

# Tax Practice Responsibilities

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## CONFLICTS OF INTEREST: IRS RULES DIFFER FROM AICPA PROFESSIONAL STANDARDS



CIRCULAR 230, THE TREASURY REGULATIONS governing ethical standards applicable to practice before the IRS, deals with conflicting interests at Section 10.29 (31 C.F.R. §10.29). It forbids federal tax practitioners from having conflicts of interest, defined as representation of one client that is directly adverse to that of another client, or 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 or 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. This column is a limited discussion of the application of conflict-of-interest rules in a federal tax practice.

The original version of Section 10.29 (essentially unchanged since before 1976) was a simple three-line prohibition against representing clients with conflicting interests except by express consent of all directly interested parties after full disclosure. In 2002, Section 10.29 was amended to its current form, with additional enhancements in 2007 that included requiring that a known conflict of interest may be waived only by the informed consent of each affected client, confirmed in writing by the client.

The rules in Section 10.29 are relatively terse and contain numerous terms that are subject to varying possible interpretations. The AICPA opposed any change to Section 10.29 from the 1992 version in a comment filed with then-IRS Commissioner Charles Rossotti on July 7, 2000. Proposed regulations published by the IRS on January 12, 2001, were

substantially revised to meet objections (including those of the AICPA). However, the preambles to the final regulations in 2002 (T.D. 9011) and again in 2007 (T.D. 9359) made clear Treasury's intent to strengthen the language of Section 10.29 and to modify it to conform more closely with Model Rule 1.7 of the American Bar Association Model Rules of Professional Conduct. The preamble to T.D. 9359 in 2007 stated that Section 10.29 as amended was broader than the ABA model rule (by, for example, requiring client confirmation in writing). The preamble said that the rules were designed to "protect taxpayer interests and protect settlements from future collateral attack." One pair of writers has commented that "precedent from comparable ethical rules, rule commentaries, bar opinions, and the like may be helpful applying the rules, but are not binding" (Cavanagh and Hynes, *Navigating an OPR Disciplinary Proceeding*, 2010 TNT 95-6 (May 18, 2010)).

The rules of Section 10.29 apply only where the CPA is acting as a practitioner as defined in Circular 230. Thus, for example, if a CPA is an expert witness in a state law trial dealing with federal tax issues, he or she is not acting as a practitioner as defined in Circular 230. However, the AICPA Code of Professional Conduct and other AICPA and state professional standards may still apply to such testimony. A CPA subject to the Statements on Standards for Tax Services (SSTS), the enforceable tax practice standards for members of the AICPA, is generally required to follow them with respect to tax practice and to follow other AICPA professional standards as applicable, unless a stricter standard applies. Thus, if Section 10.29 provides a stricter rule on the definition of conflict of interest and how to deal with such a conflict in the context of acting as a practitioner (as defined in Circular 230), a CPA should follow Section 10.29. However, he or she should in all events follow the AICPA professional standards as a minimum standard.

## Underlying Values

### Integrity and Objectivity

The Circular 230 standard on conflicts of interest and ABA Model Rule 1.7

on which it is based emphasize conflicting professional responsibilities—when the representation of one client may be directly adverse to another client. In this respect, they differ from the AICPA Code of Professional Conduct and other standards, which emphasize the broader values of integrity and objectivity (and, in attestation engagements, independence) (see Code of Professional Conduct ET §102-2.03). What effect this difference may have in Section 10.29's application requires further exploration. Section 10.29 does not include the rest of the ABA Model Rules upon which the interpretation of Rule 1.7 rests. Sections 10.29(a) and 10.29(b) define when a conflict of interest exists and when, notwithstanding the existence of a conflict of interest, a practitioner may represent a client. Unstated is the extent to which the interpretations of Section 10.29 will follow the comments on the ABA Model Rules or case law interpreting them.

Under the AICPA professional standards, a CPA is required to maintain objectivity and integrity, be free of conflicts of interests, and not knowingly misrepresent facts or subordinate his or her judgment to others. These requirements are not inconsistent with any provision of Circular 230. These ethical standards also inherently underlie Section 10.29. CPAs employed by others to perform tax services are charged with the same responsibility of objectivity under the AICPA standards as CPAs in public practice. Integrity, objectivity, and independent judgment are essential elements in a CPA's relationship with a client or employer in a federal tax practice and in his or her status as a practitioner under Circular 230.

The AICPA Code of Professional Conduct differentiates between objectivity and independence. ET Section 55.03 provides that, for a CPA in public practice, maintaining objectivity and independence requires a continuing assessment of client relationships and public responsibility. A CPA who provides auditing and other attestation services should be independent in fact and appearance. However, this standard does not apply to a practitioner under Circular 230 in the absence of any attestation service performed by a CPA

or his or her firm for a client. Thus, CPAs providing such attestation services should consider (1) whether such engagement may materially limit the ability of such CPAs and their firms to provide federal tax advocacy services for the client under Section 10.29(a)(2), and (2) whether there is a significant risk that the representation of the client in federal tax advocacy matters will be materially limited by the personal interest of the practitioner or his or her firm due to the independence requirement of the attest engagement. In such cases, the CPA would need to follow the procedures under Section 10.29 regarding consent to waive such conflict (assuming the tax engagement could be managed so as to not violate the independence requirements).

