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Tax Ethics: Accountants and Lawyers

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The self assessment system operating in Australia, the United States, and a number of other western countries, is reliant on the taxpayer taking reasonable care to comply with the provisions of the legislation in assessing their tax liability. Faced with this burden taxpayers turn to tax professionals for assistance. Hence the tax practitioners are an important element in the compliance program, and their ethics have a strong influence on the success of the self assessment system. Tax practitioners come from two professions: accounting and law. This paper is a qualitative analysis of the codes of ethics of the accounting and legal professions, and their underpinning in ethics. Accountants owe their primary allegiance to the public interest. The accountants' duty has deontological foundations. Conflict of interest between client loyalty and objectivity is resolved by reference to the duty of care to the public rather than the client. Lawyers emphasise the duties of competence, loyalty and confidentiality owed to clients, and raise the lawyer-client relationship above the duties owed to society. The utilitarian doctrine of legal professional privilege, further enhances the pivotal role of the relationship. The paper critically analyses the legal protection of confidential communications between taxpayers and their chosen practitioner, in both Australia and the United States of America. In Australia accountants are reliant on the good graces of the Australia Tax Office and the Commissioner's Guidelines in order to maintain confidentiality of client communications. However communications with lawyers are protected by the common law doctrine of legal professional privilege. This places the lawyers' client at a distinct advantage when faced with dispute or possible litigation with the Australia Tax Office. In the U.S. the Internal Revenue Service via Circular 230 recognises that accountants and lawyers are essentially performing the same tasks for their clients and should be treated equally. A recent paper by the Australian Law Reform Commission proposes the enactment of legislation to safeguard confidential communications between taxpayers and their tax practitioner, be they accountants or lawyers. This paper urges the acceptance of the proposal by the Australian Law Reform Commission.

Field of Research: Business Ethics

1. Introduction

In Australia and the United States of America, as in many western societies, the tax system relies on the taxpayer to voluntarily self assess the tax due to the Revenue authorities.

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Taxpayers faced with this burden turn to tax professionals for assistance. Taxpayers' have right to organize their affairs in such a way as to legally minimize their tax burden, in order for them to do so it is essential that communications of a confidential manner between the taxpayer and their chosen professional advisor remain confidential and are protected from the compulsory disclosure powers of the Revenue authorities. Two distinct professions, namely accountants and lawyers, are engaged by taxpayers to assist them in their dealings with the Revenue authorities. Each profession has its own code of ethics. The tax discipline is neither pure accounting nor pure law. This paper is a qualitative study of the codes of conduct of the two professions, and the basic underpinnings of the codes, that directly relate to the issue of client confidentiality. In the case of accountants their codes of conduct have deontological foundations, therefore the emphasis is on the duty of care owed to the public, not the client. The Lawyers' code of conduct, with its roots in the utilitarian doctrine, emphasises the duty of competence, loyalty and confidentiality owed to the client, with their duty to the public running a distant second.

Tax practitioners are engaged by taxpayers to file returns, give advice and represent them before the Revenue authorities. Each of these three distinct roles requires the tax professional to adopt a distinct and often different stance in their dealings with the Revenue authorities on behalf of their client. The paper will also critically analyse and contrast the prescribed legal protections offered to taxpayers' in their communications with their chosen tax professional, in Australia and the United States of America. Essentially the Australian legislation does not protect the confidentiality of taxpayers' communications with their tax accountants, the *Evidence Act* and the common law do provide protection for confidential communications between taxpayers' and their legal representative, under the umbrella of legal professional privilege. A very recent report by the Australian Law Reform Commission has addressed this issue and proposed changes that would place both professional groups on a more equal footing. In the United States tax professionals are placed on a more equal footing by the provisions of *Circular 230.*

2. Ethics and The Professions

Professional codes usually contain specific admonitions to the effect that they are not inclusive, and most professionals supplement the written rules with their own intuition and instincts. The presence a code of ethics for a profession, and the fact that a subject in ethics is required to gain accreditation to a profession is no guarantee of the development of ethical practitioners. Shirk (1965 p 127) states thus:

> One of the most difficult tasks of ethics is to help individuals recognise and be sensititive to the presence of an ethical problem. Sensitivity to others and to the nuances of human interaction is not inborn. It is not something easy to learn, and perhaps it is impossible to teach... Ethical problems do not announce themselves as such. They must be noticed and felt to be problems.

