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THE ROLE OF NEUTRALIZATION STRATEGIES IN THE TRADEOFF BETWEEN PRACTITIONER RESPONSIBILITIES

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ABSTRACT

THE ROLE OF NEUTRALIZATION STRATEGIES IN THE TRADEOFF BETWEEN PRACTITIONER RESPONSIBILITIES

By

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Practitioners are an important component of the voluntary income tax compliance system. Yet, the role practitioners perform in this system is open to debate. The Internal Revenue Service (IRS) argues practitioners owe their livelihood to the existence of this system and therefore possess a duty to uphold it by aiding the IRS in meeting its compliance objectives. Practitioners counter by arguing their duty is to assist the client in paying no more taxes than are legally owed. Penalties enacted by Congress and enforced by the IRS seek to maintain some minimum level of practitioner compliance with the system.

The purpose of this research is to investigate the tradeoff between the practitioner's responsibilities to the client and the tax system. A model of practitioner decision-making is developed and used to investigate the hypotheses that, in ambiguous situations, the conflict in practitioner responsibilities and usage of neutralization strategies contribute to the perceived erosion in practitioner support for the tax system. It is further hypothesized that neutralization strategies reduce the deterrent effects of penalties, possibly encouraging practitioner aggressiveness.

The model is also used to investigate related hypotheses concerning the effects of penalties and client importance on practitioner behavior. Obtained results suggest three conclusions. First, responsibilities to the client do not encourage practitioner aggressiveness. Second, neutralization strategies contribute to practitioners favoring the client in ambiguous situations, and contribute to a penalty threshold effect. Third, neutralization strategies are used more often by practitioners who feel a low obligation to support the tax system.

This dissertation is dedicated to

my wife, Janet,

some very special friends,

John and Sherrie Saling, and

Terry and LuElla Johnson,

and to the memory of Lorentina Quey.

I could not have done this

without them.

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

Chapter One

INTRODUCTION

Voluntary compliance provides the very foundation for tax collection in the United States, yielding gains in both efficiency and accuracy of collection (Treasury 1989). Practitioners perform an integral role in this compliance system. Yet, the nature of this role is under debate. The Internal Revenue Service (IRS) argues practitioners owe their livelihood to the existence of the system and therefore possess a duty to uphold it (Shapiro 1986; Treasury 1986). Practitioners counter by arguing they owe a duty to assist the client in paying no more taxes than are legally owed (SRTP [1988 Rev.]).

Practitioner penalties are intended to encourage accurate assessments of taxes due (Treasury 1989, VIII-2). Their underlying objective, then, is behavior modification. That is, the imposition of a penalty (or threat thereof) is expected to dissuade a practitioner from engaging in the disapproved practice, and thereby encourage compliance. Whether enacted penalties encourage compliance, however, remains unproven.[1] In addition, penalties often are enacted with little empirical evidence whether they will have the

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[1]Reckers, Sanders, and Wyndelts (Forthcoming), for example, find evidence supporting penalty effectiveness while Milliron and Toy (1988) reach a different conclusion.

sought after effect. A recent report by the Executive Task Force of the Internal Revenue Commissioner's Penalty Study (hereinafter the Executive Task Force) concluded empirical research concerning the behavioral effects of penalties is lacking (Treasury 1989, III-3). Nonetheless, recommendations concerning changes to practitioner penalties continue to be made (Treasury 1988b; Podolin 1988). This knowledge gap and the apparent tendency of interested parties to make recommendations without suitable empirical support provide motivation for the current research.

The objective of this study is to investigate the behavioral implications of tax preparer penalties. In particular, this research focuses on civil (accuracy-related) practitioner penalties.[2] The reasons for this focus are twofold. First, the current debate concerning practitioner responsibilities offers a unique opportunity to explore the implications of a penalty in the context of a conflict of interest. Specifically, the practitioner is confronted with two distinct responsibilities: (1) to be a client advocate, and (2) to uphold the integrity of the tax system. The potential for

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[2]Practitioners are required to exercise reasonable care in ascertaining that every undisclosed position on a client's return has a realistic possibility of success if litigated (taxpayers must possess substantial authority for such positions) (Circular 230; Congress 1989a). Thus, the practitioner must satisfy both a standard of care and accuracy. Although the impact of either standard on practitioner behavior is worthy of research, the current study focuses only on the standard of accuracy.

conflict between these responsibilities is well recognized but relatively unresearched. Further exacerbating this conflict is the client's unique ability to affect the ultimate outcome through increased practitioner remuneration and moral suasion (e.g., threatening to employ a new preparer). Second, recent events and publications concerning civil practitioner penalties typify recommendations made without supporting empirical research. The report of the Executive Task Force, for example, notes the lack of adequate empirical research but then proceeds to offer recommendations (Treasury 1988b).

