

## Winter 2004 Newsletter

### The Ethics of Tax Preparation

The tax practitioner has an obligation to minimize a client's tax liability. The professionals of McGill, Power, Bell & Associates consider themselves to be highly knowledgeable advocates for their clients. But there are serious ethical issues associated with the preparation of tax returns. We feel that our clients should be aware of these ethical issues --- issues such as can the practitioner advise a client to take a position on his or her return, when the practitioner expects the IRS to take a contrary position? What are the distinctions between tax avoidance and tax evasion? What are the limitations, if any, on tax avoidance?

#### **Tax Evasion.**

One ethical issue is clear. The practitioner cannot knowingly participate in a client's tax evasion. Tax evasion is characterized by fraud and illegal activity. Advising a client to provide fraudulent information on a return implicates the practitioner in illegal activity. If the tax practitioner learns that a client is engaging in a fraudulent activity, the practitioner has a responsibility to withdraw from the engagement.

#### **Tax Avoidance**

The ethics of tax avoidance are much less clear cut. There is a segment of the accounting community that perceives tax avoidance as raising no ethical issues. This view is partially supported by a ruling of Federal Court Judge Leonard Hand that there is no duty or responsibility for a filer to increase their taxes.

The profession takes the position that the practitioner's primary obligation is to the client. What if any obligation does the practitioner have to ensure that the system is operating fairly and honestly?

#### **The Economic Model**

With audits by the IRS declining, the "economic model" postulates the economic benefit of tax avoidance versus the probability of detection and the size of the penalty if detected. This approach proposes that if the tax savings exceed the potential penalty times the percentage of risk of detection, the tax avoidance is justified. The economic model has not effected compliance rates when the sources of income are regularly reported such as wage and salary income. Accurate reporting on tax returns for this type of income is estimated at 98%. In contrast, it is estimated that accurate reporting of partnership income is only 42%.

The ethical practitioner must reject this "lottery" philosophy for tax avoidance. The practitioner has a clear responsibility to facilitate compliance with accurate reporting when the law is clear.

However, when the law is complex or ambiguous, practitioners may advise their clients to take an aggressive approach. Care must be taken not to use an approach based on a legitimate position and push it to the point that it is no longer defensible and clearly becomes an avoidance technique.

### **Professional Standards**

There are several bases for defining the ethical issues associated with tax minimization and avoidance. These include:

- The rules of the American Bar Association
- The AICPA's Statement on Standards for Tax Services
- The Treasury Department's Circular 230

### **The ABA Model**

The American Bar Association issued Opinion 314 in 1965. It stated that an attorney may urge the statement of positions most beneficial to the client as long as there is *a reasonable basis for those positions*.

The tax practitioner can take this favorable position without disclosing on the return that he or she has done so.

The standard states that the attorney represents the taxpayer in what is essentially an adversarial relationship between the taxpayer and the IRS. It further states that the IRS does not represent a true tribunal or even quasi-judicial institution. Attorneys may not mislead the IRS, but are not required to disclose weaknesses in the client's case.

Later, in 1985, the ABA released formal opinion 85352. This opinion states that the attorney may advise a position most favorable to the client if the attorney has a "good faith" belief that the position is warranted under existing law. The attorney can have a good faith belief in the position if the attorney thinks that the position has at least a one third probability of prevailing, if challenged.

### **AICPA's Statement on Standards for Tax Returns**

The AICPA's standards are similar to the ABA in that they state that a CPA may only recommend a position that the CPA feels has a realistic possibility of being sustained. However, the CPA cannot prepare or sign a return that takes a position that the CPA would not recommend. The CPA has a responsibility to advise the client of potential penalty consequences and the opportunity to avoid these consequences through disclosure.

Under no circumstances can a CPA recommend a position that:

1. exploits the low risk of audit
2. serves as a mere arguing position advanced solely to obtain leverage in the bargaining process of a settlement with the taxing authority.

The CPA's advocacy of the taxpayer is limited only by the requirement to satisfy the conditions of the AICPA's Standards for Tax Returns.

### **Circular 230**

Tax professionals practicing before the IRS must also comply with the rules and regulations in Circular 230. A violation could result in the practitioner being disbarred from practice before the IRS, being suspended from practice or being censured.

Like the ABA criteria, Circular 230 states that a practitioner cannot advise a client to take a position on a tax return unless the practitioner determines that the position satisfies the "realistic possibility of success standard." This standard is defined as being satisfied if a well-informed analysis of the law and the facts by a person knowledgeable in the tax law would lead the person to conclude that the position has a 1 in 3 or better chance of being sustained on the merits.

Persons having their tax returns professionally prepared must understand that while the CPA is their advocate and has a responsibility to take positions that minimize their tax liability, they must do so under ethical and legal constraints. A CPA may not sign a return that takes a position that the CPA does not believe to have a reasonable chance of being sustained. The "audit lottery" or "leveraging negotiations for a settlement" strategies are deemed to be unethical by the profession.

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*Editor's Note --- Diana is the Partner in Charge of the Firm's Erie Office. This article is derived from a section of a seminar that she recently presented to other CPA's at seminars sponsored by Penn State University and presented in various locations in Western Pennsylvania.*