Chapter 5: Ethical Considerations

Communication with IRS personnel regarding a taxpayer’s rights or liabilities under federal tax law constitutes practice before the IRS.¹ Such communication includes the following items.²

- Preparing or filing of documents
- Corresponding or otherwise communicating with the IRS
- Providing written advice regarding an entity or transaction
- Representing a taxpayer at a conference or meeting

Circular 230 provides many of the rules essential for the tax practitioner to adhere to in connection with practicing before the IRS and outlines the disciplinary sanctions that can be imposed on the tax practitioner for failure to abide by these rules. Although the tax practitioner may believe that the various rules in Circular 230 are clearly stated, several gray areas arise when some of these rules are applied to real-life situations. Frequently, a tax practitioner’s conduct also involves laws outside of Circular 230, such as sections of the Code or state laws. This chapter addresses some of these areas.

CONFLICTS OF INTEREST

Circular 230, §10.29, indicates that a tax practitioner should not represent a client before the IRS if the representation involves a conflict of interest. A conflict of interest exists in the following situations.

- The representation of one client will be directly adverse to another client.
- There is a significant risk that a client representation will be materially limited by the tax practitioner’s responsibilities to another client, former client, or third person.
- There is a significant risk that the representation of a client will be materially limited by the tax practitioner’s own personal interests.

However, even if there is a conflict of interest, the tax practitioner may still represent a client if all of the following requirements are met.

1. The tax practitioner reasonably believes that competent and diligent representation can be provided to each affected client despite the conflict.
2. The representation is lawful.
3. Each affected client is informed of the practitioner’s conflict of interest and provides informed consent at the time the practitioner knows of the conflict. Written consent must be provided no later than 30 days after the informed consent.

Please note. Corrections for all of the chapters are available at www.TaxSchool.illinois.edu. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

¹. Circular 230, §10.2(a)(4).
². Ibid.
Scenario 1. Lucy and Desi are a married couple. They have been Carolyn’s tax clients for 15 years. Lucy comes to Carolyn’s office during the 2014 tax preparation season and announces she is divorcing Desi. She also lets Carolyn know that Desi is not yet aware that she is going to file for divorce and that Carolyn should refrain from mentioning that to him when she prepares their 2014 tax returns. Lucy indicates that they will split their assets and asks Carolyn for advice on which particular assets she should request in the divorce.

Analysis. Carolyn’s continued representation of both Lucy and Desi has implications under §10.29. Representation of either client would arguably be directly adverse to the other client and/or limited by Carolyn’s responsibilities to the other client, even for the tax advice associated with preparing their tax returns. For example, if Carolyn advises them to file as married filing jointly (MFJ), each divorcing spouse is jointly and severally liable for any tax owed for that tax year. If Carolyn advises them to file as married filing separately (MFS), this may result in a higher tax liability for one or both spouses.

Carolyn’s representation of one spouse is arguably compromised (or “materially limited”) by the continued representation of the other spouse. Accordingly, Carolyn may wish to withdraw from representing one or both spouses. Withdrawing her representation of both spouses is the best option to ensure that §10.29 is not violated.

Note. Withdrawing representation may require revocation of Form 2848, Power of Attorney and Declaration of Representative. For further details on how a tax practitioner must revoke Form 2848, see IRS Pub. 947, Practice Before the IRS and Power of Attorney. Failure to properly revoke this form may result in continued obligations to a former client under Circular 230.

Section 10.29 permits Carolyn to continue representing one or both spouses if Carolyn reasonably believes that she can continue to do so competently and diligently. This is only permitted, however, if she fully informs Lucy and Desi of the conflict and obtains their written consent to the continued representation of either or both of them. As the situation evolves, Carolyn must continue to monitor the conflict and her ability to remain objective and to competently and diligently represent both clients.

Carolyn should probably decline to advise Lucy on the particular assets to pursue in the course of the divorce proceedings because of the conflict. Any strategy Carolyn devises for Lucy may harm Desi, which violates the conflict-of-interest rules. Although informed consent is an option under the rules, it is certainly not the most prudent course of action for Carolyn to advise either or both spouses about specific assets. In addition, advice of this nature may constitute the unauthorized practice of law in Carolyn’s state. Advice on specific assets transcends ordinary tax preparation and consulting services and may constitute legal advice.

Observation. Many states, including Illinois, have a statute specifically prohibiting the practice of law by nonattorneys. In Illinois, the practice of law is defined as the giving of advice when that advice requires the use of any degree of legal knowledge or skill.

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3. The Illinois statute on this subject is 705 ILCS 205/1.

Scenario 2. Clark and Clara were married clients of Sarah, who prepared their tax returns for many years. The last tax return Sarah completed for them was for 2013. Clark and Clara were divorced in early 2014. Clark is still Sarah’s client, but Clara found another tax professional after they were divorced.

Clark and Clara received an audit letter in connection with their 2012 return. When the audit letter came, both taxpayers stormed into Sarah’s office demanding that she handle the audit. The audit is a result of $20,000 of unreported gambling income that Clark received in 2012. He did not tell Clara or his divorce attorney about this income.

Analysis. Sarah must consider the Circular 230 conflict-of-interest rules when considering whether to represent Clark and Clara in the audit. Although the conflict-of-interest rules permit Sarah to represent Clark and Clara as long as they both are informed of the conflicts and sign appropriate consents, the existence of the gambling income, known only to Clark, may prevent Sarah from providing Clara with informed consent about all the conflicts, including the tax ramifications of the gambling income. However, fully informed consent may be possible if Clark tells Sarah and Clara about the gambling income before Sarah makes a decision about whether to represent them. Even if informed consent is possible, Sarah’s best option is to advise Clara to obtain representation from her own tax professional in connection with the audit, especially because Clara may have an innocent spouse claim in connection with Clark’s unreported gambling income.

Scenario 3. James is an experienced tax professional. Orville, a current client, visits James and announces that he is forming a partnership with two other individuals, Sam and Gordon, with Gordon’s LLC as a fourth partner. He asks James to establish the partnership and be the partnership’s tax professional.

Analysis. Generally, under partnership law, partners may be liable for the actions of other partners. All partners are liable for the debts and obligations of the partnership. In addition, under partnership law in many states, partners must make decisions in many different areas, including the following.

- Initial contribution of capital
- Each partner’s share of profits or losses
- Guaranteed payment amounts to which each partner is entitled
- Management rights of each partner
- Each partner’s right to use and/or possess partnership property
- Each partner’s right to access partnership records

Note. A partner’s rights and obligations in most states are found in the state’s version of the Uniform Partnership Act (UPA). States that have adopted the UPA — which include Illinois, Iowa, Arkansas, Missouri, and most other states — may have made some amendments to the uniform version before adopting the UPA as the legislated partnership rules that prevail within their respective jurisdictions. Therefore, the rules in some sections of the UPA vary from state to state. Many of the UPA rules are default rules that the partners may override with their own partnership agreement.

Because establishing the partnership and each partner’s rights and obligations requires detailed legal knowledge and involves each partner’s legal rights, James should not represent all the partners or draft the partnership agreement. He should advise Orville that each of the partners should retain independent legal advice in the course of establishing the partnership and drafting a partnership agreement that outlines the rights and duties of each partner in accordance with what the new partners desire. This action prevents James from engaging in the unauthorized practice of law. Based on the objectives of the partners, the attorneys may recommend a different organizational structure for the partners.