The purpose of this research is to investigate the tradeoff between the practitioner's responsibilities to the client and to the tax system. Specifically, this study seeks to investigate the following questions. (1) Given the conflict in responsibilities, what effect does the practitioner's duty to assist the client have on practitioner support for the tax system? (2) Given the conflict in responsibilities, what is the impact of increased preparer penalties on practitioner behavior? (3) Deterrence theory argues that norms are supported by enacted, self-imposed, and interpersonal sanctions. Do these sanctions differentially influence practitioner behavior? (4) Neutralization theory lists several techniques (strategies) that practitioners may use to justify their level of compliance with the tax system (Sykes and Matza 1957; Minor 1981). Do these techniques contribute to the perceived erosion in the practitioner's obligation to

the tax system? (5) AICPA Statements on Responsibilities in Tax Practice (1988 Rev.) No. 1 recommends a CPA should prepare a return only when all undisclosed positions on the return possess a realistic possibility of success. Not completing the engagement of an important client, however, can significantly affect a CPA firm's association with the client. Thus, does the importance of the client to firm revenues affect a practitioner's decision?

The Executive Task Force (Treasury 1989) argues that preparer penalties should be evaluated based on how well they support the standard of behavior expected of preparers. But, as the IRS has noted, compliance decisions are dependent on much more than penalties alone (IRS 1978). Thus, additional variables must be included in a general decision model if we are to understand the penalty's effect on practitioner behavior.

The remainder of this dissertation is organized as follows: Chapter 2 discusses the standards of conduct required of both preparers and practitioners; Chapter 3 reviews relevant empirical research and develops testable hypotheses; Chapter 4 discusses the methodology employed and the sample obtained; Chapter 5 presents an analysis of the results; and Chapter 6 considers the contributions and limitations of this study.

Chapter Two

THE STANDARDS OF BEHAVIOR

The conflict in practitioner responsibilities is attributable, at least in part, to obligations assumed when attaining practitioner status. Recently, changes in tax law and professional responsibilities have influenced the degree of this conflict. However, these changes have not addressed its essential cause. This chapter reviews the current legal requirements and professional obligations of practitioners, as well as their development, with the intent of specifying the fundamental nature of the responsibility conflict.

2.1 Current Provisions

The standards of conduct imposed on tax preparers differ depending on the preparer's professional affiliation and qualifications to represent the client before the IRS.[1] All "preparers" are subject to civil penalties imposed by the Internal Revenue Code (IRC). The IRC defines a preparer as:

> any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any [income tax] return.... [T]he preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund. (IRC Sec. 7701(a)(36)(A))

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[1]Use of the term professional often suggests membership in a professional organization (AICPA, state CPA association, etc.). As used in the current context, however, a professional can be either a preparer or practitioner regardless of professional qualifications.

This definition includes more than individuals who physically prepare income tax returns. It also includes, for example, anyone who receives compensation for the preparation of a return, as well as advisors who review and mail or offer substantive advice concerning a client completed return. (Revenue Ruling 84-3, 1984-1 C.B. 264; Ernst & Whinney, 735 F2d 1296). The term "tax practitioner" describes those preparers who meet the requirements described in Circular 230 and are therefore subject to its sanctions. In general, this group includes attorneys, CPAs, and enrolled agents.

As amended by the Omnibus Budget Reconciliation Act of 1989 (Congress 1989a), the three primary civil penalties applicable to preparers are found in IRC sections 6694(a), 6694(b), and 6701.[2] Section 6694(a) imposes a $250 penalty on a preparer who knowingly prepares a return with an undisclosed tax position lacking a "realistic possibility" of success. No definition is provided, however, for the term "realistic possibility." By example, the Treasury indicates a realistic possibility exists if there is a one in three likelihood of the position being sustained on its merits (Notice 90-20, 1990-1 C.B. 328; Prop. Reg. Sec. 1.6694-2(b)). The House Ways and Means Committee Report (House Committee Report) further

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[2]Section 6695 sets forth several secondary or administrative penalties including penalties for failure to furnish a copy of the tax return to the taxpayer, failure to sign the tax return, failure to furnish the preparer's identifying number, and similar lapses.

advises that the standard "generally reflects the professional conduct standards applicable to lawyers and to certified public accountants" (Congress 1989b).

Section 6694(b) imposes a $1,000 penalty if any part of an undisclosed position results in an understatement that is considered willfully incurred or due to reckless or intentional disregard of rules. Section 6701 imposes a $1,000 ($10,000 in cases relating to corporations) penalty for aiding and abetting an understatement of tax liability.

