THE ACCOUNTING PROFESSION IN AMERICA

6. Ethical Standards for the American Tax Practitioners

M. Susan Stiner, LL. M., CPA
Villanova University, USA
and
Ichiro Shiina
Chuo-Gakuin University, Japan

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6. ETHICAL STANDARDS FOR THE AMERICAN TAX PRACTITIONERS

In addition to technical standards, tax practitioners in the United States must comply with ethical standards as well. Tax practitioners can be either attorneys, accountants, or enrolled agents. See the third article in this series for a discussion of the various pathways to becoming a tax practitioner. This article discusses the ethical precepts that regulate the behavior of tax practitioners. The comments in this article will focus primarily on attorneys and accountants.

In the United States, there are several bodies that generate ethical guidelines that apply to tax practitioners. Each of these groups will be discussed in turn. Attorneys look to the American Bar Association Model Code. The American Institute of Certified Public Accountants drafts the Code of Professional Conduct for CPAs. All tax practitioners, including both attorneys and accountants, are guided by Treasury Department's "Circular 230" and the preparer penalties found in the Internal Revenue Code.

I. ABA Model Code of Professional Responsibility

The American Bar Association is a professional organization for lawyers. Membership in the ABA is voluntary. The ABA has drafted a Model Code of Professional Responsibility. The Model Code is available for adoption by each state. States are not required to adopt the Model Code as it is written. States may choose to adopt the ABA's Model Code exactly as it is written, modify the Model Code, or develop its own set of rules entirely independently from the ABA.

In the United States the practice of law is regulated separately by each state. Each state has an agency that regulates the behavior of attorneys licensed to practice in that state. That agency may be the Supreme Court or the state bar association. The regulatory body decides on the rules that will govern attorneys within that state's borders. There are fifty different sets of rules, one for each state. However, there is not quite the confusion of rules that would appear at first
glance. Most states have chosen to adopt the ABA Code or Rules and most states modify it. So most states in practice have the same basic set of ethics rules. This paper will discuss the ABA Model Code and Rules and ignore the modifications that each state makes.

In 1969 the ABA adopted the Model Code of Professional Responsibility. This was the result of a revision of the canons of professional ethics issued in 1908. (Wolfman, p. 21) The ABA Model Code consists of three parts: the Canons, the Ethical Considerations and the Disciplinary Rules. The Disciplinary Rules represent the minimum standard of behavior. If the Disciplinary Rules are violated, the attorney must pay a penalty, ranging from a mild reprimand to disbarment. Disbarment results in the loss of the license to practice law. Disbarment is a most serious consequence, since the attorney can no longer work as a lawyer. The period of disbarment can last from a year or two, to a lifetime.

The Ethical Considerations are statements of the highest standards to which the attorney can aspire. They represent goals of behavior. While they may never reach the highest levels, attorneys are expected to strive for that level. The Canons are the general concepts from which the Ethical Considerations and the Disciplinary Rules are derived.

In 1983 the ABA adopted the Model Rules of Professional Conduct. The Rules developed from a revision of the Model Code, in response to widespread criticism of the ethical standards of the profession. (Wolfman, p. 21) The Rules consist of two parts: the Rules and the Comments. The Rules are the source of obligatory behaviors. The Comments offer explanations for the rules. To date, a majority of states have adopted the Model Rules in place of the Model Code. It is anticipated that eventually all the states will adopt the Model Rules.

Although we have ignored the changes that an individual state makes to the Model Code or Rules, it is important to note that an individual tax practitioner who is an attorney must comply with the version adopted by the state that licenses the attorney to practice law. The attorney must also comply with the Model Rules, which have been adopted by the Tax Court, a federal court specializing in
tax matters. Sometimes the Model Rules and the state ethics code conflict.

The Model Code or Rules, and each state version of the Model Code or Rules, is necessarily stated in general terms. It is intended to apply to all attorneys, whatever their area of expertise. The Model Code or Rules apply to criminal attorneys as well as tax attorneys. Among other things, the Model Code or Rules require attorneys to be free of conflicts of interest, to zealously defend the client within the bounds of the law, to act competently and to exercise independent professional judgment on behalf of the client.