## Loyalty and Advocacy

Although Section 10.29 tracks ABA Model Rule 1.7, many of the practices the section regulates differ from law practices; therefore, its application should not track that of the ABA Model Rule. Law practice requires loyalty to the client (see Comment No. 1 to ABA Model Rule 1.7), and the client of a lawyer is entitled to rely on very broad rules regarding the protection of client-attorney communications. That protection is incorporated in federal and state law. Loyalty, however, does not underlie the AICPA standards. The AICPA standard for confidentiality for the CPA's client (see Code of Professional Conduct ET §301) is not the same as that of the ABA Model Rules for the lawyer's client. The CPA's client confidentiality duty is subject to serious limitations under both federal and state law (see, for example, the limited protection available under Sec. 7525). Thus, even though there is a common value of advocacy between the ABA Model Rules and Section 10.29 and practices regulated thereby, the standards of Section 10.29 must vary from and be more limited than the interpretation of the ABA Model Rule 1.7. Similarly, even though a CPA is required to act with integrity and objectivity, unlike most aspects of a CPA's practice, his or her practice under Circular 230 inherently involves advocacy. Thus, the interpretation of what is a conflict of interest under Section 10.29 will differ

from that set forth in the AICPA professional standards. Unfortunately, the IRS and Treasury have not provided further guidance, and to date there is no case law or administrative law judge decision 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, in addition to the above-stated standards and values, the confidentiality requirement under ET Section 301, as well as the practitioner-client communication privilege under Sec. 7525. Normally, a CPA's clients have a more limited right to confidentiality than under the attorney-client communication privilege, 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 under ET Section 301 and Sec. 7525 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 confidential. For example, the CPA may reasonably conclude that not disclosing one client's trade secrets to another

client will not adversely affect representation involving a joint venture between the clients and, with the informed consent of both clients, agree to keep that information confidential.

## Potential Conflicts

Section 10.29 refers not only to actual conflicts but to situations where there is significant risk that representation of one or more clients will be materially limited. Thus, the potential for conflicts must be considered in appropriate situations.

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). To determine whether a conflict of interest may exist or is likely to develop, a CPA should adopt reasonable procedures appropriate for the size and type of firm and practice and determine the persons and issues involved. It should be assumed that ignorance caused by failure to institute such procedures will not excuse a CPA's violation of Section 10.29. The CPA should carefully consider whether a CPA-client relationship exists or, having been established, is continuing. As an engagement proceeds, a CPA may become aware of additional conflicts. In each such instance, as discussed below, a new consent to waiver must be drafted and obtained.

If, after the engagement has been undertaken, a conflict exists, or if the CPA determines that there is 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 withdraw from the engagement unless he or she has obtained the written informed consent of all affected client(s) under the terms and conditions of Section 10.29(b). Whether the CPA may continue the engagement with respect to any remaining clients is determined by either the CPA's ability to comply with the duties owed to the former client or clients or by the CPA's ability to represent adequately the remaining client(s), given the CPA's duties to any former client.

Unforeseeable developments such as a change in corporate or other organizational affiliations or in personal relationships (such as divorce, pending divorce, or conflict between spouses) may cause a conflict during an engagement. A CPA may also become aware of facts that alert (or should alert) him or her to a conflict of interest. Depending on the circumstances, the CPA may have the option or requirement to withdraw from one of the engagements to avoid the conflict. The CPA must continue to protect the confidences of the client from whose representation he or she has withdrawn.

## Identifying Directly Adverse Conflicts

Identifying conflicts of interest in directly adverse situations is critical to avoid undertaking an engagement that is directly adverse to a client without that client's informed consent. Thus, absent consent, a CPA may not act as an advocate in one federal tax matter against a person the CPA represents in some other matter (whether or not a federal tax matter). 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 spouse (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 a conflict for which consent probably cannot be waived. 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 a conflict is consentable and whether drafting appropriate disclosures is appropriate if the CPA seeks a consent of waiver to a conflict. For example, a CPA is asked to represent the seller of a business in negotiations with the buyer, who is also a client of the CPA or the CPA's firm in an unrelated matter. The CPA could not undertake the engagement without the written informed consent of each client, and even then would do so at significant risk should the transaction turn sour. Outside a federal tax engagement, however, this may not be the case

(compare AICPA Consulting Services Special Report 93-2, *Conflicts of Interest in Litigation Services Engagements* §110.17). Simultaneous representation of clients in unrelated matters where those clients' interests are only economically adverse does not ordinarily constitute a conflict of interest and thus may not require consent.