The Omnibus Budget Reconciliation Act (OBRA) also rewrote the taxpayer substantial understatement penalty. Under section 6662(b)(2), taxpayers who substantially understate their liability are subject to an additional tax of 20 percent on the understatement. An understatement is deemed substantial when the amount of the understatement exceeds 10 percent of the tax required to be shown on the return or $5,000 ($10,000 for corporations).[3] To avoid this penalty the taxpayer must either include additional disclosures or possess substantial support (authority) for all adopted positions. Substantial support, however, has never been defined. The House Committee Report (1989b), Notice 90-20 (1990-1 C.B. 328), and proposed regulations underlying the substantial understatement penalty (Prop. Reg. Sec. 1.6662-4(d)(3)(iii))

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[3]S corporations and personal holding companies use the $5,000 threshold.

list authorities that can or cannot be considered, but do not state when support is "substantial":

> There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions... (Prop. Reg. Sec. 1.6662-4(d)(3)(i)).

Authorities currently considered not acceptable for determining substantial support include legal periodicals, treatises, and professional opinions.

Practitioner responsibilities, in addition to the those governed by civil preparer penalties, include both reputable conduct and duties and restrictions related to practice (Circular 230). Table 2.1 provides a partial listing of actions violating these responsibilities. If the rules are violated, actions taken by the Director of Practice can range from a request for an explanation to suspension or even disbarment (Shapiro 1986). Isolated errors, even those resulting in penalties, generally have not resulted in disciplinary action (Treasury 1989).

Table 2.1

VIOLATIONS OF PRACTITIONER RESPONSIBILITIES

Disreputable Conduct

Criminal convictions

Offenses involving dishonesty or breach of trust

Knowingly providing false or misleading information to the Treasury

Soliciting employment by making false or misleading representations

Suggesting that special consideration from the IRS can be obtained

Willful failure to make a federal tax return

Participating in the evasion of any federal tax of payment thereof

Failure to properly remit funds received from a client for the purpose of paying obligation due to the United States

Directly or indirectly offering, agreeing, or attempting to influence an IRS employee by threat, false accusation, duress, coercion, or special inducement

Disbarment or suspension from practice

Knowingly aiding and abetting another person to practice before the IRS during a period of ineligibility

Engaging in contemptuous conduct in connection with practice before the IRS

Knowingly, recklessly, or through gross incompetence giving a false opinion on questions arising under federal tax laws

Table 2.1 (cont'd)

Violations of Duties and Restrictions

Failure to furnish records or information to the IRS upon lawful request unless the practitioner reasonably believes the request is of dubious legality

Failure to promptly notify a client of noncompliance with tax law upon discovery by the practitioner

Failure to exercise due diligence in representations to the client or IRS

Unreasonably delaying the prompt disposition of any matter before the IRS

Accepting assistance from a practitioner under suspension or disbarment from practice before the IRS

Charging unconscionable fees

Representing conflicting interests before the IRS except by express consent of all interest parties

Engaging in unauthorized advertising in the solicitation of employment in matters related to the IRS

Endorsement or negotiation of any taxpayer's refund check, except when the taxpayer is the practitioner[4]

[4]Source: Circular 230.

Prior to enactment of OBRA, the Director of Practice outlined an additional set of practitioner responsibilities (Shapiro 1986). One responsibility, formally proposed as a modification to Circular 230 (Treasury 1986), directly related to the taxpayer substantial underpayment penalty (IRC Sec. 6661 (repealed)):

> To the extent a tax practitioner is implicated by involvement in giving advice or preparing the tax return leading to the [substantial underpayment] penalty, violation of the regulations in circular 230 may be found (Shapiro 1986).

In effect, Treasury was requiring practitioners to uphold the substantial authority standard.

The automatic presumption of practitioner wrong-doing was particularly difficult for practitioners to accept (AICPA 1987). Ultimately the taxpayer controls the final contents of a return. As such, practitioners feared (1) being held responsible for client decisions to withhold disclosure and (2) being forced to rely on inadequate (i.e., non-substantial) or unacceptable support for undisclosed positions. The enactment of OBRA, however, likely reduced these possibilities by broadening the list of acceptable authorities and instructing the IRS to employ restraint in practitioner disciplinary actions:

> In matters involving non-willful conduct, the IRS should only refer cases to the Director of Practice in instances where the IRS can establish a pattern of failing to meet the required standards. An isolated instance in which a penalty may apply should not, in and of itself, require a

> referral unless willful conduct is involved (Congress 1989b).[5]

2.2 Standards Established by Practitioners

AICPA Statement on Responsibilities in Tax Practice (1988 Rev.) No. 1 (SRTP (1988 Rev.) No. 1) presents the opinion guiding accounting practitioners in recommending positions and preparing returns. It should first be noted, however, that the SRTP program is intended to be educational and the statements do not have any force of authority (although the AICPA's Code of Professional Conduct is applicable). SRTP (1988 Rev.) No. 1 states in part:

> A CPA should not recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless the CPA has a good faith belief that the position has a realistic possibility of being sustained...