II. AICPA Code of Professional Conduct

Just as attorneys look to their professional organization for ethical guidelines, so do tax practitioners who are accountants. The American Institute of Certified Public Accountants (AICPA) is the principal accounting professional group. Membership in the AICPA is voluntary.

The AICPA has long recognized an obligation to set ethical standards for the public practice of accounting. Like the ABA Model Rules or Code, the AICPA Code of Professional Conduct is written in broad terms to cover all areas of the profession. Tax practitioners and auditors alike must be technically competent, free from conflicts of interest, and independent. The Code of Conduct is divided into two parts: the Principles and the Rules. The Principles state the highest standards of behavior to which the accountant should aspire. The Rules contain the minimum standards of behavior to which the accountant must adhere. Violation of the Rules will result in some penalty. The penalty will differ in severity, depending on the infraction, from a mild reprimand to suspension of membership. Adherence to the precepts of AICPA Code is mandatory for members of the AICPA.

Just as states regulate the practice of law, so also does each state regulate the practice of accounting. Each state has its own code of ethics for accountants licensed to practice within the state. Most of the states have adopted the AICPA Code of Professional Conduct. Most of the states have modified the Code.
Although a violation of the AICPA Code would seem to affect only AICPA members, that is not actually the case. The AICPA reports to the states names of members who violate disciplinary rules. Each state can then make a separate investigation to see if further action is warranted. Suspension from practice may be the result of a serious offense.

The two sets of standards developed by the professional organizations for accountants and attorneys are similar in many respects. Both ethical codes are written broadly to apply to all members of the profession. In both cases, although membership in the organizations is voluntary, the codes apply to a broader range of people than members. The precepts in both codes apply to anyone licensed to practice the profession because most of the states who have the authority to license professionals have adopted essentially the same codes as developed by the professional groups.

Both professions have certain ethical standards in common. Both accountants and attorneys must keep communications from the client to them confidential. Neither professional is permitted to reveal to anyone else matters told them by a client. Tax practitioners are in a unique position with regard to client confidences. Tax returns are by their very nature intended to be shared with a third party: the government. Both professions agree that client confidence is not broken when information that was never intended to be kept to oneself is revealed to another person.

While accounting and law professionals must not reveal client matters to another person, they may be compelled to reveal details of their work for a client to the taxing arm of the government. Accountants are particularly vulnerable here. It is a fundamental ethical principle of attorneys that matters discussed between the client and the lawyer shall not be revealed to anyone, including a court. Only if the matter relates to the commission of a crime, or was intended to be revealed to a third party, such as a tax return, can talks between client and lawyer be disclosed. The accountant and client have not had such a privilege of communication accorded to them. The different treatment flows from the
different societal roles of the lawyer and the accountant. The attorney is ethically obligated to be an advocate for the client. In order to be an effective advocate, the client must be completely honest with the attorney. In order to create an environment that will foster the necessary honesty, the notion of "privileged communication" between lawyer and client was created. The accountant's unique contribution to society is his independence from the client. The Supreme Court of the United States has ruled that the accountant's duty to the public interest is more important than keeping a client's confidences.

III. AICPA Statements on Responsibilities in Tax Practice

The Statements on Responsibilities in Tax Practice (SRTP) were drafted by the Responsibilities in Tax Practice Committee of the AICPA and approved by the Tax Executive Committee of the AICPA. These standards are appropriate for accountants who practice in the area of taxation. The current version of the SRTPs was issued in 1991. Originally ten statements were issued between 1964 and 1977. These original statements were intended to give the accountant tax practitioner specific guidance in certain areas. The Statements were modified over the years in response to changing governmental standards and other external pressures to maintain high standards. Today there are eight statements.

