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Sprint Corporation: Ethical Decisions and Tax Avoidance Strategies

Daniel A. Verreault, Simon Yang, and Jack Angel

ABSTRACT: The case focuses on events surrounding Ernst & Young's tax shelter advice to senior executives of Sprint. The principal ethical lens used for analysis is Integrative Social Contracts Theory (ISCT). We believe that this is the first instance of ISCT applied specifically to a situation in accounting and to an ethical problem in a nonglobal context. Additionally, it is one of a small number of tax-oriented cases focusing on ethics. ISCT offers several benefits over the traditional models applied in ethical analysis (Mintz 1997). ISCT integrates implicit and explicit contracts among affected business communities that enable a detailed normative assessment of rich ethical problems in a realistic economic world. The use of ISCT in this particular case provides students, instructors, and practitioners with a model to aid in: (1) understanding the normative justification for business decisions, and (2) assessing the quality of ethical decision making in a complex business setting.

PROLOGUE

On February 2, 2002 Sprint announced that William T. Esrey, Chairman and CEO, and President Ronald LeMay were leaving the company. On May 13, 2003, 38 percent of Sprint shareholders voted to fire Ernst & Young (hereafter E&Y) as Sprint's auditors. The complex links between these two events involve the quality of Board of Director oversight, the downward spiral in telecom valuations, conflicts of interest between E&Y and Sprint, and the decisions made by E&Y in creating and marketing aggressive tax shelters to Sprint executives. The focal point of this case is the role of E&Y and the substance of its tax shelter. We will explore the structure of the shelter, its promised results, and its relationship to relevant professional tax standards. We will use a particular ethical model to sharpen and structure the analysis. The model will take some effort to learn. However, knowledge of the model will improve your ability to analyze Sprint and will aid you in "go or no-go" ethical decisions in all areas of professional life. The tax aspect of the case is particularly appropriate. Grasso and Kaplan (1998, 98) note that "tax courses have historically placed little or no emphasis on integrating ethics into their content. Thus individuals who begin performing tax work may have the desire to maintain high ethical standards and yet feel unequipped to solve ethical dilemmas involving tax issues." This case will provide the needed guidance to tax students and professionals.

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PART 1: ETHICAL ANALYSIS USING INTEGRATIVE SOCIAL CONTRACTS THEORY (ISCT)

Introduction

The purpose of this section is to strengthen your ability to analyze complex situations from an ethical point of view. The situations involved in ethical issues are often not all clear-cut. So you must ask yourself, given a certain situation, "How do I determine if an action is ethical?" You will be asked to make such determinations for a series of decisions made by E&Y, Sprint's Board of Directors, and Sprint's senior executives.

The case includes ethical elements relating to executive compensation levels, Board of Director oversight duties, several dimensions of potential and apparent conflicts of interest, and the role of professional tax practice standards in guiding tax-planning professionals. Part 2 describes Sprint's business situation and the key actions of its management team. Part 3 conveys the important facts surrounding E&Y's role in constructing and selling the tax shelter. Part 4 presents the case assignments.

In order to undertake ethical analysis, a person needs to consider: (1) his or her own ethical framework, (2) the various ethical evaluation methods available, and (3) the diverse authority to which different affected communities could appeal. ISCT is a particular methodology based on social contracts that helps in the analysis of the ethical dimensions of the Sprint case, and, more importantly, can serve as a useful decision aid in recognizing the ethical dimensions of decisions in all aspects of professional life. ISCT provides a decision maker with a way of thinking that is designed for business situations.

Development of ISCT

ISCT is an approach that includes both statements of enduring nobility and value as well as specific guidance in particular instances. One may see in social-contract thinking an emphasis on agreements, the rights and responsibilities of different groups, and potentially a way to adjudicate disputes and/or evaluate policy and actions based on those agreements. ISCT thinking is more easily and closely related to the world of business than are other approaches to ethical decision making because of its three principal strengths: (1) the relevance to real business situations due to the current adaptation of social contract thinking by Donaldson and Dunfee (1999), (2) a focus on various communities affected by decisions, and (3) realistic and specific guidelines to ethical reasoning that may be lacking in other ethical systems.

ISCT's development focused primarily on the problems inherent in a global economy, especially the ethical problems encountered by multinational companies when operating in developing countries. However, there is nothing in the system itself that limits its application only to the environmental, wage, and cultural issues of international business. The corporate governance and ethical issues apparent in the market system as implemented in the U.S. also provide an excellent opportunity to use ISCT as a guide to moral reasoning.

Assumptions of ISCT

ISCT asserts the following three assumptions in establishing the groundwork for a common economic ethics. These assumptions set limits to the behavior of individuals and groups in undertaking economic activity—capital formation, production of goods and services, compensation, taxation, and distribution of profits.

- All humans are constrained by bounded rationality.
- The nature of ethical behavior in economic systems and communities helps determine the quality and efficiency of economic interactions. Higher-quality and more efficient economic interactions are preferable to lower-quality and less efficient economic interactions.
- Economic activity that is consistent with the culture, philosophical, or religious attitudes of economic actors is preferable to economic activity that is not.

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The notion of bounded rationality is now common in the management literature. In terms of ethics, not all the relevant moral facts or processes can be recognized. People may not know exactly how to trade off two different approaches that seem to be inconsistent but based on legitimate, or at least deeply held, moral beliefs. In terms of the quality and efficiency of economic interactions, ISCT clearly recognizes that systems delivering higher orders of output in terms of quality and quantity and accomplishing the outputs more efficiently represent a preferred system. Thus, ISCT explicitly allows the economics of a decision to affect the ethical content of the decision. ISCT also requires analysis of the appropriateness of an economic system to a particular community. Here we must be aware of the potential to sink into moral relativism. The creators of ISCT refer to it as a pluralistic ethical system rather than as either relative or absolute. ISCT is located on the continuum between relativism (there is no right or wrong outside of context) and absolutism (only one way is right and context does not matter).

The Structure of ISCT

In *Ties That Bind: A Social Contracts Approach to Business Ethics,* Donaldson and Dunfee (1999) (hereafter D&D) provide a business-oriented treatment of social contracts. Their book is the most complete presentation of a stream of work that examines international business ethics and develops the arguments for a social contracts approach to business ethics. Examples of ethical analysis developed by D&D and others using ISCT include the setting of wage rates and living conditions of employees by multinational companies in developing countries; the appropriateness of participating in business systems that rest on graft or nepotism; and the obligations of multinational companies to the host country in the area of environmental protection (Dunfee and Warren 2001; Donaldson and Dunfee 1994; Donaldson 1989; Dunfee and Robertson 1984).

ISCT consists of five major components to maintain and balance cross-cultural demands of particularity and generality and interactions among communities. First, the system proposes that all communities and all agreements within and between communities should be guided by a set of fundamental moral precepts for all human beings called *hypernorms*. The existence and content of hypernorms is perhaps the most controversial part of ISCT. We will provide a list of hypernorms below for use in the case analysis.

Second, participants in individual communities form agreements consistent with a set of culturally generated norms. These are *authentic norms* and are determined by local contracts. These contracts recognize that rationality is bounded by the context and finite capacities of its community members. To be an authentic norm, members of the community must have the rights of *voice* (the right to have their opinions considered) and *exit* (the right to withdraw from the agreement).

Third, authentic norms become *legitimate norms* when they do not contradict hypernorms. For example, the authentic norm of slavery in the pre-Civil War south of the U.S. could not now be considered a legitimate norm when judged against a hypernorm of freedom and dignity for each human being. Indeed, it could not have been considered a legitimate norm then based upon hypernorms asserted in the U.S. Constitution. Nor could slavery be considered an authentic norm for the community of slaves who were denied both voice and exit.

Fourth, the system expects conflicts among legitimate norms of different communities. A set of "priority rules" are derived from hypothetical *macrosocial contracts* to determine how to identify and resolve conflicting legitimate norms. We will cover the priority rules in a later section.

Fifth, ISCT is not an ethics calculator that allows you to provide inputs and to expect back a deterministic result. The system allows for and expects indeterminacy and conflict in some cases even after following the steps of the system. This places the decision maker in *moral free space* where a decision must be made in a considered way by appealing to virtue, consequence, duty, or some other moral reasoning system. The decision maker may be forced in a particular situation to

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follow her internal "moral compass." However, moral free space only comes into play after the other steps in the system are completed and the ethical indeterminacy persists. Thus, ISCT circumscribes the bounds of moral free space through tests of an action or policy against hypernorms, authentic norms, legitimate norms, and priority rules.

Communities

The basic unit in ISCT is a community. A *community* is a self-defined, self-circumscribed group of people who interact in the context of shared tasks, values, or goals, and who are capable of establishing norms of ethical behavior for themselves. Nation states are a relatively easy and historically compelling example of a community. The Democratic and Republican parties in the U.S. are also communities. Corporations are certainly communities. Thus, Sprint and E&Y qualify as communities. Subunits of firms qualify so that we may look at the audit and tax functions of E&Y as well as the Board of Directors of Sprint. One of the major tasks in our case will be to identify and to analyze the effects of decisions taken in the Sprint case on relevant communities.