A position should not be recommended merely to aid bargaining with the IRS, nor should it exploit the "audit lottery." In addition, a preparer should not prepare or sign a return

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[5]The reduction in possibilities is, of course, strictly conjecture. Evidence enabling a comparison of practitioner referrals both pre- and post-enactment of OBRA remains to be compiled. In addition, the U.S. Government Accounting Office (GAO) argues that the underlying concern of congress was that referral would automatically result in additional penalties (GAO 1991). As argued by the GAO, mere referral does not necessarily result in additional penalties. Hence, the IRS can strengthen its referral policy without undermining the concerns of congress.

Unfortunately, this ignores the possibility that referrals may be a form of sanction (a possibility the GAO recognizes elsewhere in the same report (GAO 1991, 34)). To the extent the IRS adopts the GAO's recommendations, the reduction in possibilities becomes more uncertain.

containing a position failing the realistic possibility standard unless the position is disclosed and not frivolous.[6] Support for determining realistic possibility can come from many sources, including well-reasoned articles and treatises.[7] Alternatively stated, support can be found beyond the definition of authority underlying the taxpayer substantial underpayment penalty.

Importantly, the opinion advises that the content of a return is the taxpayer's responsibility. If the CPA believes a taxpayer penalty may be asserted, (s)he should advise the client and disclosure should be considered. Nevertheless, the decision to disclose additional information is the client's. The CPA's duty is to assist the client in paying no more taxes than are legally owed and to be an advocate for the client with respect to all positions satisfying SRTP (1988 Rev.) No. 1.

The Tax Division of the American Bar Association's standard for tax positions states in part:

> A lawyer may advise reporting a position on a tax return so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated. (Formal Opinion 85-352)

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[6]Similar guidelines apply for recommending positions.

[7]The acceptability of articles and treatises for determining realistic possibility is consistent with the AICPA's response to the IRS proposed amendments to Circular 230 (AICPA 1987; Treasury 1986).

Frivolous positions should not be advanced, and the attorney owes no duty to disclose additional information on the return as long as this standard is met. In addition, the attorney is duty bound to "zealously and loyally" represent the interests of the client. Similar to the accounting standard, a lawyer should advise clients when the potential for a penalty exists and that disclosure may mitigate such penalty. However, it is the client's responsibility to determine if additional disclosures will be included.

2.3 Summary

The extent of practitioner responsibilities is the focus of this debate. The IRS's opinion, as explained in the proposed revisions to Circular 230, states that the reasonable basis standard has "eroded" in recent years resulting in problems with taxpayer compliance. These problems, according to the Treasury, have adversely affected the integrity of the voluntary self-assessment system. The practitioner, whose livelihood is derived at least in part from the tax system, owes a duty to uphold it.[8] This duty manifests itself in the representations made on clients' returns, which should accurately reflect the facts, and positions taken on the return must be supportable by law (Treasury 1986). Prior to

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[8]It is important to note that the Treasury's proposal specifically concerns practitioners (Treasury 1986). Thus, the Treasury is effectively arguing that practitioners owe a different duty to the tax system than preparers.

the enactment of OBRA, the Treasury interpreted this duty to require all undisclosed positions to be supported by substantial authority, and further advocated an even higher "more likely than not" standard. The current standard, however, requires a realistic possibility of success.

The accounting profession's advisory opinion states CPAs have a duty to assist the client in paying no more taxes than are legally owed and that positions adopted on a return are the client's responsibility. Thus the decision to further disclose a transaction is the client's responsibility and not the practitioner's. The recommended standard is also a realistic possibility of success. However, in contrast with the enacted realistic possibility standard (Section 6694(a)), support for this determination can include legal articles and treatises.

The levels of practitioner assurance ("comfort levels") range from frivolous (no support exists for the position) to certainty (unqualified support exists for the position). In between these extremes are less quantifiable comfort levels (Table 2.2). The highest comfort level, advocated by the Executive Task Force, is "more likely than not" (Treasury 1989). The lowest, "reasonable basis," was repealed by OBRA. Of all four intermediate standards only "more likely than not"

is readily quantifiable; requiring something greater than a 50 percent chance of success.[9]

[9]Evaluating success, of course, still requires a subjective analysis.

