct and other rules created by state boards of accountancy. The AICPA's Statements on Standards for Tax Services (SSTS) provide guidelines for member CPAs who prepare tax returns which are very similar to Circular 230 and include sanctions as well.

To enforce taxpayer compliance, Congress has enacted penalties. Criminal penalties can include imprisonment. Civil penalties are of two types: ad valorem penalties and assessable penalties. Ad valorem penalties are additions to tax that are based on a percentage of the delinquent tax. Assessable penalties typically are a flat dollar amount. Civil penalties are imposed when tax statutes are violated without reasonable cause, as a result of negligence or intentional disregard of rules, or through willful disobedience or fraud. Civil penalties can arise for failure to file a tax return, failure to pay tax, failure to pay estimated income taxes, negligent understatement of income tax, substantial understatement of the tax liability, and other instances.

An accuracy related penalty, based on negligent or substantial understatement of income tax liability, amounts to 20 percent of the portion of the tax attributable to negligence or substantial understatement of tax. The penalty applies only if the taxpayer fails to show either a reasonable cause for the underpayment or a good-faith effort to comply with the tax law.

Negligence can include the failure to report gross income, the overstatement of deductions, and the failure to keep adequate records. For IRS fiscal year 2007, civil penalties for negligence (pre-abatement) related to individual income tax filings totaled almost \$15 billion; fraud penalties (pre-abatement) totaled over \$122 million.

Under Section 10.34 of Circular 230, tax practitioners must not sign tax returns if they determine that a position taken on the return does not have a realistic possibility of being sustained if challenged by the IRS unless the position is not frivolous and is accompanied by adequate disclosure. The position needs “a confidence level of at least more likely than not” – essentially a greater than 50% chance. A fairly similar “realistic possibility” standard applies under SSTS No. 1, stating that the AICPA member must have a “good faith belief that the tax return position being recommended has a realistic possibility of being sustained administratively or judicially on its merits, if challenged.” In addition, Rule 501 of the AICPA Code of Professional Conduct states that a CPA must not sign a false document.

<b>EXHIBIT 1 SUMMARY OF ISSUES</b>	
ISSUES	REFERENCE
Tuition Deduction for Law School	IRC Section 162
Home Office Deduction	IRC Section 280A
Transportation Expenses	IRC Section 162
Substantiation of Transportation Expenses	IRC Section 274
Receipt of Taxable Income from Bartering	Treasury Regulation Sec. 1.162
Taxability of Gambling Winnings	IRC Section 61(a) U.S. v Manley S. Sullivan, 6 AFTR 6753, 1 USTC PP 3236 (USSC, 1927)
Deduction of Gambling Losses	IRC Section 165
Advertising	Rule 502 of the AICPA Code of Professional Conduct
Contingent fees	AICPA Code of Conduct: Rule 302 and IRS Circular 230

## EPILOGUE

In this teaching case, students are placed in the role of inexperienced tax practitioners who must deal with two aggressive clients who want to minimize their tax liabilities. The students must analyze several tax issues, determine the appropriate tax treatment for each issue, and identify ethical issues. The purpose of the case is to improve the student’s ability to deal with technical and ethical issues that can typically arise early in the career of a tax professional.

The students have a supervisor who encourages them to have an excellent relationship with these long-time clients. Unfortunately, the clients’ 2007 tax return contains underreported taxable income and improper deductions. As a consequence, the clients need to contact the IRS, report the errors, and pay additional tax. The preparer of the 2007 return must determine if the errors were made based upon incomplete information or were in fact professional mistakes that must be corrected for the client at no cost for preparation. Often, when CPA firms discover professional mistakes, they will pay for related penalties but not for the additional tax and interest. The clients may be unhappy and complain to the supervisor. But, despite the wishes of the clients, there are technical and ethical limits on the tax positions a CPA can take. The CPAs

who overstep these limits can suffer numerous sanctions including penalties, malpractice claims, expulsion from the AICPA, loss of a CPA license, and even imprisonment.

If conflict arises with the clients due to professional mistakes in the prior tax return and the denial of deductions for the current return, the CPA can try to minimize the stress by maintaining a highly professional approach. The CPA can carefully explain the nature of each problem, the rules that apply, and the required actions for both tax returns. The explanations can show how careful compliance with tax law is mutually beneficial to both the clients and the CPA.

A CPA can avoid many of these problems by carefully evaluating a CPA firm prior to accepting a job offer. It can be important to avoid employment at a firm that has a reputation for mistakes, ethical lapses, and conflicts with clients.

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