Authentic and Legitimate Norms

An authentic norm is a norm generated by a community in accordance with explicit or implicit consent of community members. Authentic norms must be supported by a clear majority of the community, reflected in community behavior, and seen as standing for an ethical principle. An authentic norm that is consistent with hypernorms is a legitimate norm. When legitimate norms conflict, priority rules are applied to resolve the conflict. Legitimate norms are morally binding for members of the norm-generating community.

Rules of thumb for choosing authentic norms may include the requirement of consent to certain agreements within a single community and may require that norms increase efficiency of business operations or improve the economic environment in which the community operates. In the Sprint case, there are several possible sets of authentic norms in place. For instance, one set of authentic norms is that generated by executives of Sprint. These norms are indigenous to the culture and expectations for the group and might include concepts like increasing quarterly profits, developing systems for more efficient business operation, and maximizing personal wealth. Shareholders of Sprint may represent another possible set of norms such as profitable investment returns, legitimate business operations, and trust in the integrity of management, etc. Authentic norms of the executive community may conflict with the norms of the nonexecutive stockholder community with respect to certain techniques of wealth maximization used by executives.

It is possible that authentic norms held by the tax planners at E&Y may include tax minimization based on a strategic assessment of IRS enforcement weakness. It is possible that not all the authentic norms are legitimate. For example, Exhibit 1 presents a letter from top executives at the AICPA that discusses the commitment of the AICPA with regard to ethics and the AICPA's strong stance against abusive tax shelters. You will consider the possibility that the statement by the AICPA may also represent an authentic norm for all tax professionals belonging to the AICPA. Exhibit 2 presents the AICPA's Statement on Tax Practice that likewise may be considered in forming an opinion about authentic norms in tax practice. Also consider that there is an important difference between the AICPA's position and the IRS's position on tax avoidance strategies. The AICPA's position is that a shelter is abusive if there is no business reason other than tax avoidance. The IRS maintains that if a "significant purpose" of the shelter is tax avoidance, then the mechanism is abusive. Two authentic norms may be in conflict.

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EXHIBIT 1
Letter from AICPA on Abusive Tax Shelters

March 24, 2003

Dear AICPA Member,

We know that CPAs in public practice, industry, and many other fields are working long, hard hours into the nights and weekends this time of year. Accordingly, we hesitate to take up any of your time now, but considering recent publicity in the "tax shelter" area, we thought it important enough to write to you about our ongoing efforts.

Many of you have contacted us about the AICPA's position on so-called abusive tax shelters or inappropriate tax avoidance transactions. Media coverage of the issue has escalated dramatically with the recent release of the report of the staff of the Joint Committee on Taxation analyzing Enron's tax transactions, and a related Senate Finance Committee hearing. Also, we have all been reading a number of stories lately related to large corporate tax transactions. Moreover, the IRS has recently released final regulations relating to the disclosure, registration and listing of certain "reportable transactions."

The AICPA has a clear position on abusive transactions—they should be eradicated. They insult the large majority of honest taxpayers and their CPA advisors who strive every day to obey the increasingly complex tax laws.

The AICPA has been working hard for years to help society effectively separate abuse from appropriate tax planning. We have consistently supported the protection of the public interest and prohibitions on the misuse of our tax system. Our enforceable *Statements on Standards for Tax Services* (SSTSs) are a clear example of this. We continue to be actively engaged in proposing and evaluating various legislative and regulatory measures that are designed to identify and prevent taxpayers from undertaking, and tax advisers from rendering advice on, transactions having no purpose other than the reduction of federal income taxes in an abusive manner.

Through our Tax Executive Committee, we have shared with Congress and relevant regulatory bodies our recommendations to help them deal with misuse of the tax code through inappropriate tax avoidance transactions. The conceptual framework of our solution is built on our belief that the most effective way to combat abusive tax shelters, without interfering with a taxpayer's right to legally minimize taxes, is through disclosure and penalties.

Basically, it would: Require any person involved in the marketing of potentially abusive tax shelters to keep lists and descriptions of these transactions and of the taxpayers who buy them. Failure to maintain lists and produce records describing this activity should subject such persons to penalties and possible ethical enforcement. Require taxpayers using potentially abusive tax shelters to provide clear disclosure on their tax returns. Failure to disclose should result in penalties. Impose the most severe penalties for transactions that are determined to be abusive. These penalties should apply to those persons who promote or support abusive tax shelters, and to the taxpayers using them.

The disclosure ideas generally are consistent with the previously mentioned tax shelter regulations issued by the Treasury Department on February 28, 2003. Those regulations have existed in various forms (Proposed, Temporary) for several years; but in their current, final, iteration Treasury has attempted to make the various definitions uniform and to narrow the transactions that taxpayers and advisors must report to the IRS. We have been commenting and working with them in this regard, and have pressed Treasury

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EXHIBIT 1 (continued)

49 to limit the scope of "reportable transactions" (those that require disclosure and list maintenance) so that
50 legitimate business transactions are excluded. The final regulations embrace some, but not all of our
51 comments. Nonetheless, we support the government's objectives of (1) identifying and shutting down
52 abusive tax avoidance transactions and (2) providing greater clarity about the criteria which, if met, will
53 trigger enhanced taxpayer and promoter responsibilities and obligations. The regulations are available at
54 http://www.treasury.gov/press/releases/js70.htm.
55
56 The registration, list maintenance and disclosure regulations are now final. To the extent their
57 implementation can be made more user friendly, an AICPA task force will be giving suggestions to the IRS
58 and Treasury Department on ways to ease the compliance burden. But make no mistake—we strongly
59 support compliance with these (as with any) final regulations. They are authoritative, and members ignore
60 them at their peril. A deliberate decision not to follow the regulations would have to be clearly disclosed on
61 appropriate return(s). In addition to any governmental sanctions, our own disciplinary process will be (and
62 has been) invoked where our rules of professional conduct, including the enforceable *Statements on*
63 *Standards for Tax Services*, are violated.
64
65 Tax practice by AICPA members has always been subject to the Institute's Code of Professional
66 Conduct. We are determined to ensure that our members maintain the highest ethical standards in their
67 practices or employments. We investigate every allegation of unprofessional or unethical conduct by an
68 AICPA member that is brought to our attention by another AICPA member, a state CPA society, a client, a
69 member of the public, the media or any other source. Many of our investigations are based on information
70 derived from government sources including a review of the IRS Internal Revenue Bulletin for reported
71 sanctions imposed by the IRS Director of Professional Responsibility (formerly the Director of Practice).
72 Indeed, we have a long history of cooperation with the Director of Professional Responsibility and other
73 IRS officials as we all work to oppose abusive conduct which calls into question the high standards of our
74 profession.
75
76 Most recently, the AICPA released, on November 11, 2002, the exposure draft of an Interpretation
77 to SSTS No.1, which discusses a member's ethical obligations and responsibilities in connection with *tax*
78 *planning*. The Interpretation clarifies how the standards would apply across the tax practice spectrum,
79 including situations involving tax shelters (regardless of how that term is defined). Comments on the
80 proposal, Interpretation No. 1-2, "Tax Planning," of *Statement on Standards for Tax Services No. 1, Tax*
81 *Return Positions,* are welcome through April 30, 2003. For more information and a copy of the
82 interpretation, see http://www.aicpa.org/members/div/tax/sstsint.asp. A full copy of the SSTSs is also
83 available at http://www.aicpa.org/download/tax/SSTSfinal.pdf.
84
85 We noted above our support for a solution involving disclosure and penalties as well as for the
86 government's regulatory approach to a system requiring disclosure of certain types of "reportable"
87 transactions. Still, tough questions remain. The most difficult is fundamental to solving the problems:
88 devising a workable definition of abusive transactions for purposes of penalizing those involved with them.
89 An agreed-upon definition has eluded Congress, the Treasury Department, the IRS and tax practitioner
90 groups for a number of years. The present statutory language (any plan "a significant purpose" of which is
91 income tax avoidance or evasion) is generally recognized as being overbroad. Our approach would define
92 an abusive transaction as one having no business purpose other than tax avoidance, unless clearly
93 contemplated by tax rules. We believe this description is workable in a legislative context, but it differs in a
94 number of respects from that presently included in proposed legislation under consideration by Congress.
95 We have and will continue to share our views with lawmakers and administrators, in our mutual interests in
96 curtailing abuses.
97 *(continued on next page)*

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EXHIBIT 1 (continued)