Unlike the two previously mentioned sets of guidelines, the ABA Model Code or Rules and the AICPA Code, the Statements on Responsibilities in Tax Practice (SRTP) are not mandatory. They do not have the force of law and have not been adopted by any professional regulating body. Their purpose is educational and advisory. (SRTP, p. 2)

However, tax accountants who ignore these very specific guidelines are ill-advised. The Internal Revenue Service and all courts who hear tax cases are aware of the standards. The IRS and the courts will not be reluctant to apply these standards in appropriate situations.

The Statements address a variety of issues. SRTP No. 1 sets out the standards a CPA should follow in recommending a tax return position or in preparing or
signing a tax return. The CPA must have a "good faith belief" in the realistic possibility of administrative or judicial success. (SRTP No. 1, Para.02a) If the CPA does not have a good faith belief in the possibility of success of the position, the CPA may still recommend that the taxpayer adopt the position on the tax return, provided the position is not frivolous and the taxpayer properly discloses the position. A frivolous position is defined as a position that is knowingly advanced in bad faith and is patently improper. (SRTP No. 1, Para.09) Proper disclosure is made by using a special form, Form 8275-R, to set out the position and the authorities that support the position.

Recommending proper disclosure can put the CPA in a difficult position. In effect the CPA is calling special attention to the position and asking the Internal Revenue Service to audit the return. There is no certainty that the IRS will agree with the taxpayer's position. In fact, by telling the IRS the authorities that support the taxpayer's position, the taxpayer has helped to build the case against himself. It is much easier to refute an argument, than to devise a theory and build support for the theory. This is a clear conflict between the tax practitioner's duty to the client and the duty to the public.

In most contexts the CPA is independent of all parties. In tax, however, the CPA is an advocate for the client. (SRTP No. 1, Para.04) This shifting of roles does not eliminate the CPA's duty to the public. It may suggest, however, that conflicts between the public and the client duties may be resolved in favor of the client.

If the CPA is an advocate for the client, a troubling question is: who is the advocate for the government? The immediate answer would seem to be the IRS. After all, they are on the other side of the table in a tax audit. However, the Mission Statement of the IRS, found in the prefatory pages of any volume of the Cumulative Bulletin, requires the IRS to enforce the federal tax laws in a neutral manner. If the laws are applied neutrally, then who is looking after the government (public) interest? According to the graduate students of the American author, there is a strong feeling that the public interests are at least adequately
represented by the IRS. That well may be the case in practice. Nonetheless, the question of public interest representation is worth examining, at least momentarily.

The "realistic possibility" standard contained in SRTP No. 1 is a relatively new standard. The AICPA issued SRTP Interpretation No. 1-1 in December, 1990, to explain what is meant by that standard. Under the realistic possibility standard the CPA must have a good faith belief that the position on the tax return is supported by existing law or that there are sufficient arguments for an extension, modification, or reversal of existing law. SRTP Interpretation 1-1 lists several authorities to be used to support the CPA's arguments. (SRTP Interp. 1-1 Para.07) It is important to note that the authorities suggested in Interpretation No.1-1 is a more expansive list than the authorities the Treasury Department uses for its standard of "substantial authority," discussed later in this paper. An authority that meets the standard under the SRTPs may not meet the standard under Treasury rules.

SRTP No.2 advises the CPA to make a reasonable effort to obtain the information necessary to answer all questions and requests for information on a tax return. In some cases an answer may be omitted, but the effect of the omission should be considered. As long as the omission will not significantly affect taxable income or tax liability, there may be reasonable grounds for failure to answer the question, and the omission will not render the tax return incomplete. An answer should not be omitted simply because the answer is disadvantageous to the client.

Under SRTP No. 3 there is no obligation for the CPA to verify the supporting data for the information supplied by the client. While the CPA need not make a separate investigation of client information, the CPA cannot ignore inconsistencies in client information. Neither can the CPA disregard information obtained from other clients that may be relevant. As an illustration, assume the CPA prepared the corporate income tax return, the corporation paid dividends to shareholders and the CPA is preparing a shareholder's income tax return. If the shareholder omitted mention of receipt of the dividend, the CPA cannot omit the
dividends from the shareholder's gross income. Dividends are a common item of gross income in the United States, the CPA had prior knowledge of its receipt by the shareholder, and the use of that knowledge does not violate any confidentiality requirement.