Table 2.2

HIERARCHY OF STANDARDS

Standard	Assurance	Basis/Definition
"Certainty of Success"	100%[10]	Discussed and discarded by the Executive Task Force as "not feasible."
"More Likely than Not"	51% - 100%	Executive Task Force Proposal.
"Substantial Authority"	35% - 100%	IRC Section 6662(b)(2); Proposed Amendment to Circular 230.
"Realistic Possibility of Success"	30% - 100%	AICPA SRTP (1988 Rev.) No. 1; ABA Opinion 85-352; Omnibus Budget Reconciliation Act of 1989; IRC Section 6694(a); Notice 90-20.
"Reasonable Basis"	20% - 100%	Repealed IRC Section 6694(a); (Repealed IRC Section 6661, AICPA SRTP (1988 Rev.) No. 1, and Proposed Amendment to Circular 230 if accompanied by adequate disclosure).
"Frivolous"	0%	"Groundless" (IRC Section 6673) or a position "knowingly advanced in bad faith" (AICPA SRTP [1988 Rev.] No. 1).[11]

[10]Note: The assurance percentages presented above represent the opinions of Banoff (1988) and are not meant to be strictly interpreted. The AICPA recommends against assigning assurance percentages to standards (AICPA 1990).

[11]Source: Banoff (1988).

As created by enactment of the taxpayer substantial understatement penalty, "substantial authority" is stricter than "reasonable basis" but not as strict as "more likely than not." The "realistic possibility of success" standard evolved from practitioner desires to strengthen "reasonable basis" without requiring "substantial authority" (Banoff 1988). Hence "realistic possibility" and "reasonable basis" lie below "substantial basis," with "reasonable basis" being more easily met.

Prior to the enactment of OBRA a direct conflict existed in the standards supporting the practitioner's duty to the tax system. Specifically, the Treasury sought to require a substantial basis for all undisclosed positions whereas the AICPA (and ABA) advised a realistic possibility of success. This particular conflict was substantially addressed by OBRA. However, a considerably more fundamental issue was not addressed. Application of the realistic possibility standard is not performed in a vacuum. Practitioner's must also consider their duty to assist the client. It is the resolution of this conflict (i.e., duty to assist the client vs. duty to comply with the tax system) that is the focus of the current research.

Chapter Three

PREVIOUS RESEARCH AND THE IMPLICATIONS OF THEORY

Theoretical and empirical research offers insight into the relations between various elements the practitioner either explicitly or implicitly considers in client/practitioner relations. Chapter three reviews this research and develops a decision model based on their combined implications. The final section of this chapter describes several hypotheses based on the decision model and earlier research.

3.1 Practitioner and Taxpayer Research

Several prior studies concerning practitioner responsibilities have implications for this research. Renfer (1982) investigated the use of 18 information items in separate decisions to represent a client and include additional disclosures. Participants included CPAs, lawyers, and students, all Michigan residents. Results indicate all items were accessed by participants in every decision. However, the importance of each variable (i.e., number of times the item was accessed) differed depending on the decision. In the context of client representation decisions Renfer also investigated relations between (1) client fees and the amount of error, and (2) client fees and the number of years of client representation. Results indicate 75 percent

of the lawyers and 59 percent of the CPAs considered fees more important than either the amount of error or number of years.

Renfer (1982) also provides evidence that practitioner resolution of the conflict in duties (i.e., system vs. client) can impact the practitioner's duty to the system. The manipulated penalty variable included possible negligence, valuation, failure to pay tax, fraud, and preparer penalties. Of note, three of twenty-eight CPAs selected as their preferred client one who would place the practitioner in danger of a penalty.

To obtain this data Renfer (1982) relied on an information board (Payne 1976); a unique instrument that imposes no cost for accessing information. The uniqueness of the instrument and easy availability of information may have encouraged respondents to access information out of curiosity and not as a part of the normal decision process. Hence, the validity of the importance measure is problematic. Nevertheless, the results suggest client fees and practitioner penalties are relevant to the reconciliation of practitioner responsibilities.

Reckers, Sanders, and Wyndelts (forthcoming) investigated the impact of preparer penalties and client importance on CPA aggressiveness in giving advice and signing returns. Obtained evidence further develops Renfer's (1982) results. First, clients possessing a higher perceived value to the CPA's firm, as measured by current and potential fees, tended to be

represented more aggressively. Second, preparer penalties were found to inhibit CPA behavior when signing returns. While the results are offset somewhat by a potentially biased sample (all 59 respondents were members of the same CPA firm), Reckers et al. find evidence supporting the relevance of penalties and client importance to client representation decisions.

Ayres, Jackson, and Hite (1989) investigated the effect of differing degrees of regulation on the judgments of preparers. Employing the economic theory of regulation (Peltzman 1976), Ayres et al. hypothesized that preparers subject to a higher degree of regulation (CPAs) would recommend and justify more pro-taxpayer positions than those subject to less regulation. This is attributed to privileges conferred by Circular 230, including the ability to represent clients before the IRS, the opportunity for frequent interactions with the IRS, and the suggestion of protection from some penalties (provided Circular 230 is followed).[1]

To test their hypothesis Ayres et al. (1989) constructed five cases involving questions of deductibility (two), classification of income (one), and recognition of income (two). Obtained results indicate significant differences

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[1]A recent, and controversial, IRS study (Treasury 1987) concluded that the suggestion of reduced penalties may be more fact than fiction. That is, the study concluded that a practitioner is often able to spare the client from penalties. For a somewhat caustic critique of this study see Jackson and Milliron (1989).

exist between CPAs and non-CPAs, with differences concentrated primarily in the deduction cases. As noted by the authors, this is not surprising given the limited number of third-party reporting requirements for deductions. Fewer reporting requirements allow tax professionals a greater degree of discretionary judgment.