98 To assist you in understanding this and other issues, and our positions on them, we have developed
99 several Questions and Answers that describe in some detail the work in which we are engaged regarding
100 the elimination of abusive transactions, including the "abusive tax shelter" definition we referred to above.
101 We hope you will take the time to look at the full elaboration of the definition and the complete document
102 which is located at http://www.aicpa.org/members/div/tax/shelters_qa.asp. We shall also be adding to it,
103 going forward, as further developments warrant, so we would invite you to return to those Qs and As from
104 time to time, to keep abreast of current AICPA positions. Finally, in the midst of the furor of this debate we
105 can't forget that the term "tax shelter" has taken on a pejorative meaning as a result of the constant equating
106 of that term (explicitly or implicitly) with "abusive transactions." For many of us, "sheltering" income
107 meant nothing more than entering transactions such as asset sales timed properly to incur capital losses and
108 offset realized capital gains. Any fair analysis must take into consideration the fact that the overwhelming
109 majority of the transactions entered into by taxpayers and the tax advice given by tax professionals with
110 respect to such transactions is appropriate. Tax minimization is a basic taxpayer right. Many such "shelters"
111 serve the important purpose of delivering economic incentives to taxpayers as specifically provided for in
112 the tax code. These include tax-advantaged retirement savings and education plans, life insurance on key
113 business partners and the development of manufacturing facilities and housing. Others enable business
114 units to merge and grow to remain competitive. Still others postpone tax collection to avoid undue
115 economic hardship on taxpayers. However, abusive tax shelters are another matter; our members simply
116 should not be involved. Rest assured, we will continue to work with Congress, the IRS and Treasury to
117 reach the common goal of producing the best standards for insuring that sanctions will be appropriately
118 imposed on abusive transactions and any other abuse of our tax laws. We will also continue to actively
119 enforce our ethical rules against those who promote abuse. Americans deserve to pay only their fair share
120 of taxes and should not have to assume the cost of abuse.
121
122 Sincerely,
123 **Barry C. Melancon** **Robert A. Zarzar**
124 **President and CEO** **Chair, Tax Executive Committee**

Hypernorms

Hypernorms represent limits on what communities may agree to do in their local community and are similar to universal principles that are designated to provide the normative basis to resolve transcommunal disputes.[1] Hypernorms usually invite the same kind of criticism as those directed against any conception of universal principle—namely, why is your universal principle (say "liberty and justice for all") any better than mine (say "Aryan racial superiority guides all conception of liberty and justice")? ISCT specifies some distinctive characteristics of hypernorms such as: *universal consensus*, *conformance with well-known global industry standards, consistency with the precepts of major religions, support by relevant communities of professionals* (e.g., accountants or engineers), and *support by the laws of many different countries*. Thus, one cannot simply claim a principle and justify an action or policy.

Hypernorms should include notions of *exit* and *voice* for a community's authentic norms, *support for the essential background institutions* in society (e.g., legal system designed to assure freedom of people), *promise keeping,* and *respect for human dignity.* In a sense, hypernorms are used to identify philosophical criteria for moral behavior, such as "what ought to be." That is, a community *ought* to structure its agreements regarding business to promote efficiency in the production of goods and services. The hypernorm of *necessary economic efficiency* projects the performance of the system for capital formation, production, and distribution of goods and services directly into the ethical arena. *Integrity*, *honesty*, *informed consent*, and the *right to subsistence* are also commonly included in hypernorms (Donaldson and Dunfee 1994).

[1] The concept of hypernorms is closely related to Walzer's (1992) arguments concerning the nature of a minimal morality and Taylor's (1989) concept of a hypergood.

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1

2 **EXHIBIT 2**

3 **Statement on Standards for Tax Services No. 1**

4 **Tax Return Positions**

5

6 1. This statement sets forth the applicable standards for members when recommending tax return
7 positions and preparing or signing tax returns (including amended returns, claims for refund,
8 and information returns) filed with any taxing authority. for purposes of these standards, a *tax*
9 *return position* is (*a*) a position reflected on the tax return as to which the taxpayer has been
10 specifically advised by a member or (*b*) a position about which a member has knowledge of all
11 material facts and, on the basis of those facts, has concluded whether the position is
12 appropriate. For purposes of these standards, a *taxpayer* is a client, a member's employer, or
13 any other third-party recipient of tax services.

14

15 **Statement**

16 2. The following standards apply to a member when providing professional services that involve
17 tax return positions:

18 *a.* A member should not recommend that a tax return position be taken with respect to any item
19 unless the member has a good faith belief that the position has a realistic possibility of being
20 sustained administratively or judicially on its merits if challenged.

21 *b.* A member should not prepare or sign a return that the member is aware takes a position that the
22 member may not recommend under the standard expressed in paragraph 2*a*

23 *c.* Notwithstanding paragraph 2*a*, a member may recommend a tax return position that the
24 member concludes is not frivolous as long as the member advises the taxpayer to appropriately
25 disclose. Notwithstanding paragraph 2*b*, the member may prepare or sign a return that reflects a
26 position that the member concludes is not frivolous as long as the position is appropriately
27 disclosed.

28 *d.* When recommending tax return positions and when preparing or signing a return on which a
29 tax return position is taken, a member should, when relevant, advise the taxpayer regarding
30 potential penalty consequences of such tax return position and the opportunity, if any, to avoid
31 such penalties through disclosure.

32

33 3. A member should not recommend a tax return position or prepare or sign are turn reflecting a
34 position that the member knows—

35 *a.* Exploits the audit selection process of a taxing authority.

36 *b.* Serves as a mere arguing position advanced solely to obtain leverage in the bargaining process of
37 settlement negotiation with a taxing authority.

38

39 4. When recommending a tax return position, a member has both the right and responsibility to be
40 an advocate for the taxpayer with respect to any position satisfying the aforementioned
41 standards.

42

43 **Explanation**

44 5. Our self-assessment tax system can function effectively only if taxpayers file tax returns that
45 are true, correct, and complete. A tax return is primarily a taxpayer's representation of facts,
46 and the taxpayer has the final responsibility for positions taken on the return.

47

48 6. In addition to a duty to the taxpayer, a member has a duty to the tax system. However, it is well
49 established that the taxpayer has no obligation to pay more taxes than are legally owed, and a
50 member has a duty to the taxpayer to assist in achieving that result. The standards contained in
51 paragraphs 2, 3, and 4 recognize the members' responsibilities to both taxpayers and to the tax
52 system.

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Exhibit 2 (continued)

53
54 7. In order to meet the standards contained in paragraph 2, a member should in good faith believe
55 that the tax return position is warranted in existing law or can be supported by a good-faith
56 argument for an extension, modification, or reversal of existing law. For example, in reaching
57 such a conclusion, a member may consider a well-reasoned construction of the applicable
58 statute, well-reasoned articles or treatises, or pronouncements issued by the applicable taxing
59 authority, regardless of whether such sources would be treated as *authority* under Internal
60 Revenue Code section 6662 and the regulations there under. A position would not fail to meet
61 these standards merely because it is later abandoned for practical or procedural considerations
62 during an administrative hearing or in the litigation process.
63
64 8. If a member has a good-faith belief that more than one tax return position meets the standards
65 set forth in paragraph 2, a member's advice concerning alternative acceptable positions may
66 include a discussion of the likelihood that each such position might or might not cause the
67 taxpayer's tax return to be examined and whether the position would be challenged in an
68 examination. In such circumstances, such advice is not a violation of paragraph 3*a*.
69
70 9. In some cases, a member may conclude that a tax return position is not warranted under the
71 standard set forth in paragraph 2*a*. A taxpayer may, however, still wish to take such a position.
72 Under such circumstances, the taxpayer should have the opportunity to take such a position,
73 and the member may prepare and sign the return provided the position is appropriately
74 disclosed on the return or claim for refund and the position is not frivolous. A frivolous position
75 is one that is knowingly advanced in bad faith and is patently improper.
76
77 10. A member's determination of whether information is appropriately disclosed by the taxpayer
78 should be based on the facts and circumstances of the particular case and the authorities
79 regarding disclosure in the applicable taxing jurisdiction. If a member recommending a
80 position, but not engaged to prepare or sign the related tax return, advises the taxpayer
81 concerning appropriate disclosure of the position, then the member shall be deemed to meet
82 these standards.
83
84 11. If particular facts and circumstances lead a member to believe that a taxpayer penalty might
85 be asserted, the member should so advise the taxpayer and should discuss with the taxpayer the
86 opportunity to avoid such penalty by disclosing the position on the tax return. Although a
87 member should advise the taxpayer with respect to disclosure, it is the taxpayer's responsibility
88 to decide whether and how to disclose.
89
90 12. For purposes of this Statement, preparation of a tax return includes giving advice on events
91 that have occurred at the time the advice is given if the advice is directly relevant to
92 determining the existence, character, or amount of a schedule, entry, or other portion of a tax
93 return.

Priority Rules and Moral Free Space

Moral free space is the area bounded by hypernorms in which communities develop ethical norms representing a collective viewpoint concerning right behavior. Recognition of the existence of community moral free space is an important foundation of ISCT (Donaldson and Dunfee 1999, Fig. 1 and Fig. 2). Moral free space is necessary in ISCT because there are areas that simply are not prescribed and that require difficult judgments and trade-offs.

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ISCT is certainly not moral relativism because it recognizes pervading principles that can override local (*microsocial*) contracts. It is not absolute in that it explicitly recognizes that different communities may contract differently and not be in conflict with any hypernorms. ISCT is pluralistic and allows for differences. Help in investigating conflict between legitimate norms in order to aid ethical decision making consists of *priority rules*. Those six rules of thumb appear below.