I will briefly outline three basic approaches that relate to tax practitioners: utilitarianism, deontological theories and virtue ethics.

2.1 Utilitarianism

The ultimate moral standard of utilitarianism is utility, it is the production of happiness which makes something right. The focus is on consequences of actions, and more specifically on the value of these consequences to the people affected. Economic models of tax compliance built on the utility theory hypothesize that the taxpayers reporting behavior is driven primarily by the incentives offered by the tax system, and that taxpayers will seek utility-maximization. Ethical values in these economic models are often viewed as interfering with rational behavior and utility maximization. Sociological studies have shown that the notion of utility can be broadened to include concern for social duty as well as self-interested goals. A study by Reckers, Sanders and Roark (1994) found that a personal tax ethics are a significant factor in compliance decisions. Similarly a study by Erard and Feinstein (1994) found that many taxpayers are inherently honest and report truthfully regardless of the incentive to cheat.

2.2 Deontological Theories

The Greek “deon” means duty. Deontological theories focus on the correctness of the action itself, the assumption is that there are duties that are inherently valuable and should never be violated. A moral person has a duty to take the right action regardless of the consequences. Kant, formulated his famous “categorical imperative” thus:

> act so that you treat humanity, whether in your own person or in that of another, always as an end, and never as a means only. (Kant, 1959)

Contemporary deontologists have shifted the focus from an emphasis on our duties to an emphasis on other people’s rights. Rights are not instrumentally derived. People have moral rights by virtue of their humanity. Dworkin’s (1977) work may be seen as a formula for modern deontologists, wherein rights triumph over utility. He states:

> Individual rights are political trumps held by individuals. Individuals have rights when, for some reason, a collective goal is not a sufficient justification for denying them what they wish, as individuals, to have or to do, or not a sufficient justification for imposing some loss or injury upon them. (Dworkin, 1997 at ix))

2.3 Virtue Ethics

Aristotle formulated the first systematic expression of virtue ethics, emphasizing the character of the actor. His discussion focused on the virtue and vices of the actor: what it is to be courageous or cowardly, moderate or immoderate, wise or foolish. The Aristotelian tradition has been revived by a number of contemporary philosophers. MacIntyre’s (1984) view is that we argue endlessly about moral issues because we no longer share a moral language, there is no shared concept of the community’s good, and no substantial concept of what it is that contributes to the achievement of that good.

3. Accounting Ethics

In Australia there are two main professional accounting bodies, the Australian Society of Certified Practising Accountants (ASCPA) and the Institute of Chartered Accountants (ICA). The ASCPA's first Code of Professional Conduct came into force on July 1, 1988. Prior to this date the professional accountant sought guidance from the numerous Ethical Pronouncements by the ASCPA. Following a number of high profile corporate collapses, a newly established body, namely the Accounting Professional and Ethics Standards Board (APESB) was created in February 2006. This Board issued the Code of Ethics for Professional Accountants (APES 110) effective as of July 1 2006. Compliance with the Code is mandatory for all members of the ASCPA and ICA. Accountants are informed that they should be guided not merely by the terms, but also the spirit of the Code and they should be prepared to justify to their professional body, any departure from the provisions or the spirit of the Code. The Code reinforces that the distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. The Code is in three parts. Part A establishes the five fundamental principles of professional ethics namely: integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour. It then goes on to provides a conceptual framework for applying the fundamental principles to specific situations, along with examples of safeguards that may be appropriate to address threats to compliance. Part B addresses issues that apply to accountants in public practice, and Part C addresses issues that apply to accountants in business. The five threats specifically identified in the Code are self-interest, self-review, advocacy, familiarity and intimidation. The safeguards identified in the Code fall into two main categories: safeguards created by the profession, legislation or regulation, and safeguards in the work environment. In the first category of safeguards education both prior to certification, and on going education in ethics is central. The ASCPA has been very proactive in encouraging tertiary institutions to integrate ethical concepts throughout the accounting curriculum.