Unfortunately, instrument limitations create uncertainty as to whether this result is due to differences in regulation or in the knowledge of participants. Nonetheless, the results imply that the IRS call for different (stricter) treatment of practitioners may be appropriate. The validity of this implication, however, hinges on the assumption that penalties (either threatened or imposed) achieve the desired behavior modification. Finally, the evidence supporting increased use of discretionary judgement for deductions suggests research into practitioner decision-making should focus on deductions.

Chang and McCarty (1988) analyzed the effect of experience and firm affiliation on practitioner judgments involving substantial authority. Their results indicate that experience and firm affiliation affect the degree of practitioner consensus on whether substantial authority exists, and the perceived importance of different information cues in making this determination. In addition, their results suggest that despite the uncertainty surrounding "substantial authority," practitioners display relative homogeneity in interpreting the probability of courtroom success achieving this standard.

Obtained results are tempered by a small sample size (30 practitioners). Yet, they still suggest that experience and firm affiliation must be considered when modeling practitioner decision-making, and further, that ambiguous guidance may not result in widely disparate interpretations of a behavioral standard. This last conclusion implies violations of practitioner standards may not result from error, but from some other heretofore unrecognized mechanism.

Helleloid (1989) examined the effects of ambiguity in client documentation on practitioner judgments. Specifically, in the context of business-use automobile deductions he considered three questions. First, are tax professionals sensitive to differences in client documentation? Second, if sensitivity is found, what tends to be the direction of the ambiguity adjustment? And third, does client attitude or professional experience affect the tax professional's judgments? Obtained results suggest sensitivity exists towards client documentation; respondents often estimated the amount of deductible mileage to be less than the client's "supported" amount. Many respondents, however, estimated values in excess of client support. Similarly, many professionals were ready to support the client's position even though they may violate their duty to exercise reasonable care (i.e., to make reasonable inquiries into the adequacy of the taxpayer's evidential support). IRC section 274(d) clearly prohibits automobile-related deductions that are not supported with

adequate records. Nonetheless, respondents still supported the client's deduction even when the evidential matter was not compiled until year-end. The precise mechanism employed by tax professionals to reach these outcomes is unknown, however, and provides the basis for the current study.

Further insight into practitioner behavior can be obtained by reviewing related taxpayer compliance research.[2] Scotchmer (1989) explores the implications of penalties given taxpayer and preparer incentives and proposes that preparer penalties perform three roles in a competitive market. First, as preparers pass the expected penalty through to taxpayers the compounded taxpayer penalty rate increases, thereby discouraging taxpayer underreporting. Second, the consequential increase in preparer fees serves to dissuade taxpayers from seeking preparer assistance. Third, the disproportionate allocation of penalties across preparers may result in heavily penalized preparers withdrawing from the market. Thus, penalties perform a quality assurance function. Although Scotchmer did not empirically test these ideas, Klepper, Mazur, and Nagin (1990) obtain supporting results.

In their study, Klepper et al. (1990) develop a theoretical model of taxpayer behavior formalizing their argument that preparers work to reduce unambiguous violations of tax law while simultaneously exploiting ambiguous law. In testing

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[2]Additional compliance research will be discussed in the following section.

their model with data from the Taxpayer Compliance Measurement Program, updated as of 1982, they obtain results suggesting that an increase in preparer penalties would have two effects on taxpayer compliance. First, preparers would react by recommending less legally ambitious tax positions, thereby improving taxpayer compliance. Second, as preparers increase their fees to compensate for the additional risk involved, taxpayer use of preparers would be discouraged, thereby reducing the pro-compliance effect of practitioners in non-ambiguous tax matters.

Unfortunately, the innumerable structural assumptions employed and the use of a potentially inappropriate data base (it pre-dates the substantial revisions to preparer penalties found in the Tax Equity and Fiscal Responsibility Act of 1982) limit the value of this study. Nonetheless, Klepper et al. obtain results supporting the existence of a positive relation between fees and risk assumption by preparers.

Chang and Schultz (1989) investigated the taxpayer's inclination to play the audit lottery. Using prospect theory, they found support for the hypotheses that under-withheld taxpayers are more inclined to play the lottery and the smaller the likelihood of success, the less the inclination to gamble. More relevant to the current study, however, are results derived from several debriefing questions. Taxpayers who either consider themselves more knowledgeable of tax laws or more experienced with IRS audits tended to adopt more

contentious return positions. Additionally, familiarity with tax law was associated with reduced intimidation by an additional 10 percent penalty.