### **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 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 relationship and loyalty to the others, impairing his or her integrity or objectivity. The conflict, in effect, may foreclose alternatives to a client.

However, a mere possibility of subsequent harm does not require disclosure or consent. The critical questions are whether a difference in interests is likely to arise, and, if it does, whether it will materially limit or interfere with the CPA's independent professional judgment in considering alternatives or will foreclose courses of action that reasonably should be pursued on behalf of the client. In such a situation, a CPA should consider whether a consent to waiver of the conflict is appropriate or whether he or she should refuse the engagement altogether.

Relevant factors in determining whether there is a significant potential that the representation will be materially limited include the duration or intimacy of the CPA's relationship with the client(s) involved, the functions the CPA is performing, the likelihood that disagreements will arise, and the likely prejudice to the client from the conflict. The question is often one of proximity and degree. For example, a CPA may be called upon in connection with estate planning for several family members, such as a husband

and wife, and, depending upon the circumstances, a conflict of interest may be present.

The CPA should not allow his or her own interests to have an adverse effect on the representation of a client. For example, if the probity of the CPA's own conduct or quality of work in a transaction is in serious question, it may be difficult or impossible for him or 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 or 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 be materially limited by the CPA's personal interest in avoiding a penalty (or action by OPR).

### **Consenting to Waiver**

As indicated in Section 10.29(b), clients may not consent to some conflicts. This means the CPA cannot properly ask for such an agreement or provide representation on the basis of the client's consent. 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 a representation burdened by a conflict of interest. Thus, representation is prohibited if, under the circumstances, the CPA cannot reasonably conclude that he or 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 confidentiality requirements under ET Section 301, and (3) the advantages and risks involved in the common representation.

### **Preventing or Resolving Conflicts**

Whether clients can consent to a conflict depends on the circumstances. For example, a CPA should not represent multiple parties to a negotiation whose

interests are fundamentally antagonistic to each other. However, common representation is permissible where the clients are generally aligned in interests even though there may be some differences among them. Thus, a CPA may seek to establish or adjust an amicable and mutually advantageous relationship between clients. Examples could include helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest, or arranging a property distribution in settlement of an estate. In such instances, the CPA seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party may have to obtain separate representation and perhaps face additional costs, complications, or even litigation. After considering these and other relevant factors, the clients may prefer that the CPA provide services to all of them.

In considering whether to represent multiple clients in the same matter, however, a CPA should be mindful that if common representation fails because the potentially adverse interests could not be reconciled, the result can be additional costs and other problems for all involved, including forced withdrawal from representing all the clients. Where adverse interests clearly are not likely to be reconciled, the risk of failure is so great that multiple representation is plainly impossible and thus nonconsentable. For example, a CPA cannot undertake common representation of clients where contentious negotiations are imminent or contemplated. Because the CPA is required to be impartial between commonly represented clients, representation of multiple clients is improper when it is unlikely that he or she could maintain impartiality and when integrity and objectivity could be impaired.

Under some circumstances, it may be impossible to make the disclosures necessary to obtain consent to a waiver. For example, when the CPA represents different clients in related matters and one of the clients refuses to agree to a disclosure necessary to permit the other client

to make an informed decision, the CPA cannot properly ask the latter client to consent. The affected clients may need to consider the additional costs and benefits of separate representation in determining whether common representation is in each of their best interests.

## 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.

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 gives 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. As joint representations proceed, one or more of the clients may develop concerns regarding disclosures to other clients. The written confirmation is required not only to comply with Section 10.29 but to impress upon the clients the seriousness of the decision and to avoid disputes or ambiguities that could occur later.

A client who has given consent to a conflict may revoke that consent and may terminate the CPA's representation at any time. Whether a client's revoking consent to the representation precludes

the CPA from continuing to represent other clients depends on the circumstances, including the nature of the conflict, whether the client revoked consent because of a material change of the circumstances, the reasonable expectations of the other client(s), and whether material detriment to the other clients or the CPA would result.

## 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 practice is also deemed to impair independence in an attestation engagement.) Many clients cannot evaluate whether they should make such an agreement before a dispute has arisen, particularly if they have been represented by the CPA seeking the agreement. This is an instance where the client's interests conflict with the CPA's personal interests. However, a CPA should not be prohibited from entering into an agreement with a client regarding alternative procedures to resolve a conflict, such as arbitrating malpractice claims, provided such an

agreement is enforceable and the client is fully informed of the scope and effect of the agreement.

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. For example, a CPA who has represented multiple clients in a matter may not represent one of the clients against the others in connection with a federal tax matter that could cause the IRS to act adversely against the other clients, unless all affected clients give informed consent.

## Conclusion

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 may as a result 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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## EditorNotes

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