SRTP No. 4 acknowledges that estimates may be used in preparing a tax return. When estimates are used, they should be reasonable and they should not convey an impression of greater accuracy. Generally, there is no need to disclose the fact that estimates were used. However, there can be some extraordinary circumstances in which disclosure should be made, such as pending litigation or destruction of the records by accidental fire.

Sometimes the IRS and a taxpayer will disagree over the treatment of a certain item on the tax return. The disagreement is resolved either at the administrative level or on a judicial level. Resolution at the administrative level means that the IRS and the taxpayer came to a mutual agreement. Resolution at the judicial level means that a federal court decided who won. If the government won, either administratively or judicially, on the next tax return can the preparer recommend that the taxpayer take a position contrary to the previous result? SRTP No. 5 indicates that under certain circumstances the CPA may recommend a position contrary to the administrative or judicial outcome of the prior return. If the CPA follows the standard of SRTP No. 1, that is, has a good faith belief in the realistic possibility of success of the position, then the CPA may make the contrary recommendation. The existence of the unfavorable result is one of factors that the CPA will consider in making the judgment as to the realistic possibility of success.

The CPA makes recommendations for a particular tax year based on the facts and the law that apply to that tax year. It is quite possible for either the facts or the law, or both, to differ from one year to the next. The CPA is obligated to make recommendations appropriate to each year. The recommendations need not be the same every year. Of course, usually the recommendations will be the same from year to year.

If, however, the administrative or judicial resolution of a prior year also
obligated the taxpayer to treat the item in a certain way on future years, then the CPA must make recommendations consistent with the administrative or judicial directive.

SRTP Nos. 6 and 7 address the responsibilities of the CPA who discovers an error in a return that was or should have been filed. A filed return may or may not be the subject of an administrative proceeding, such as an examination. "Error" refers to an item that will have significant impact on the client's tax liability.

In both cases, where an error is discovered after the return was filed or discovered during an administrative proceeding, the CPA should inform the client of the error. The CPA should tell the client of the error, its impact and the suggested remedy. It is the client's responsibility to inform the IRS of the error. Under SRTP No. 6.03, for filed returns, and SRTP No. 7.03, for returns undergoing an administrative proceeding, the CPA is not permitted to inform the IRS of the error unless the client gives permission.

If the client will neither disclose to the IRS himself, nor permit the CPA to disclose the error, the CPA should consider whether or not to continue representing the client. This is a difficult decision to make. Both SRTP Nos. 6 & 7, in footnote 1, warn that there may be a conflict of interest between the client and the CPA. This warning is given in the context of a recommendation that the CPA consult an attorney before any decision to withdraw is made. It would seem that the potential conflict could not result from notifying the IRS of a client error, since the IRS was the body for whom the information was originally intended. If the conflict is between the client and the CPA's own interests and would result from notifying an attorney retained to protect the CPA's interests, clearly a party not originally intended to receive the client's tax information, then the choice is more difficult. Rule 301 of the AICPA Code is violated if client confidentiality is breached. Severe penalties to the CPA can result from this breach. However, if the CPA fails to consult an attorney on his own behalf, the CPA's own interests are unprotected. Severe consequences can result from that. The conflict could also exist between the client's interest and the CPA's duty to the public. The self-
assessment system of taxation in the United States depends on the taxpayers’ proper reporting of tax liability. If the client refuses to properly report, then the system is in danger. Deciding at what point the CPA’s duty to the system outweighs the duty to the client is a difficult task.

SRTP No. 8 discusses the form and content of advice given to clients. There is no standard format for giving advice. The advice may be given either orally or in writing. Giving the advice in writing is helpful in complicated matters. Regardless of the form, however, the advice should be competent and appropriate. Since the advice is assumed to affect a tax return position, the advice should conform to the standard of SRTP No. 1. The advice should be supported by the CPA’s good faith belief in the realistic possibility of success. If subsequent changes make the advice inappropriate, the CPA is not required to notify the client. The CPA may choose to inform the client of the changes.