While Chang and Schultz's (1989) results apply to taxpayers, their results do suggest an interesting possibility for practitioners. Specifically, to the extent practitioners can be considered highly experienced taxpayers, Chang and Schultz's results suggest that increased preparer penalties may not have the intended effect on practitioners. The applicability of these results to practitioners must be determined empirically, however.

3.2 The Doctrine of Deterrence

Congressional and Treasury attempts towards improving practitioner support for the voluntary compliance system appear to both assume a valid deterrence doctrine and ignore the implications of neutralization theory. These theories offer insight into practitioner behavior. Thus, what follows is a brief review of these theories and related research.

In its simplest form the deterrence doctrine asserts: The greater the celerity, certainty, and severity of punishment, the lower the crime rate (Gibbs 1975; Cramer 1978).[3] Specifically, the objective characteristics of punishment (celerity, certainty, and severity) first affect the

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[3]The term "crime" is used loosely in this context, denoting any illegal or undesirable behavior.

individual's perceptions of punishment. Perceptions, in turn, affect deterrence, which inversely affects deviant behavior. Deterrence operates through fear of punishment and cannot be directly observed ("common sense to the contrary, we never observe someone omitting an act because of the perceived risk and fear of punishment" (Gibbs 1979)).

Researchers have suggested several elaborations to this early form of the doctrine. For example, in its earliest form no distinction existed between the objective characteristics of sanctions and perceptions of those characteristics. Deterrence, however, does not seem plausible if punishment is not perceived or the act is considered legal (Gibbs 1979). Early deterrence research also focused on the effect of enacted (legal) sanctions. However, subsequent research indicates two additional forms of punishment inhibiting undesirable behavior: (1) self-imposed (moral) and (2) group-imposed (interpersonal) sanctions.

Schwartz and Orleans (1967) obtained some of the earliest evidence suggesting the possibility of self-imposed sanctions impacting undesirable behavior. Conducted in cooperation with the IRS, their research investigated the effectiveness of enacted sanctions and appeals to conscience in increasing taxpayer compliance. Although both sanction forms yielded improvements, the gains resulting from conscience appeals were greater than those resulting from sanction threats.

Using a survey approach, Grasmick and Scott (1982) obtained evidence suggesting that both interpersonal and self-imposed sanctions contribute to deterrence beyond that of enacted sanctions. Comparing the effects of each sanction type on tax evasion, self-imposed sanctions possessed the greatest inhibition to the intent to evade taxes while the threat of enacted sanctions possessed the least. Nonetheless, the effects of all three sanction threats were significant.

Grasmick and Scott's results stand in marked contrast with Hite (1988). She obtained conflicting results concerning the importance of interpersonal sanctions to taxpayer compliance decisions. However, this may be partially due to an ineffective manipulation of peer reporting behavior. Specifically, Hite attempted to manipulate peer behavior by stating whether a "close friend" was in compliance or not. Grasmick and Scott chose to measure the threat of interpersonal sanctions by asking " 'how many of the five people you know best' they thought had committed the offense."

When Grasmick and Scott combine the differences in sanction effectiveness with results suggesting the level of the perceived threat of guilt is low, the implication is the same as that derived from Schwartz and Orleans (1967). Specifically, increased compliance could result by increasing the public's sense of moral obligation to pay taxes. A similar implication can be derived for practitioner behavior.

That is, the IRS may augment practitioner support for the voluntary compliance system by increasing the practitioner's sense of duty to it.[4] However, Tittle and Rowe (1973) found that a moral appeal may not always work. In their study an attempt to stimulate guilt in a classroom setting did not result in the expected reduction in cheating. Instead, the moral appeal may have inspired previously honest students to cheat.

In sum, the results of Schwartz and Orleans (1967), Grasmick and Scott (1982), and Tittle and Rowe (1973) clearly demonstrate that deterrence theory is far more complicated than the early deterrence doctrine. Although consistently supporting the importance of enacted sanctions, these studies also provide evidence that other sanction forms (self-imposed and interpersonal) are relevant. In addition, self-imposed and interpersonal sanctions may not be related to deterrence as enacted sanctions are. Hence, both peer-imposed and self-imposed sanctions must be considered in the current investigation into the deterring effects of enacted sanctions.

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[4]This may have been what the Treasury intended when it proposed modifications to circular 230. In this proposal the Treasury argues "[w]hile it is generally agreed that a practitioner owes a client competence, loyalty, and confidentiality, it is also recognized that a practitioner has responsibilities to the tax system as well (Treasury 1986, 29113)."

