

**ETHICS IN TAXATION**  
**AN HISTORICAL OVERVIEW**  
*and*  
*a Timeless Case Study*

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**&**  
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## **FARMER BROWN CASE STUDY**

Farmer Brown was a pig farmer in the tiny English hamlet of Worcestershire. Back in the early 1500s, tax wasn't much of an issue, but then again neither was income. One day, the town council passed a "pig tax". \$10 per pig per year. Farmer Brown consulted Guy Wise, a recent graduate of Golden Gate University Tax School.

Wise read the statute "\$10 per pig per year." Wise consulted the dictionary. A pig is "a four legged animal with a snout." Wise wisely decided against using the subjective test, since no one knows when a mere nose becomes a snout. Instead, Wise focused on the quantitative test, 4 legs. Wise confidently wrote Brown a note advising him to remove one leg from each animal.

Brown was a kindly man, but acting on advice of counsel, he implemented the tax strategy. Somewhere between the veterinary bills, the tax penalties, the 6 month prison sentence he served for animal cruelty, and his wife's successful divorce based on insanity, all Brown now has left is his malpractice action against Wise.

1. What did Wise do wrong?
2. Did Wise violate the AICPA statements of standards for tax services?
3. Did Wise violate the standards of IRS Circular 230?
4. What would the correct advice have been?

## **I OLD**

- A Taxpayers sought out tax advisors and others for shelters.
- B “Bad” shelters were product of low life firms.
- C IRS audited taxpayer returns.
- D IRS litigated case by case - taxpayer usually went to Tax Court.

## **II NEW**

- A Tax professionals created devices and aggressively sold to clients.
- B High prestige accounting and law firms most aggressive - value billing.
- C IRS switched to Interdiction and Intimidation.
- D If litigated, taxpayers go to District Court.

## **III IRS INTERDICTION-INTIMIDATION STRATEGY**

- A Attack confidentiality privilege - John Doe Summons.
  - 1 John Williams - “Alamo” speech.
  - 2 KPMG - BDO Seidman.
- B Required Disclosure.
  - 1 Reportable Transaction requirements.
  - 2 Material Advisors.
  - 3 M - 3.
- C Penalties.
  - 1 “Son of BOSS” settlement required 10% penalty.
  - 2 Long Term Capital Holding - court upheld 40% basis overstatement penalty.

- a Opinion letters not provide reasonable basis defense.
- b How losses disguised on return evidence of lack of “good faith.”

D Legislation.

- 1 Penalties for Reportable Transaction violations.
- 2 Mandatory negative basis adjustments.
- 3 Sec. 6662 tax shelter standard lowered to “Substantial” from “Principal” purpose.

E Circular 230 revisions.

- 1. Favorable written advice.
  - a E-mails.
  - b Cover letters.
- 2 No penalty protection from most written advice.
  - a Principal purpose transactions - no penalty disclaimer allowed.
  - b Significant purpose transactions - not defined anywhere.
  - c Prominent disclosure requirements.
- 3 No assumed facts.
  - a Economic effect.
  - b Business purpose.
- 4 Other written advice.
- 3 Severe penalties for violations.
  - a Censured, suspended or disbarred
  - b Reckless or gross incompetence.

#### **IV CRIMINAL CHARGES.**

- 1 Thompson Memorandum.
  - a Waive Attorney-client, work product privileges.
  - b Not pay attorney's fees.
- 2 KPMG.
  - a Plea bargains for testimony.
  - b Banker testify on fraudulent loans.
  - c IRS has all internal e-mails, etc.

#### **V SOX**

Audit Committee approval required for auditor tax shelter work.

- 1 Auditor must be independent.
- 2 Auditor can not act as advocate.
- 3 Auditor can not audit own work.
- 4 "Front page of Wall Street Journal" test.
- 5 Corporate VP Taxes terrified of restatements of reserves.

#### **IV CURRENT SITUATION**

Tension between Tax advisor and client.

- 1 Penalty protection very expensive.
- 2 No privilege - plan on everything you write being read by IRS.
- 3 For written advice, can not accept client statements about their intentions or business purpose.
- 4 Limited scope opinions.

5 Premium on oral advice.

**V SOME THINGS NEVER CHANGE.**

A Consult your conscience, not just the rule book.

B Fire your greedy clients and/or bosses.