IV. U.S. Treasury Department’s “Circular 230”

The Treasury Department is the U.S. government agency that contains the Internal Revenue Service. The Treasury Department issued a document called “Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries and Appraisers Before the Internal Revenue Service.” This document, known popularly as “Circular 230,” sets out rules governing practice before the IRS. Although Circular 230 applies to anyone permitted to practice before the IRS, this paper will emphasize the rules that apply to the CPAs.

Circular 230 sets out rules governing the authority to practice before the IRS, the duties and restrictions of those permitted to practice and disciplinary rules for those who violate the standards of Circular 230. Attorneys and CPAs who are in good standing with their respective state professional licensing boards may practice before the IRS, provided the attorney or CPA files the proper declaration and is not currently disbarred or suspended from practice before the IRS. (Circ. 230, §. 10.3(a), (b)) “Practice” as used throughout Circular 230 means any matter
brought before the IRS that relates to a client's rights, privileges or liabilities. This includes, but is not limited to, the preparation and filing of tax returns and the representation of a client at an administrative procedure. (Circ. 230, § 10.2(a))

Circular 230 describes several duties of an attorney or CPA permitted to practice before the IRS. First, the tax practitioner must promptly submit records or information that has been properly requested by the IRS. The practitioner may refuse to comply with the request for information only if there is a privilege of communication or a good faith belief on reasonable grounds that the request is not legal. (Circ. 230, § 10.20) Only attorneys may assert the privilege of communication. The CPAs and their clients do not enjoy privileged communications.

Second, when the CPA becomes aware of errors or omissions relating to tax matters or of non-compliance with the revenue laws, the CPA must inform the client. (Circ. 230, § 10.21) Circular 230 does not require the CPA to inform the IRS of the error, omission or non-compliance. The Treasury Department apparently recognizes that the obligation to make the change rests with the client. This is similar to the standard in SRTP No. S. 6 & 7, discussed above.

Third, the CPA must exercise due diligence in preparing and filing tax documents, and in oral and written representations made by the CPA to the IRS and clients. (Circ. 230, § 10.22) Due diligence is the standard by which the Treasury Department measures the CPA's work. Due diligence requires the CPA to act as a reasonable, prudent person. This is similar to the standard under the AICPA Code (due care) but different from the standard under SRTP No. 1 (realistic possibility of success). It is not always easy to determine when the various standards have been met. In 1986 the Treasury Department proposed a stricter standard for practice before the IRS. Instead of due diligence, the practitioner could recommend positions that were supported by "substantial authority." The proposed standard is the same standard taxpayers must use to avoid a substantial understatement penalty. This standard is contained in § 6662 of the Internal Revenue Code. The new standard represented a significant change. Both the ABA and the AICPA protested the change. To date, the Treasury Department has not
adopted the proposed standard. In the meantime, the Internal Revenue Code and professional standards have become more stringent. The Treasury Department proposed the new standard because it was dissatisfied with the existing level of professional standards. Perhaps the Treasury Department goals have been accomplished without adoption of the new standard for Circular 230.

Compliance with Circular 230 is required of all tax practitioners. Failure to adhere to its standards can result in disbarment or suspension from practice before the IRS. This can have serious consequences for an attorney or the CPA. Their respective licensing agencies can make a separate inquiry. Withdrawal of a license to practice is a possible result.

There are several other duties and responsibilities of tax practitioners listed in Circular 230. This paper has discussed the major responsibilities.

V. Internal Revenue Code Preparer Penalties

The last set of ethical guidelines discussed in this paper is found in the Internal Revenue Code. Referred to as “preparer penalties,” these Internal Revenue Code sections contain both civil and criminal penalties. Preparer penalties are levied against the person who prepares the return. There is a separate set of standard that apply directly to the taxpayer. These are primarily the accuracy and fraud-related penalties found in IRC §§ 6662-6664.

