Focus on Ethics

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How Do IRS Conflicts of Interest Rules Impact You?

Circular 230, the Treasury regulations governing ethical standards applicable to practice before the Internal Revenue Service (IRS), deals with conflicting interests at Section 10.29 (31 C.F.R. §10.29). It forbids federal tax practitioners (a defined term that includes CPAs) from having conflicts of interest. Conflicts of interest are defined as representation of one client that is directly adverse to that of another client, or as representing a client in circumstances creating a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

However, a practitioner may represent a client despite a conflict of interest if the practitioner reasonably believes he/she can provide competent and diligent representation to each affected client and if all affected clients waive the conflict by giving their written informed consent. Circular 230 has at least two major potential effects on covered practitioners: (1) violation of a Circular 230 standard may subject the practitioner to sanction by the IRS Office of Professional Responsibility (OPR); and (2) Circular 230 may be used in a lawsuit for damages filed by a client in connection with asserted errors and omissions by the practitioner as the standard to which the practitioner should be held in performing services. Thus, CPAs have a strong interest in understanding the standards to which they will be held under Circular 230.

The rules in Section 10.29 track the language in the American Bar Association Model Rules (the "ABA Rules"). They are terse and apply to a CPA only where the CPA is practicing before the IRS. However, the American Institute of CPAs' Code of Professional Conduct (the "AICPA Code") and other professional standards may still apply if Section 10.29 does not. A CPA subject to the Statements on Standards for Tax Services (SSTS) is generally required to follow them and other AICPA professional standards as a minimum standard. Thus, if Section 10.29 applies and provides a stricter rule on the definition of how to deal with such a conflict, a CPA should follow Section 10.29.

UNDERLYING VALUES

The Circular 230 standard on conflicts of interest emphasizes conflicting professional responsibilities. It differs from the AICPA Code and other standards that emphasize the broader values of integrity and objectivity (and in attestation engagements, independence) as compared to the ABA Rules that are based on the values of advocacy and loyalty.

Unstated is the extent to which the interpretations of Section 10.29 will follow the comments on the ABA Rules or case law interpreting them. Unfortunately, the IRS and Treasury have not provided further guidance and to date, there is no case law or administrative law judge decisions that could provide guidance as to how OPR will interpret Section 10.29.

CONFIDENTIALITY IN MULTIPARTY REPRESENTATIONS

In any multiparty representation, a CPA must consider the confidentiality requirement under ET Section 301, as well as the practitioner-client communication privilege under IRC Sec. 7525. Normally, a CPA's clients have a more limited right to confidentiality than any attorney's clients, but that right is still of great significance. Commencing or continuing common representation would almost certainly be inappropriate if one client asks the CPA to not disclose to the other client information relevant to the common representation. The CPA must act with integrity and objectivity with respect to each client equally; each client has a right to be informed of anything bearing on the representation that might affect the client's interests and the right to expect that the CPA will use that information to the client's benefit. Therefore, in any consent to a waiver of conflict as required in Section 10.29, suspension of a client's rights to confidentiality must be anticipated and provided for with respect to the other client being commonly represented.

The CPA should, at the outset of the common representation and as a part of the process of obtaining each client's informed consent, advise each client that the information will be shared and that the CPA will have to withdraw if one client decides that information material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the CPA to proceed with the representation when the clients have agreed, after being properly informed, that the CPA will keep certain information (such as one client's trade secrets) confidential provided that there is informed consent of both clients in such regard.

CONSENTING TO WAIVER

When the CPA is representing more than one client, the question of consent must be resolved for each client. The clients' ability to consent is typically determined by considering whether their interests will be adequately protected if they give their informed consent to such a representation. Representation is prohibited if, under the circumstances, the CPA cannot reasonably conclude that he/she will be available to provide competent and diligent representation. Considerations include (1) possible effects on integrity and objectivity; (2) the Sec. 7525 practitioner-client privilege and other confidentiality requirements; and (3) the advantages and risks involved in the common representation.

POTENTIAL CONFLICTS

Section 10.29 also refers to actual conflicts and to significant risk that representation of one or more clients will be materially limited. If a conflict of interest may exist or may be likely to develop before an engagement is undertaken, the engagement must be declined unless the CPA obtains the informed consent of each client under the conditions set forth under Section 10.29(b).

If, after the engagement has been undertaken, the CPA determines because of a change in circumstances that there is a conflict or a significant risk that a conflict will likely occur (either because clients will be directly adverse to each other or because representation will be materially limited), the CPA must obtain the written informed consent of all affected clients under the terms and conditions of Section 10.29(b) or withdraw. Only if the CPA can represent adequately the remaining client(s), given the CPA's duties to any former client, may the CPA continue the engagement as to any remaining clients. The CPA must continue to protect the confidences of the client from whose representation he/she has withdrawn.