1. Transactions solely within a single community, which do not have significant adverse effects on other humans or communities, should be governed by the host community's norms.
2. Existing community norms indicating a preference for conflict of norms should be utilized, as long as they do not have significant adverse effects on other individuals or communities.
3. The more extensive or more global the community that is the source of the norm, the greater the priority that should be given to the norm.
4. Norms essential to the maintenance of the economic environment in which the transaction occurs should have priority over norms potentially damaging to the environment.
5. Where multiple conflicting norms are involved, patterns of consistency among alternative norms provide a basis for prioritization.
6. Well-defined norms should ordinarily have priority over more general, less precise norms.

At the end of the process, it is still possible that the priority rules will not yield a clear answer to the problem. Then, one must make the best decision possible. The process is one of estimating rather than calculating. However, the framework of hypernorms, focus on diverse communities, and application of priority rules allows us to approach a confined or restricted area within which we hope to exercise judgment to make an ethical decision. Areas outside the moral free space are illegitimate because they are inconsistent with hypernorms.

Summary and Use of ISCT

Figures 1 and 2 present decision aids to guide you in analysis of a prospective or past decision, action, or policy. First, consider whether the action or policy is consistent with hypernorms, the global statements of what society has deemed to be good. Remember, there is no definitive list of hypernorms, but we have supplied a sample list in the prior section. You may find at first cut that one or more hypernorms are violated. If a hypernorm is clearly violated, reject the action or policy. Second, consider whether the norm is an authentic one, based upon the local contract to which community members have agreed. Using the example of E&Y, we could look at the guides for professional tax practice, the published letter from the AICPA regarding the AICPA position on ethics and abusive tax shelters, and the Internal Revenue Code as indicators of authenticity for the community of tax planners. Third, consider whether the norms you believe are authentic are also legitimate; that is, compatible with hypernorms. Again, carefully consider whether there is conflict or tension between the norm represented by the action or policy and the overriding limits to community action called hypernorms. Fourth, examine whether your legitimate norm is in conflict with other legitimate norms. Here you will apply the priority rules to solve conflicts among legitimate norms. If application of priority rules fails to yield a clear answer, then the decision lies within the area of moral free space. Use the methods of classical ethics theories or other trusted guides to ethical action, and finally look long and hard at what your moral center is telling you. Then, make your decision.

PART 2: SPRINT'S BUSINESS SETTING

The Tax Situation

In February 2003, the *Wall Street Journal* and other publications disclosed that two key executives of Sprint Corporation were forced out of the company because they utilized a questionable tax shelter in order to avoid taxes on the gain realized from the exercise of options received in 1999 and 2000. The two executives, William Esrey, the company's chairman and chief executive officer, and

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FIGURE 1
Application os ISCT to an Action or Policy

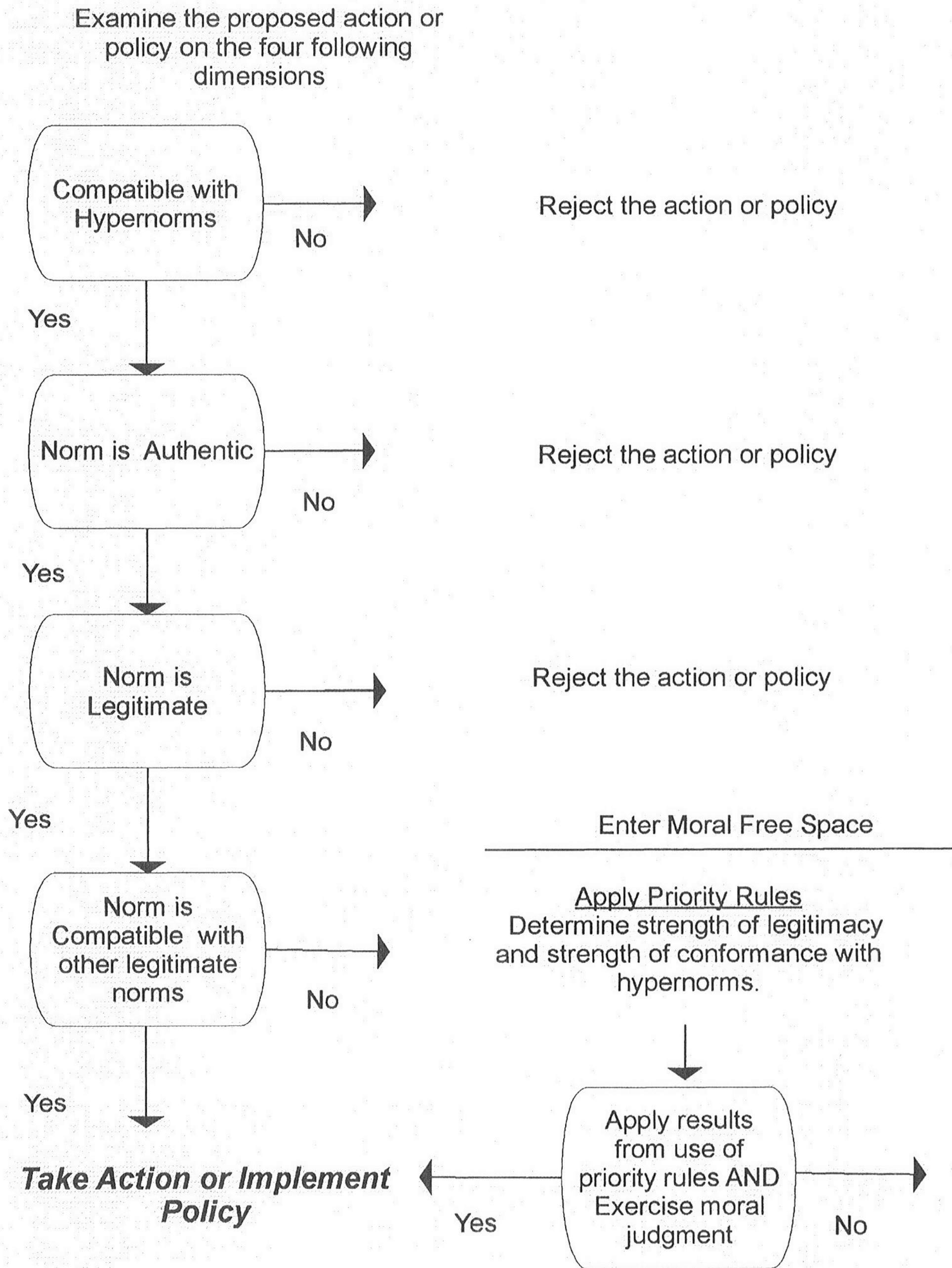

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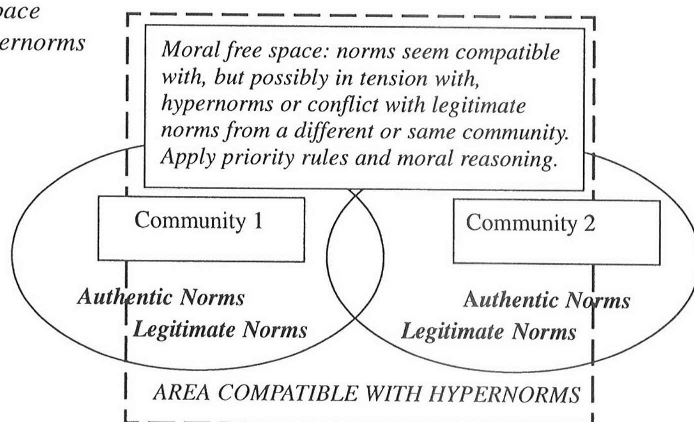
FIGURE 2
ISCT Model: Components and Definitions



1. A *community* is a self-defined and self-circumscribed group of people who interact in the context of shared tasks, values, and goals, e.g., the tax planning group of E&Y and the IRS are relevant communities in this case.
2. *Authentic norms* bind individuals in communities to agree on the structure and direction of their community; the concept of authentic norms is designed primarily to maintain cultural sensitivity and to allow for diverse systems within an overall system that is compatible with hypernorms. In the figure, some authentic norms of communities 1 and 2 lie outside the dotted lines and therefore are not legitimate. An example of an illegitimate norm might be for the tax planning group of E&Y to knowingly promote an abusive tax shelter.
3. *Moral free space* is the area bound by and compatible with hypernorms in which communities can act with integrity to their traditions, customs, and mores. The decision maker acts in moral free space when an act or policy seems to be in tension with a hypernorm and/or two or more legitimate norms conflict. For example, the E&Y tax planners may often be in conflict with the IRS where E&Y's motives to minimize taxes legally conflict with the IRS's desire to maximize tax receipt income compatible with the tax law.
4. Hypernorms and priority rules are designed to provide the normative basis to resolve transcommunal disputes. *Hypernorms* are universal principals and set "the boundaries of the moral free space of communities"; *priority rules* describe the procedures to settle disputes between conflicting authentic norms. For example, the hypernorms of *necessary economic efficiency* and *trust* may be violated if the IRS never attempted to challenge abusive tax shelters.
5. Application of priority rules may still be indeterminate. In those instances, the decision maker must make his or her own moral judgment. We should note that application of priority rules themselves might require a good deal of judgment. For that reason, we place application of the priority rules as part of moral free space in Figures 1 and 2.