The civil preparer penalties are monetary penalties. They are imposed on a “person who prepares for compensation ...... any [income tax] return ......” (IRC § 7701 (a) (36) (A)) The major preparer penalty is found in IRC § 6694. It imposes a monetary penalty on the preparer of an income tax return that shows a substantial understatement of tax liability, if the substantial understatement is due to a position that had no realistic possibility of success and was not properly disclosed on the return. The realistic possibility standard in the Internal Revenue Code is similar to the standard in the SRTPs. If the understatement is due to a willful or intentional disregard of the tax laws, the preparer is subject to a higher monetary penalty.
There are several other civil preparer penalties for failure to meet certain recordkeeping and disclosure requirements. These involve nominal monetary amounts for each return incorrectly prepared. Although the individual amount is nominal, the aggregate amount of the civil penalties can be substantial.

A preparer can also be subject to a civil penalty for aiding and abetting the understatement of tax liability. (IRC § 6701) This penalty can apply to taxpayer, preparer or anyone else. There are separate penalties for persons involved in tax shelters. (IRC §§ 6700, 6111, 6112)

A preparer can be subject to criminal penalties under IRC §§ 7206 and 7207 for involvement with false or fraudulent returns. These criminal sanctions are not limited to preparers. The offender will pay a significant fine or receive a prison term of one to three years or both.

VI. Ethical Guidelines for Certified Tax Accountants in Japan

In Japan, there is a separate professional credential for tax accountants. Certified tax accountants (CTA), not CPAs, advise clients, primarily corporations, on tax return positions and prepare the clients' returns. The current Certified Tax Accountant Law was passed in 1952. Selected ethical guidelines are contained in the statute. In Article 1, the mission of the CTA is to adhere to the ideals of the self-assessment tax payment system. For salaried individuals the tax collection system in Japan is largely not self-assessing. Tax is collected by the employer and remitted directly to the government. The individual need not complete a tax return at the year's end. For corporations and self-employed individuals, however, Japan's tax system is self-assessing, as is the United States' system. Since individuals generally have no need of a tax preparer, certified tax accountants generally assist corporate clients. The CTAs also are obligated under Article 1 to realize the proper payment of taxes as required by the revenue laws. Article 36 forbids the CTA to advise on the evasion of taxes. Article 37 prohibits the CTA from causing the public to lose confidence in the taxation system. Although framed in the negative, this provision would create a duty to the system similar to that of the
United States. Article 38 sets out the CTA’s duty of confidentiality and Article 39 requires the CTAs to comply with the tax and other regulations. Article 44 contains sanctions for violations of the rules. The penalties include a warning for lesser offenses, suspension of business for one year for more serious offenses, and disbarment for the most serious violations.

VII. Conclusion

There are many conceptual similarities between the ethical guidelines of the United States and Japan. One similarity is that, while some guidelines are legislated by the national governments, other ethical standards are established by professional societies. The Institute of Certified Tax Accountants has established professional standards for its members.

In the past there were many difficulties in Japan with violations of ethical standards by tax accountants. Relatively little has been brought to public light, either by practitioners or by academicians. The study of ethical standards in Japan and other countries is an area that warrants further research by those in the academic community.

(October 5, 1992)
APPENDIX

STATEMENT OF PRINCIPLES OF INTERNAL REVENUE TAX ADMINISTRATION (IRS MISSION STATEMENT) (emphasis added)

"The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress."

"With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a governmental nor a taxpayer point of view."

"At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is 'protecting the revenue.' The revenue is properly protected only when we ascertain and apply the true meaning of the statute."

"The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position."

"Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and consideration. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud."
LITERATURE CITED


*Internal Revenue Code*, 26 United States Code, Subtitle F, Chapter 61B, Subchapter B; Subtitle F, Chapter 68A, Part II; Subtitle F, Chapter 68B, Part I; Subtitle F, Chapter 75A, Part I


ENDNOTES

(1) Only California has adopted neither the Model Rules nor the Model Code. (Wolfman, p. 21)

(2) See Article 4 in this series for a discussion of the many accounting professional organizations.

(3) See Article 5 in this series for a discussion of the general ethical standards of public accounting in America. These standards apply to tax practitioners as well as auditors and other accountants.