The Code imposes a duty of confidentiality on accountants. Accountants are under an obligation not to disclose confidential information acquired in the course of their professional work unless the client consents to disclosure or there is a legal right or duty to disclose. The American Institute of Certified Public Accountants (AICPA) is responsible for the Code of Professional Conduct that governs the actions of Certified Public Accountants. The latest substantial revision of the Code was in January 1988. The Code applies to all AICPA members, regardless of job function. The attest function is the service ideal for which accountants are granted their monopoly. The AICPA Articles support the premise that the CPA owes primary allegiance to the public, Article II stresses that the interest of the public should be considered before those of the client. Collins and Schultz (1995) suggest that in practice that there are instances when the public interest runs a poor second to other interests, namely the client, the employer, and the profession itself. Unfortunately ethics research in accounting has effectively not proceeded beyond the descriptive level. Schweikart (1992) noted that one of the basic deficiencies of accounting ethics research is the failure to delineate the major functional areas in accounting, for example: financial accounting, management accounting, solvency, and taxation. Each area presents accountants with distinctive ethical problems. The professional codes of ethics are based on the financial function, specifically in the audit function and hence the

emphasis on the public interest, and the accompanying principles of independence and objectivity.

4 Legal Ethics

In a narrow sense legal ethics can be defined as the system of professional regulations governing the conduct of members of the legal profession, as noted by Greenwood (1990 p724):

> As a matter of general principle there has been plenty of support for the proposition that all that legal ethics requires is that the lawyer discover the law fearlessly to the client while leaving to the client the making of any consequential moral judgments, even if a loophole pointed out has overtones which approach the unconscionable.

Every lawyer owes his client the duty of competence, loyalty and confidentiality. These three responsibilities to the client are the central concerns of ethical and legal rules governing lawyers. Lawyers also owe a duty to society and the legal system. Conflict between loyalty to the client and the duty to the legal system tends to be resolved in favor of the client. As noted by Patterson (1980 p917):

> one of the best kept secrets in American jurisprudence may be that the rules of legal ethics limit the lawyer's duty of loyalty to the client by imposing additional duties of respect for and candor to the court and fairness to others, including opposing counsel and parties. The prevailing notion among lawyers seems to be that the lawyer's duty of loyalty to the client is the first, the foremost, and on occasion, the only duty of the lawyer.

In Australia, the present structure of the legal profession has its foundation in the early development of the colonies, and the influence of the English system. The main eastern states developed a divided profession, while Tasmania, South Australia, Western Australia and the territories did not. Reform of restrictive practices of the legal profession has been a difficult task to accomplish in states with divided professions. Ethics has not gained a strong place in Australian law schools or the profession. The main source of ethical education is the CCH loose leaf service on tax ethics for practitioners. In the U.S. the American Bar Association (ABA), adopted the *Cannons of Professional Ethics* in 1908. 1983 saw the adoption of the rules that operate in most states today, the *Model Rules of Professional Conduct.* The ABA is a private organization with no right to impose its rules on anyone. It is for the courts to decide on the standards, as noted by Gillers (1995) different jurisdictions accord the Model Rules varying degrees of respect. Ethics scholarship is strong in the U.S. with many State bar associations having formed ethics committees. In this environment the Model Rules are only one part of a larger system aimed at promoting ethical conduct in a supportive environment for professionals. Law students in most states are required to undertake professional responsibility courses, and legal ethics is generally recognized as an important aspect of legal education. Wigmore's (McNaugton, 1961) famous treatise on privilege, justified privilege on instrumental grounds as a means to the end - maximizing lawyer-client communication.

5. The Tax Practitioner's Roles

The tax practitioner has three distinct roles in relation to their client: return preparation, advocate, and tax planner. In all cases the practitioner is under a duty not to mislead the Revenue authority either by misstatements, or by silence, or by permitting the client to mislead. Firstly as a preparer of tax returns the practitioner is essentially performing a compliance function. In this role it can be argued that the practitioner is acting as a government agent to ensure maximum compliance in a self assessment system. As preparers of tax returns practitioners must ensure they do not sign a return, or become party to a return in which the client has knowingly taken a position that is false. The practitioner has an affirmative duty to try to persuade a client not to file such a return, and if the practitioner is unsuccessful the question of whether or not to continue to act for the client must be seriously considered.