Ronald LeMay, president and chief operating officer, engaged in transactions involving well over \$100 million of options. The tax at risk was more than \$50 million.[2]

[2] We created the Sprint case study with this real-world event in mind. We make the following disclaimer: Although we relied on publicly available information for the general fact pattern of the case, we created dramatic situations to illustrate the ethical tension or likely ethical reasoning that may have surrounded key decision points in the processes. Nothing in the case is meant to construe any conclusion as to any legal issue outstanding or impugn any person or organization. The case is meant solely as a device to help the accounting or tax student understand the issues and to apply a certain ethical reasoning system, namely ISCT, to a current real-world situation.

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E&Y structured the tax shelter and sold the plan to the Sprint executives using accountants trained in effective sales techniques. The terms imposed by E&Y required the executives to first sign papers agreeing not to disclose how the shelter worked before disclosing the plan to the executives. The fee to E&Y upon adoption of the plan by the clients was 3 percent of the amount involved in the transaction, with a minimum fee of $150,000. In addition the clients paid a separate $50,000 fee to a law firm for a tax opinion that it was "more likely than not" that the shelter would survive an audit. The goal of the tax shelter was: (1) to delay the taxable impact of option exercise for a period of 30 years and shift the tax to family members with lower marginal rates and, (2) under phase two of the plan, completely avoid the tax by offsetting the taxable income of option exercise through losses from an offshore partnership in which the Sprint executives would have a 50 percent share.

E&Y has since stated that they stand by the tax advice they provided to the Sprint executives, but would not discuss the details of the tax shelter. At the 2003 annual meeting, 38 percent of the votes cast opposed the reappointment of E&Y as auditors. The Internal Revenue Service (IRS) announced that the tax shelter would be disallowed, and Mr. Esrey announced that he was under audit by the IRS. Clients have sued E&Y and other firms for faulty tax advice. The Board of Directors of Sprint fired Mr. Esrey over the conflict of interest with Ernst & Young. Mr. LeMay also left Sprint. Mr. Esrey is facing potential bankruptcy because he never sold any of the shares acquired through his option exercise. Sprint's stock price plummeted and the liquidation value of Mr. Esrey's holdings was less than the pending tax bill. It is interesting to note that Sprint *required* its top executives to utilize E&Y for their personal tax compliance and planning. Table 1 illustrates the most important tax events surrounding the Sprint case.

The Telecommunications Industry and Sprint

Corporate spending on information technology (IT) has on average increased at two to three times the rate of economic growth since the 1960s. The remarkable growth of wireless communications and the emergence of Internet-based telephone systems in the mid-1990s made the telecommunication industry the crown jewel of the business world. "The IT industry is fundamentally a growth industry because it underpins production," a chief IBM executive said (*New York Times* 2003). IT was regarded as the vehicle by which a business can turn ideas and content into intellectual property products. However, by 2000, NASDAQ values for IPOs of online companies turned sour and billions of dollars in valuations for online companies were stripped. "IT doesn't matter," an article in the *Harvard Business Review* asserts, "the IT sector is inevitably headed in the same direction as the railroads, the telegraph, electricity and the internal combustion engine—becoming just ordinary factors of production, or commodity inputs" (Carr 2003, 45).

Sprint Corporation, incorporated in 1938 under the laws of Kansas, is mainly a holding company. Sprint is the nation's third largest long distance and wireless company and had stable growth in the late 1990s (see Table 2).

In November 1998, Sprint's shareholders approved the formation of the FON Group and the PCS Group. Sprint reclassified each of its publicly traded common shares into one share of FON stock and 1/2 share of PCS stock. The recapitalization was tax-free to shareholders. The PCS stock reflects the performance of Sprint's domestic wireless personal communication services (PCS) operations and FON represents Sprint's long distance services, other core operations, and directory publishing businesses.

The FON Group's long distance division (LDD) is the nation's third largest long distance phone company. LDD operates a nationwide, all-digital long distance telecommunications network using state-of-the-art fiber-optic and electronic technology. It provides domestic and international voice, video, and data communications services as well as integration management and support services for computer networks. The FON division competes with AT&T, MCI WorldCom, and other telecommunications providers in all segments of the long distance communications market. AT&T continues to have the largest market share of domestic long distance communications. MCI WorldCom is the

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TABLE 1
Synopsis of Relevant Tax Facts

Fact	Description
1. Options granted to executives	• Stock options issued based on Sprint's compensation and stock option plan
2. Executives met with tax advisors	• Tax shelter set up by Ernst & Young for Sprint executives • Ernst & Young assures that the investment and tax strategy was perfectly legal • Minimum value that can be realized from exercising options must be $5 million
3. Options were amended by Board of Directors to meet the need of tax planners, i.e., vesting was accelerated, and executives were granted the right to sell options to family-controlled entities	• Approval of merger deal with MCI WorldCom triggered accelerated vesting and options met the certain criteria are immediately exercisable
4. Options vested upon approval of pending merger by Board of Directors and stockholders	• Normal practice requires waiting until a merger is finally approved before vesting any related options
5. Family controlled entities (partnership/trust) were created	• Incorporate wealth transfer opportunity • A law firm provides an opinion that "more likely than not" the IRS will accept the shelter
6. Options were sold by executive to family-controlled entities in exchange for 30-year balloon installment note	• Transfer of options by sale was permitted under the company's plan
7. Family-controlled entity eventually exercises options and sells acquired stocks	• Benefits include eliminating need for current payment of ordinary income tax on the option exercise • Post-sale appreciation is taxed as capital gain
8. In the 30th year when the installment note is paid, the executive reports income from the sale of the options	• The tax shelter results in deferring ordinary income on the exercise of stock options for up to 30 years

nation's second largest long distance phone company. Competition in long distance is based on price and pricing plans, the types of services offered, customer service, and communications quality, reliability, and availability.

Sprint PCS Group includes Sprint's domestic wireless mobile phone services. It operates the only 100 percent digital PCS wireless network in the United States, with licenses to provide nationwide service using a single frequency and a single technology. PCS operates in 45 of the 50 largest U.S. metropolitan areas and has licenses to serve 270 million people in all 50 states, Puerto Rico, and the U.S. Virgin Islands. The wireless market for PCS is also competitive. Other two-way wireless service providers, including cellular and PCS operators and resellers, serve the market.

Strategic Merger with MCI WorldCom

In October 1999, Sprint announced a definitive merger agreement with fast-growing MCI WorldCom—a $129 billion merger that, if completed, would have been the largest in telecommunication history. Sprint's shareholders approved the proposed merger; however, the government later disallowed it based on antitrust considerations. However, shareholder approval of the deal triggered

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TABLE 2
Stock Performance, Profitability, and Pay-Performance Relationship

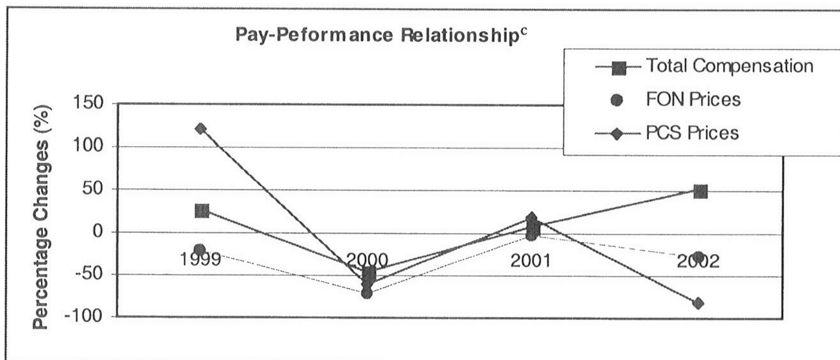
Panel A: Stock Performance and Operating Income

	2002	2001	2000	1999	1998	1997	1996	1995	1994
Stock Prices ($/share)									
FON	14.48	20.08	20.31	67.31	84.13	58.62	39.87	39.63	27.63
PCS	4.38	24.41	20.63	51.25	23.13				
Operating Income (in million $)	2,100	(901)	296	(484)	190	2,451	2,267	1,834	1,691

Panel B: Five-Year Returns for Sprint

	2002	2001	2000	1999	1998	1997
Sprint FON (%)[a]	61.72	82.06	81.00	261.95	162.48	100.00
Sprint PCS (%)[a]	47.19	220.21	263.02	552.19	124.58	100.00
S&P 500[b]	97.08	124.42	141.14	155.15	128.34	100.00
S&P Integrated Telecom	67.22	96.51	106.35	164.01	151.54	100.00
Barclay's Capital Wireless	69.14	126.68	165.16	280.70	114.19	100.00

Panel C: Pay-Performance Relationship



[a] The yearly percentage change in the cumulative total stockholder return for FON and PCS stocks as compared with the S&P 500 Stock Index and the S&P 500 Integrated Telecommunications Index, for the five-year period from 1997 to 2002. All the returns are compounded annually.