IDENTIFYING DIRECTLY ADVERSE CONFLICTS

Identifying conflicts in adverse situations is critical to avoid undertaking an engagement that is directly adverse to a client without that client's informed consent. One example is spouses who are jointly liable with respect to a tax liability, but one spouse may have defenses to the detriment of the other (such as the innocent spouse defense). It would be difficult, if not impossible, for the CPA to represent both spouses in such a situation because their interests are directly adverse to each other. In such a case, the CPA may not ask both spouses to consent to common representation.

Similarly, with divorcing spouses, CPAs should carefully consider whether drafting appropriate disclosures is appropriate for a consent of waiver to a conflict. Assume that a CPA is asked to represent the seller of a business in negotiations (involving federal tax issues) with the buyer, who is also a client of the CPA or the CPA's firm in an unrelated matter. Under Section 10.29, a conflict would exist even though in a non-federal tax engagement under the AICPA Code, this may not be the case.

MATERIAL LIMITATION

Even where there is no directly adverse relationship, a conflict of interest exists if there is a significant risk that the CPA's ability to consider, recommend or carry on an appropriate course of action for the client will be materially limited as a result of the CPA's other responsibilities or interests. For example, assume a CPA is asked to provide federal tax services to several individuals (one of whom is a long-time client) seeking to form a joint venture. The CPA's ability to recommend or advocate all possible positions that each client might take is likely to be materially limited because of the CPA's long-time relationship, impairing his/her integrity or objectivity. The question is often one of proximity and degree.

However, a mere possibility of subsequent harm does not require disclosure or consent. The critical questions are whether a conflict is likely to arise and if it does, whether it will materially limit or interfere with the CPA's independent professional judgment.

The CPA's own interests may create a conflict. If the CPA's own conduct or quality of work in a transaction is in serious question, it may be difficult or impossible for him/her to give a client detached advice with integrity and objectivity. Such a situation may occur if the CPA is representing a client at the IRS Office of Appeals and penalties are proposed to be imposed on the client with respect to a return that the CPA or his/her firm prepared. If the CPA learns that the IRS is proposing to assert penalties on the CPA (or another preparer in the CPA's firm) under Sec. 6694 in the same matter, the representation would also be materially limited by the CPA's personal interest in avoiding a preparer penalty (or action by OPR).

OBTAINING AND RECORDING CONSENT

Section 10.29(b) requires the CPA to obtain the written informed consent of each client confirmed at the time that the CPA knows of the existence of a conflict of interest. Written confirmation may be made within a reasonable period after the informed consent, but no later than 30 days after. Merely obtaining consent without adequate written disclosure of relevant issues does not create informed consent.

Section 10.29(c) requires CPAs and other practitioners to retain copies of written consents for at least 36 months after the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any IRS officer or employee on request. CPAs should consider, in consultation with legal counsel, whether to redact confidential portions of communications between clients and the CPA that may be subject to privilege under Sec. 7525.

The client's written confirmation does not supplant the need for the CPA to talk with each client and to explain any risks and advantages of the representation burdened with the conflict of interest, as well as reasonably available alternatives. This affords each client a reasonable opportunity to consider the risks and alternatives and to raise questions and concerns, as well as to object before any disclosures of confidential information are made to another client.

SPECIAL SITUATIONS

A CPA engaged by a corporation or other organization does not necessarily represent any constituent or affiliated entity, such as a parent or subsidiary. An organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. A CPA engaged by an organization may also represent a principal officer or major shareholder of that organization. In such an instance, the CPA should be alert to the potential for conflict of interest between the principal officer or major shareholder and the organization. Their interests may not be congruent and may be in conflict. For example, an organization's method of accounting for tax purposes desired by an equity holder for a particular item or expense may be in conflict with the best interests of the organization and the other equity holders.

Another special area of potential conflict is agreements prospectively limiting a CPA's liability from malpractice. Unless the client is independently represented in making the agreement, such agreements create the potential for a conflict of interest because they are likely to undermine competent and diligent representation. This is an instance where the client's interests conflict with the CPA's personal interests.

Obviously after termination of a client-CPA relationship, the CPA has certain continuing duties with respect to confidentiality and conflicts of interest and thus may not represent another client except in conformity with the rules of Section 10.29.

CAREFUL ANALYSIS

CPAs in federal tax practice face risks from potential conflicts of interest that they may not have fully identified or focused on. CPAs need to carefully analyze these risks and as a result, may want to strengthen their client acceptance practices and procedures.

Situations that bear special scrutiny include those involving services in multiparty representation situations, such as related entities and equity holders, spouses, and clients being represented before the IRS Office of Appeals. ■

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