Secondly in representing the taxpayer in a controversy with the Revenue authority the tax practitioner serves as advocate for the taxpayer. Initially cooperation with the Revenue authority will frequently lead to successful resolution. However if during an audit, possible fraud is revealed the audit becomes adversarial and the tax practitioner would have to represent the client with undivided loyalty and to the best of their ability. Thirdly as a tax planner the practitioner assists the client in the creation of a transaction and will help the client arrange affairs so as to minimize tax liability. Tax planning is characterized as the legitimate exploitation of revenue legislation and ordinary business structures to ensure tax minimization, and is sanctioned by law. The advice provided by the practitioner will generally be designed to avoid controversy. The concern is to ensure the tax adviser is not promoting tax shelters or tax evasion schemes.

Tax evasion with its accompanying characteristics of falsification or non-disclosure is clearly illegal and unethical. The Australian tax legislation anti-avoidance provisions, Part IVA of the ITAA seek to identify and provide penalties against artificial and contrived schemes that have no rationale other than the obtaining of a tax benefit. The IRS Circular 230, which applies to all U.S. tax practitioners, in section 10.33 establishes ethical rules aimed at reducing the sale of tax shelters, it does this by establishing rules about the amount, quality and content of the advice to be provided to clients. The operation of a self assessment system depends on taxpayers' voluntary compliance with the law and taxpayer honesty in preparing tax returns**.** It imposes upon the taxpayer an obligation to maintain records and exercise reasonable care in reporting on matters concerning tax liability. The self assessment system shifts the burden upon the taxpayer to make accurate returns. Taxpayers faced with such responsibilities turn to tax practitioners for assistance.

The revenue authorities' first and main source of information is the income tax return. However, the self assessment system has given increasing prominence to the revenue authorities' audit function. Audits are not usually specifically provided for or mentioned in revenue legislation. Audits rely on the revenue authorities' power to gain access to information, in the hands of taxpayers or others, and to question taxpayers and others for the purposes of taxation law. Revenue authorities' recognise that the effective use of their access powers is an important part of the process of investigation, re-assessment, and enforcement. The authorities can use their powers of access to compel the handing over of the necessary information in the hands of advisors. The only real impediment to their power is the doctrine of legal

professional privilege, a doctrine that protects the confidential communications between legal advisors and their clients.

6. Tax Ethics

In Australia the *Income Tax Assessment Act* (1936 Commonwealth) (ITAA) section 226A requires the taxpayer to take reasonable care in complying with provisions of the act. In the case of contentious issues section 226K of the ITAA provides a second standard of care, namely a reasonably arguable position. If it can be concluded that the taxpayer's position is about as likely as not correct then the test of reasonably arguable position is met. The ITAA has given registered tax agents, the majority of whom are accountants, a virtual monopoly over income tax practice. In return, section 251K allows for the suspension or cancellation of registration, however this sanction does not apply to any solicitor or counsel who acts on behalf of the taxpayer in any litigation or proceedings before either the Administrative Appeals Tribunal or the courts. This stands in contrast to lawyers in the U.S.

The accounting profession adopted, the Statement of Taxation Standards APS6 in June 1982. In addition many accounting firms have developed private standards for tax practice. The legal profession has not adopted specific standards for tax practice, nor have legal firms generally adopted private standards for tax practice. In the U.S. there are standards of practice for all tax practitioners, these stem mainly from three sources. Firstly, the *Internal Revenue Code* in particular, the penalty provisions - Section 6694. Secondly, the *Tax Court Rules* 200-202 applying to all appearing before the court, and thirdly the Treasury regulations. Treasury promulgated a set of standards, *Treasury Department* Circular *230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries and Appraisers Before the Internal Revenue Service (1985)* (Circular 230). Circular 230 sets out the rules for eligibility to practise before the Internal Revenue Service (IRS), the duties and restrictions for those practising, and the rules on discipline for violating the regulations.