[b] The S&P 500 Integrated Telecommunications Index is composed of the following companies: ALLTEL Corporation, AT&T Corporation, BellSouth Corporation, CenturyTel, Inc., Citizens Communication Company, Qwest Corporation, SBC Communications, Inc., Verizon Communications Inc., and Sprint FON Group. The Barclays Capital Wireless Index is composed of the following companies: ALLTEL Corporation, Centennial Communications, Millicom, Nextel Communications, Price Communications, Telesystem, US Cellular, Vimpel Communications, Vodafone, Western Wireless, and Sprint PCS Group.

[c] The total compensation in pay-performance relationship is the annual compensation, which consists of base salary, bonus, and other compensation.

"accelerated vesting" by Sprint's Board of more than $1 billion of stock options for Sprint's executives and other key employees. As the result of the proposed merger, the top executives could exercise their options immediately, rather than wait for them to mature. The vesting occurred on the day the board voted as a consequence of a positive shareholder vote approving the merger, not when

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the merger was finally approved by regulators mindful of antitrust considerations. As a result, Mr. Esrey and Sprint president Ronald LeMay enjoyed a $300 million windfall, partly for orchestrating a merger that never happened. Regulators rejected the merger on concerns over reduced competition.

Sprint's Pay for Performance System

Sprint's compensation philosophy is to link, by use of specific objectives, executive compensation to the short-term and long-term performance of Sprint so as to maximize long-term shareholder value. Sprint's executive compensation consists of three elements: (1) base salary, and short-term incentive compensation, (2) base salary and long-term incentive compensation, and (3) stock options.

(1) Short-Term Incentive Plan

The Compensation committee reviewed executive's performance and compensation against national surveys and key competitors. Target incentive opportunity is established as a percentage of salary and is based on job level and potential impact on organization results. Seventy-five percent of short-term incentive plan payout was based on the achievement of two financial objectives: operating income and cash generation, and revenue growth relative to market growth. Twenty-five percent of payout was based on the achievement of certain personal objectives. These include qualitative factors related to business unit and departmental results of a nonfinancial nature, e.g., the support the executive provided in meeting strategic and tactical objectives, contributions to the progress of the quality improvement process, and individual growth and development.

(2) Long-Term Incentive Plan

Employees meeting certain eligibility requirements were included in the long-term incentive plan. Under this plan, participants received units, which vested 25 percent per year beginning one year from the grant date and expired after ten years. The appreciation units were converted to shares and options, based on a formula designed to replace the appreciated value of the units. Target incentive opportunity is based on return on assets (ROA) and earnings before interest, income taxes and depreciation as a percentage of revenues (EBITD).

(3) Stock Option Plan

Under Sprint's 1990 Stock Option Plan (SOP), Sprint grants stock options to officers and key employees. The options generally become exercisable at the rate of 25 percent per year, beginning one year from the grant date and have a maximum term of ten years. At year-end 2001, this plan authorized options to buy approximately 67.6 million FON shares and approximately 54.2 million PCS shares. In 2001, Sprint granted stock options with extended vesting schedules to its executives to provide competitive compensation and to link their compensation to shareholder value.

In 2000, Sprint granted special stock options (Retention) to executives who agreed to defer the benefit of the accelerated vesting of stock options until the close or cancellation of the proposed WorldCom merger. In addition, Sprint granted a portion of the annual option grants (Accelerated) normally expected to be made in early 2001 to officers and key employees.

PART 3: E&Y'S TAX SHELTER FOR STOCK OPTION GAINS

The tax shelter named Equity Compensation Strategy (E.C.S.) was structured by E&Y to defer capital gains realized from the exercise of stock options. The fee to Ernst & Young was 3 percent of the amount involved in the transaction, with a minimum fee of $150,000, plus each executive paid a separate $50,000 fee to a law firm for a opinion that the shelter would more likely than not survive an audit.

Normally, an employee stock option gives an individual the right to buy shares from a company in the future at a set price. The Sprint executives arranged with the Board to vest options upon

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approval by Sprint shareholders of a pending merger with WorldCom (a $129 billion merger) before final regulatory approval. Once vesting occurred, the options could be exercised. Further, the Sprint executives arranged with the company to provide that the options could be sold to family members or an entity controlled by family members. Most corporate arrangements only vest options on final implementation of a merger and most prohibit transfer to family-owned entities.

The tax shelter worked in the following way. The executive sold his options to a family trust or a family partnership in exchange for a 30-year promissory note. The sale price of the options was based upon the Black-Scholes technique, an option valuation model accepted by the IRS. The family-controlled entity owned the options as a result of the purchase and inheritance of the promissory note; and subsequently exercised the options resulting in their ownership of the corporation's stock. The stock was eventually sold by the family controlled entity and taxes, if any, were paid at the preferential capital gain rates. The executive deferred the reporting of this sale until the 30-year note was paid.

Ernst & Young obtained written assurances from outside tax attorneys that it was "more likely than not" that the tax shelter would be accepted by the IRS in the event of an IRS audit. Since the IRS can impose penalties as high as 75 percent of taxes owed plus interest if a tax shelter is fraudulent, the possibility of penalties was a serious matter. Generally, penalties can be mitigated if:

- The taxpayer acted in good faith and there was reasonable cause for the understatement of tax;
- The understatement was based on substantial authority; or
- The relevant facts affecting the tax items tax treatment were adequately disclosed on Form 8275, and there was a reasonable basis for the tax treatment of the item.

The tax shelter, if accepted by the IRS, would have permitted the executives to transfer wealth to their family (usually children and grandchildren) while delaying for 30 years income taxes on the option gains.

Mr. Esrey stated that future taxes could consume most, if not all, of his assets and that: "I relied on the advice and representations of Ernst & Young, and I believed at the time that I was receiving sound tax advice" (*Wall Street Journal Online* 2003). "During my entire career at Sprint, I have never sold FON or PCS shares to receive income from the sale of any Sprint stock or option," said Mr. Esrey (*Wall Street Journal Online* 2003). He defends his position that executives' tax should not arise because he never sold shares to cover the tax on shares exercised during the boom. E&Y, in a prepared statement, said it stood by the tax advice and counsel it provided. Spokesmen for Verizon Communications Inc. and AT&T Corp., two of Sprint's major competitors, separately stated they do not allow employees to transfer options into shelters or to avoid or defer taxes when they exercise options. The IRS has questioned whether a *bona fide* sale took place, and whether the options were sold at an arm's length price.

Continuing Developments

- Ernst & Young stated that they stand by the tax advice they provided to the Sprint executives, but would not discuss the details of the tax shelter;
- The IRS announced that the tax shelter would be disallowed;
- Mr. Esrey announced that he was under audit by the IRS;
- E&Y announced that their tax departments would no longer handle tax-compliance or tax-planning assignments for executives of audit clients;
- Mr. Esrey was fired by Sprint. According to the employment agreement, the severance package includes 18 months of salary and eligible bonuses, and millions of options that would immediately vest. If Mr. Esrey continues to advise Sprint for as many as 30 days a year, he would earn a daily fee based on his final salary. Even if Sprint does not employ its

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departing executive as a consultant, Mr. Esrey will still receive an office and secretarial support for life—plus two club memberships, financial-planning services, and use of corporate aircraft for a decade;

- In 2003, shareholder advocates called on Sprint to dismiss E&Y and strongly signaled that investors remain troubled by the potential conflicts of interest when auditors also serve as financial advisers to a company or its top executives;
- Sprint shareholders sued the company over the accelerated vesting of options;
- Sprint's Board prohibited its executives from receiving personal wealth and tax planning services from its independent auditor. Previously, the company required its executives to use the company auditor for those services;
- E&Y paid $50 million in settlement of law suits; and
- On July 1, 2003, the IRS issued Notice 2003-47 attacking the type of tax plan utilized by E&Y and the Sprint executives. The Notice held that: (1) taxes are due upon the transfer of the stock options to a related party and not deferred until the installment note is paid; (2) a transfer of stock options to a related party is not an arm's length transaction.

PART 4: CLASS ASSIGNMENT QUESTIONS

1. Plagiarism is a problem on many campuses. Do you believe that plagiarism is unethical? How would you defend your position? How might ISCT apply to an examination of the ethics of plagiarism?
2. What relevant communities are involved in the Sprint case?
3. What hypernorms do you think are applicable to the relevant communities affected by the case?
4. Assume that the AICPA letter (Exhibit 1) and the Statement on Standards for Tax Practice No. 1 (Exhibit 2) represent the local community contract for tax advisors. Explain how this contract is or is not consistent with ISCT. Are the AICPA views on abusive tax shelters consistent with the IRS position?
5. In the following situations, assess whether the action or policy is ethical using the ISCT model. Some situations may place you in moral free space.
   a) Do you think that the accelerated vesting of stock option awards to Sprint's executives based on the proposed WorldCom merger was ethical?
   b) Consider Sprint's stock performance and income. Do you believe that the overall level of stock option grants to Sprint's executives is ethical?
   c) Was Mr. Esrey acting ethically in accepting the accelerated vesting of the option awards for the WorldCom merger?
   d) Do you think that professionals from E&Y who developed and sold the tax shelter to the Sprint executives acted ethically?
   e) Did Mr. Esrey and the other executives act ethically in contracting to enter the tax avoidance plan?
   f) Did Sprint act ethically in firing Mr. Esrey?
6. Discuss the problems that will determine the legality of the tax shelter.
   a) Underlying purpose of the shelter
   b) Transferability of options to family members
   c) Early vesting of options
   d) Tax validity of installment sale technique
7. Did the sale of the tax shelter by the accounting firm cause a conflict of interest in giving advice to the executive at the expense of the corporation? When does Sprint get the deduction for the stock option grant?