7. Client Confidentiality And The Revenue Legislation

The argument advanced for confidentiality is essentially that compelled disclosure of tax advice information would make taxpayers less likely to seek advice from tax practitioners. Generally, taxpayers seek to protect the thought processes, notes, opinions and analyses of their advisers; this may include tax opinions, tax planning memoranda, analyses of what constitutes substantial authority, discussions of contrary authority and analyses of alternatives rejected in tax planning. (Friedman and Mendleson, 1996 p155). In Australia the ITAA is silent on legal professional privilege and accountant-client confidentiality. The High Court of Australia in *Baker v Campbell* (1983 153 CLR 52) ruled that legal professional privilege as a substantive rule of law, applies to all forms of compulsory disclosure of communications, judicial or administrative, unless legislation *expressly abrogates* the privilege. The High court decision in *The Daniels Corporation International Pty Ltd v Australian Competition and Consumer Commission* (2002 CLR 543) has once again strengthen the position of privilege as evidenced in the majority judgment (Gleeson CJ, Gaudron, Gummow and Hayne JJ at 552):

> It is now settled that legal professional privilege is a rule of substantive law which may be availed of by a person to resist the giving of information or the production of documents which would reveal communications between a client and his or her lawyer made for the dominant purpose of giving or obtaining legal advice or the provision of legal services, including representation in legal proceedings.

Furthermore the Full Federal Court decision in *Pratt Holdings Pty Ltd v Commissioner of Taxation* ((2004 207 ALR 217) found that a third party communication with a client, even where there was no litigation pending, potentially could be protected by client privilege. In and effort to establish appropriate administrative procedures to safeguard documents that attract legal professional privilege, the Commissioner in consultation with the Law Council of Australia had issued guidelines on the documents held on lawyers' premises. The Commissioner of Taxation has also established guidelines concerned with access to documents prepared by an external accountant acting in a capacity of professional accounting adviser independent of the taxpayer. The guidelines are administrative concessions and do not as such abrogate the Commissioner's powers of access and compulsory disclosure provided for in the ITAA. These guidelines do not have the force of law. The tax legislation and the common law define the rights and duties of the Commissioner and the taxpayer respectively. Access guidelines may provide some encouragement to accountants, however their effect in terms of accountant-client confidentiality is yet to be tested.

The Australian Law Reform Commission (ALRC) released a Discussion Paper, *Client Legal Privilege and Federal Investigatory Bodies* (DP 73) on 26 September 2007. DP 73 is due to be tabled in Parliament in 2008. It proposes that the Australian Parliament should enact legislation of general application to cover various aspects of the law and procedure governing client legal privilege claims in federal investigations. Proposal 6-3 in DP 73 directly addressed 'tax advice' and essentially recommends that tax advice provided by an independent professional accounting advisor should be protected from disclosure to the ATO. As a safeguard the ALRC in Proposal 8-3 recommends that where the ATO so requests the client's lawyer is to review the tax advice communications to certify that there are reasonable grounds for the making of a privilege claim. Proposal 8-21 recommends the renegotiation of the *Commissioner's Guidelines*. The IRS via Circular 230 has recognized that accountants and lawyers acting on behalf of taxpayers are performing the same tasks and should be treated equally. The *Internal Revenue Code* (1954) does not provide for attorney-client privilege, however an IRS summons can be challenged on the ground of attorney-client privilege. The *Internal Revenue Code* (1954) is silent on accountant-client privilege. Nineteen States have incorporated courtroom accountant-client privilege in their accountancy There is no accountant-client privilege under federal law.

8. Conclusion

The legal profession's code of ethics grounded as it is in the criminal defense lawyer role emphasizes the duty of competence, loyalty and confidentiality owed to the client. The doctrine of legal professional privilege serves to protect the confidential communications between the legal practitioner and the client from the access and compulsory disclosure powers of the Revenue authority. The accounting profession's

code of ethics is grounded in the role of auditor emphasizing the duty to the public interest and the accompanying principles of independence and objectivity. The accountant's clients must rely on the good graces of the Revenue authority in exercising voluntary restraint over their access, and compulsory disclosure powers, to safeguard confidential communications. This places accountants' clients in Australia at a distinct disadvantage, compared to lawyers' clients in the tax arena. The paper recommends that the government enact legislation as recommended by the Australian Law Reform Commission, to even out the playing field. Taxpayers' confidential communications with the tax practitioner should be protected from the compulsory disclosure powers of the tax office.

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