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CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Learning Objectives

This case provides students, instructors, and practitioners with a model to aid in understanding the normative justification for business decisions, and assessing the quality of ethical decision making in a complex business setting centered on a tax issue. Hartmann (1996) asserts that those in business education who understand the dynamics of the market system must be more involved in ethical analysis and must ask more of students by replicating realistic and complex situations and providing the tools to help them recognize and analyze those situations. We hope that ISCT and the facts surrounding the Sprint case provide both the tools and an appropriate setting for improving our students' ethical reasoning ability.

Purpose of the Case

Our principal motivation for the case is: (1) to provide a methodology for analysis of ethical problems and issues of professionalism that allows and encourages the student (or professional) to undertake a careful and systematic analysis of potential ethical dilemmas, and (2) to use a case with a strong tax component since tax courses have historically placed little emphasis on ethics issues. ISCT is a methodology that fulfills the first objective. The tax issues at the heart of the Sprint case meet the second objective.

We believe that the structure of ISCT, though applied primarily to help resolve ethical problems of global companies in developing host countries, translates well to domestic applications in advanced economies. Many of the ethically oriented cases and problems in financial, managerial, and auditing texts are precise, and often transparent, in the presentation of the critical issues; sparse in terms of preparation for ethical problem solving; and unsupportive of extended classroom discussion. Often, discussion is limited to something like "It's unethical for Alice to change overhead application rates to enhance the profitability of department 101. That's the same as lying and lying is unethical." The discussion then ends. Even a text devoted to cases in ethics and professionalism provides relatively little in the way of "how to" conduct ethical analysis (Mintz 1997).

The deeper issue is that even more detailed instruction might not really help because most traditional approaches to ethical problem solving are difficult to apply to many modern settings. It is quite a difficult leap for anyone to study virtue ethics, consequentialism, or deontology by reading the classic works and then trying to apply the theories to a specific problem in a modern business setting.

Compounding the problem of teaching ethics is that many articles in the field of business ethics seem to be written by expert philosophers with relatively little background in business. Hartmann (1996) believes that those writing about business ethics need to understand business. He asserts that those in business education who understand the dynamics of the market system must be more involved in ethical analysis and must ask more of students by replicating realistic and complex situations and providing the tools to help them recognize and analyze those situations. We hope that ISCT and the facts surrounding the Sprint case provide both the tools and an appropriate setting for improving our students' ethical reasoning ability.

Case Validation

The case has been used in two undergraduate sections of Federal Income Taxes and in two graduate M.B.A. sections of Managerial Accounting. At the time the case was used, the tax sections had not yet covered issues relating to options. The two managerial sections had reviewed the IMA code of ethics, covered selected end-of-chapter ethics cases, and reviewed the WorldCom and Enron frauds. The description of the application is in the following table.

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	Enrollment	Sessions	Session 1	Session 2
Undergraduate				
Tax 1	12	2	Introduction	Discussion - No Teams
Tax 2	11	2	Introduction	Discussion - No Teams
Graduate				
Managerial 1	19	2	Introduction	Scenarios - Teams
Managerial 2	17	2	Introduction	Scenarios - Teams

Session 1

The first session focused on exploration and understanding of the case facts and the ISCT system. The essential facts of the option grant, sale to the family LLP, balloon note, tax effects, and potential conflicts between E&Y, the IRS, Sprint, and the executives were reviewed. With respect to ISCT, the instructor discussed with the class the background and potential benefits of ISCT as an ethical reasoning system. The notions of communities, microsocial contracts, hypernorms, authentic norms, legitimate norms, priority rules, and moral free space were all explicitly discussed. The instructor attempted to convey a sense of enthusiasm for the potential benefits of studying the system in the context of a complex fact pattern and reviewed Case Figures 1 and 2, focusing on the language and logic of the system.

Session 1 also included application of ISCT to the plagiarism example in three of the four sections. (In one of the graduate sections, debate on issues related to Sprint and ISCT that the instructor believed were fruitful crowded out the plagiarism example.) The instructor covered the microsocial contract by illustrating the code of conduct for the university. For the graduate courses, that code had been posted on the class BlackBoard and referenced in the class syllabus at the beginning of the semester. The instructors believe that the goals of Session 1 were met in that the fact patterns were generally understood, and the ISCT logic and language was accessible to, and usable by, both the undergraduate and graduate sections. Participation level in the undergraduate sections was good. Participation level for the graduate sections was outstanding.

Instructors asked the students in the undergraduate sections to review the case and prepare to discuss the questions at the end of the case. The format for the undergraduate sections was one of general discussion. In the graduate sections, the instructor distributed the scenarios included in the appendices, assigned one of the scenarios to each student team, and asked each student team to review the issues in Table 1 to structure their post-scenario analysis. The instructor distributed the Table to all class members via the class BlackBoard. The modality for the graduate sections required role playing, teamwork, and analysis.

Session 2

During the second session, the undergraduate students focused on the discussion questions. They successfully used the terms, although the instructor needed to ask leading questions from time to time to keep the focus on covering each step in the process. It was not possible to cover all of the discussion questions in one session. Students participated, asked questions, and in one of the sections engaged in a debate on the ethics of executive compensation based on the amount of the option grants. The instructor did refocus on the issue of the E&Y and IRS communities through coverage of the AICPA letter (Exhibit 1) and the Tax Practice Standards (Exhibit 2).

In the graduate session, the students engaged in a spirited delivery of the scenarios and used the table to structure their discussion. The debate was highly animated, and the level of emotive involvement was high. For these students, the ISCT system led to rejection of virtually all of the actions and policies of the Board, the executives, and E&Y as unethical without ever applying the priority rules or using moral free space. The findings were based on the illegitimacy of the norms as perceived by the class. The ISCT model seemed to focus the students on the communities of employees, stockholders,

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and taxpayers. Once these were explicit, the clarity and conviction against the principal actions and policies was virtually one hundred percent across the teams. In this particular class, the graduate section discussed here is a cohort of managers from a Fortune 500 company.

Instructor Assessments

We have enjoyed teaching the case. The reasoning process of ISCT provides a structure and process that *requires* the user to think through several steps. The facts surrounding the case seemed to be of interest to graduate students even though they were not in a tax class. We believe that our prime motivators for the case—(1) rich complex fact patterns, and (2) a structured system of ethical reasoning relevant to business problems—overall proved to be well founded.

Student Assessments

Discussion with students and a post-case questionnaire revealed that both the graduate and undergraduate students believed that the Sprint case was of "moderate" to "high" educational value and that the ISCT structure was of "moderate" to "high" help in analyzing the situation. The graduate rating was slightly higher than the undergraduate.

Comments from the undergraduate sections included the following:

- "It was very informative about a subject not often covered in class but experienced in the real world. We should study more cases like this."
- "I enjoyed the case because of its relevance to today's business environment. It is great to look at a current case which you can follow and analyze on your own."
- "It's true that it isn't always clear cut as to what is ethical or not, and it is easy to see that although things are legal, it doesn't automatically mean that they are ethical."
- "This case study is of great benefit to us. A new aspect of the corporate world was brought up and discussed. I believe we need to study ethics more thoroughly. This was a great idea, hope to have many more."

Comments from the graduate section included the following:

- "This case reflects what goes on all the time in corporations. It gave us the opportunity to apply different types of reasoning to unethical behavior."
- "I though it was a valuable experience that helped me understand the universe of ethics as they function in communities."
- "I am appalled by what they tried to do. Completely unethical in terms of every community except their select community of very few."
- "Terrific exercise. Dynamic discussion. Perhaps an additional case with some more gray area or ambiguity would be interesting too."

TEACHING STRATEGIES

Two possible teaching strategies are provided. Both strategies envision a three-step approach to managing the basic case. The three-step approach is as follows:

1. Assign the case to the class/teams to study (2–3 hours outside class). Assign discussion question 1.
2. Discuss the ISCT approach and the case facts with the class. The ISCT initial discussion should include case Figures 1 and 2 and supporting discussion of elements such as norms, priority rules, and moral free space. Work with the class through the plagiarism example (discussion question 1) until you are satisfied that students can reason with the system and reach a conclusion. If time allows, you may review the fact pattern of the business and tax settings (50- to 75-minute class).
3. Require participation by the class under strategy 1 or 2 below. Students should be active and use the ISCT system as well as supporting material cited from the AICPA and the case facts (50- to 75-minute class).

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TEACHING STRATEGY 1—DISCUSSION AND TEAMS

Sprint is written to be suitable for courses in financial accounting, taxes, and professional ethics in M.S.A., M.B.A., M.S.T, or upper-level undergraduate study. The primary emphasis of the case is on developing the student's ability to reason with ISCT and to apply the structure to a relatively complex and multifaceted situation focusing on a tax avoidance strategy. An instructor in a tax course focusing on stock options or tax shelters might choose to emphasize a tax research component. The references to do so and the supporting notes are provided. The general tax aspects of the case are accessible to virtually all students at the target levels while the tax research component is available for more advanced tax classes.

In terms of delivery, the instructor might employ discussion and teams. The danger of straight discussion is that the effort is not invested by a substantial portion of the class and the instructor may end up walking the students through the thought process. For that reason, we favor a combination of discussion with either teamwork and/or role playing. Initial discussion should focus on the structure of ISCT. Use Figures 1 and 2 to review the major terms and the logical flow of decision making using ISCT. The second major class discussion point in the learning process is the first discussion question concerning plagiarism. All students should be asked to formulate an ethical conclusion based on the plagiarism example. If teams are used, allow for the possibility of a team conclusion.

The remainder of the questions can be handled by teams. For example, teams may analyze the various ethical dimensions raised in Question 5. Alternatively, the instructor might pick one or two of the situations and ask student teams to take one or the other side of the issue and argue it using ISCT. All of the situations need not be covered. Allow about 50 minutes in total for discussion.

The structure of scenario 1 using teams is: (1) create teams, (2) teams execute study assignment, (3) instructor conducts a full class discussion reviewing ISCT, facts, and the plagiarism example, and (4) in the follow-up class, teams lead discussion of the questions selected by the instructor from the list of discussion questions. (If teams are not used, the forum is an open discussion.)

TEACHING STRATEGY 2—SCENARIOS AND ROLE PLAYING BY TEAMS

Dramatized Scenarios of Meetings

The following scenarios provide a dramatized (i.e., invented) version of what may have happened at several key junctions in the events surrounding the Sprint case. Nothing herein is meant to impugn any individual or business entity. The purpose of the scenarios is to highlight issues to consider when evaluating the conflicts or problems raised by the case. If you decide to use the scenarios, distribute both the table below identifying the issues linked to each scenario and the scenarios themselves to the class, and assign teams of students to deliver the scenarios during class discussion of the case. Allow time between distribution and role play for students to closely study the issues involved in each scenario. Require that the presenting team be prepared to discuss the issues raised by the scenarios and require members of the class to query the team members using the language and approach of ISCT.

In this approach, allow about ten minutes for each scenario and ten minutes for a wrap-up.

Structure	Time	Issues
S1: Granting Options	10 minutes	• Ethics of making the grant • Involved communities • Ethics of not surrendering the grant • Identification of applicable hypernorms • Legitimacy of implied norms • Authenticity of norms • Priority rule application • Use of moral free space • Ethical conclusion based on ISCT

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S2: Plan Design by E&Y	10 minutes	• Ethics of the plan • Involved communities • Identification of applicable hypernorms • Legitimacy of implied norms • Authenticity of norms • Priority rule application • Use of moral free space • Ethical conclusion based on ISCT
S3: Executives Attend Meeting	10 minutes	• Personal situation of Mr. Esrey • Involved communities • Apparent norms employed by Mr. Esrey • Ethical conclusion using ISCT
S4: Board Meeting Fallout	10 minutes	• Ethics of firing Mr. Esrey • Analysis of Board performance from ISCT viewpoint

The structure of teaching scenario 2 using teams and role playing is: (1) create teams, (2) teams executes study assignment, (3) conduct a full class discussion reviewing ISCT, facts, and the plagiarism example, and (4) teams role play each scenario assigned and teams lead discussion of the questions and issues attached to each.

Scenario 1: The Board Accelerates the Vesting of the Executive Stock Options Based on the Pending Merger with WorldCom

B = Board Member

B1: "So, are we in agreement as to the accelerated vesting of the stock options to our two top executives?"

B2: "If we do this, aren't we actually removing the long-term incentive aspect of the program? I mean, couldn't they sell as quickly as possible and just invest in other companies?"

B1: "Well, they could, but there are two things to think about. We know the CEO has virtually all his net worth in Sprint stock and he is likely to continue that way. Also, there are certainly other options that we can vote and tie into long-term targets. Remember, we have to stay competitive with our top executive compensation."

B3: "Look, we all agree with that. But, these options are granted for the successful completion of the WorldCom deal? We have a positive shareholder vote, but we have no regulatory approval yet. And it might not be so easy to get approved. Why are we going to accelerate the vesting?"

B1: "We all know the team worked tirelessly on the deal. Why don't we move ahead on this issue? We have some other items to consider."

(The board votes unanimously to approve the accelerated vesting of the options. The merger eventually fails due to regulatory objections. The executives retain the options as granted.)

Scenario 2: The Service Firm Designs a Tax Avoidance Plan

(Meeting taking place at national headquarters)

TP = Tax Planner

TP 1: "Great job to the team. This plan can defer over $40 million in taxes for decades for our principal Sprint clients. If phase two works, they might be tax-free."

TP 2: "We think it's a winner. We should have the letter from the law firm any day now. They are going to be positive on chances of surviving IRS audit."

TP 3: "For $50,000 per letter, I should hope so. I'd like to see their margins!" (All laugh) "Whatever their margins, the results will be even better for our clients."

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TP 1: "Well, the law firms and our clients will do well. How about us? Is the marketing plan in place?"

TP 2: "We're set to go. The ticket to the meeting is $1 million. We should have six clients minimum. We don't tell them any of the details until payment is in. The only ones not to make money on this are our friends at the IRS."

TP 3: "What about our clients' employers? Let's take Sprint. They won't have a deduction for the options because there will have been no sale."

TP 2: "That's true. But really, who will notice that amount. It's huge for our client but not so big for Sprint."

TP 1: "Are we OK with our tax practice standards?"

TP 2: "I think so. Both the firm standards and AICPA standards clearly allow for advocacy in the tax area. The lawyer's letter covers us with an independent statement that the plan will withstand audit. It's aggressive, no doubt, but we believe that we are covered. Besides, it's not registered as a shelter and we get a pledge of complete confidentiality from the clients."

TP 1: "Call tomorrow when the lawyer's letter arrives. We'll plan the clients' meeting for two weeks out. Let's close the deal."

Scenario 3: The Executive Attends the Meeting with E&Y and Executes the Plan

TP = Tax Planner, E= Executive

TP: "Well, that wraps it up. In summary, depending on the amount of options, tens of millions of tax liability will be gone, or at least deferred for a very long time."

E: "It seems almost impossible. I see how much tax comes out of my salary check. Can we really achieve this?"

TP: "The firm has its best people on the design. We have the independent counsel's letter that it is likely to withstand challenge. Look, Congress creates the laws. It's complicated and that complexity often works to our advantage. Remember, you're only wealthier based on what you get to keep. Our job is to help you keep more."

E: "You guys are great. I have the options vested now. Let's move forward with implementation. This has to be bullet-proof. I haven't sold any of the shares to reserve for taxes."

TP: "Just remember. Our agreement prohibits you from disclosing the shelter to anyone. Also, you agree not to seek any outside independent review of the plan. Everyone must be extremely discreet. Everything will work just fine."

Scenario 4: The Fallout: The Board Takes Action

(Meeting of December 9, 2002 at Sprint headquarters, Overland Park, Kansas)

Board members reconvene after listening to a presentation by their CEO as to why Sprint should not fire him but instead fire Ernst & Young.

B = Board Member

B1: "Well, this is a mess! As I look back on the last four years, I'd like to just ask some questions. How did we allow the amounts of these options to explode like we did? In 1996, this whole problem couldn't have happened because there simply wasn't the huge amount of grants."

B2: "You know why that happened. We looked at Qwest and Global Crossing and decided to keep up with them in terms of compensation. It really bothers me that we never looked more carefully at total option compensation and our corporate income. I think they're out of whack."

B1: "OK, here's another question. How did we make the decision to vest the huge amount of options based on the shareholder approval of the WorldCom buyout?"

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B3: "In retrospect the accelerated vesting was a questionable decision. To be honest, I think that we never should have required our top executives to use the auditors to do their personal taxes. In addition, we threw in tax consulting for free. Now we have our executives at odds with our auditors. That's a disaster."

B1: "Look, no matter how we feel personally, I think that we have to let him go. We would be in an untenable position if we fire the auditors. We'd practically be asking the IRS to audit our books. If we keep him and the shelter explodes, as it seems likely now, we might end up with a bankrupt CEO. That can't look good."

B4: "I think that's pretty much the sense of the Board at this time. I'd like to call for a vote."

(The Board fired Mr. Esrey.)

TEACHING NOTES

Teaching Notes are available through the American Accounting Association's new electronic publications system at http://aaahq.org/ic/browse.htm. Full members can use their personalized usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed.

If you are a full member of AAA and have any trouble accessing this material, please contact the AAA headquarters offices at office@aaahq.org or (941) 921-7747.

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