3.3 Norm Neutralisation

Tittle and Rowe's (1973) study demonstrates the limitations of a moral appeal. Neutralization theory, developed in the attempt to understand juvenile delinquency, provides one possible explanation for their results. The concept of norm neutralization is based on the notion of a before-the-fact justification process working to neutralize the potential guilt associated with violating internalized norms (Thurman et al. 1984). Once neutralized, these feelings (or self-imposed sanctions) no longer present an inhibition to behavior. Thus, individuals become more likely to engage in behavior they normally oppose.[5]

In the practitioner's context, neutralization of self-imposed sanctions supporting the practitioner's duty to the tax system may reduce the inhibition against violating this norm. The ultimate effect of neutralization may then be the perceived erosion in practitioner support for the system.

As originally envisioned, five strategies were identified through which neutralization operated (Sykes and Matza 1957). The first, "denial of responsibility," neutralizes guilt by placing the blame for behavior on forces beyond the control of the individual. "Denial of injury," the second strategy,

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[5]As originally developed, internally used neutralization techniques do not directly affect externally imposed legal or interpersonal sanctions. This implicitly assumes that behavior is affected by actual (as opposed to perceived) legal and interpersonal sanctions. To facilitate comparisons with prior research, this study maintains this assumption.

denies the existence of negative consequences to the behavior. The third strategy, "denial of the victim," argues that the victim deserved the negative consequences. "Condemnation of the condemners" neutralizes guilt by placing the blame for deviant behavior on the creators or enforcers of the unjust law. "Appeal to higher loyalties," the fifth strategy, argues for the existence of norms that are more important than those violated. Subsequently, Minor (1981) identified two other strategies: "defense of necessity" and "metaphor of the ledger." The former reduces guilt by arguing no other choice existed given the circumstances. The latter argues that in balance the individual has a good nature and need not feel guilty over the incident.

Empirical research into the validity of neutralization theory has generally focused on three issues. First, is the acceptance of neutralization strategies associated with subsequent behavior? Second, as developed by Minor (1981, 300), neutralization may only be needed by individuals with high levels of self-imposed sanctions (i.e., individuals "who have a strong bond to the conventional moral order"). Thus, is there an interactive effect between self-imposed sanctions and neutralization? Third, is neutralization causally related to subsequent behavior?

Minor (1981) investigated these issues using a sample of introductory criminology and law enforcement students. Relying on self-reported behavior for various acts including

marijuana use, cocaine use, fighting, drunk and disorderly behavior, cheating on exams, nonmarital sex, and shoplifting, he investigated the relation between the neutralization strategies and reported subsequent behavior. With regard to the first issue, Minor found a significant positive association between strategy acceptance and subsequent behavior. When he controlled for self-imposed sanctions, students with low moral sanctions were still found, albeit less frequently, to use neutralization strategies. Finally, when admitted prior behavior was controlled, participants who had previously engaged in the act, and thereby presumably would have no need for neutralization, still demonstrated a relation between strategy acceptance and subsequent behavior. Respondents who had not previously engaged in the act also demonstrated a relation, albeit to a lesser degree.

These results provide tangible evidence that neutralization techniques may have a mitigating effect on self-imposed sanctions. First, by controlling for prior behavior they suggest a non-spurious relation exists between the acceptance of neutralization excuses and subsequent behavior. Second, controlling for self-imposed sanctions only slightly affected the acceptance of neutralization strategies. Thus, these results offer little support for an interaction between feelings of guilt and neutralization. Unfortunately, methodological limitations, including a potentially biased sample of participants and subject attrition, hinder the rigor

of this test (Hamlin 1988).[6] Additionally, any generalization of these results to a population confronted with a conflict in norms, e.g., practitioners, is tenuous.

Thurman et al. (1984) extended neutralization research to taxpayer compliance by investigating the relation between anticipated tax evasion, threat of self-imposed sanctions, and the respondent's ability to neutralize this threat. Anticipated tax evasion was measured by asking respondents if they would ever fail to report income or claim undeserved deductions on their income tax return. Similarly, the threat of self-imposed sanctions was assessed by asking respondents if they would feel guilty for performing either act. The ability to neutralize was determined by asking participants if it was all right not to pay their taxes in full under several extenuating circumstances (Table 3.1). These circumstances were designed to reflect the seven neutralization strategies developed by Sykes and Matza (1957) and Minor (1981).

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[6]In particular, Hamlin (1988, 428) argues "there is conceivably a great deal of bias built into a student body taking introductory criminology... it is quite possible that a self-selection process of criminology students may explain the findings."

Table 3.1

NEUTRALIZATION STRATEGIES FOR TAXPAYER NONCOMPLIANCE

Strategy	Measure
Denial of Responsibility	It is okay to claim an undeserved tax deduction in the case where you are not really sure what the rule is.
Denial of Injury	It is not wrong to fail to report certain income since it does not really hurt anyone.
Denial of the Victim	It is not wrong to fail to claim certain income on your tax return since the government is often careless with your tax dollar.
Condemnation of the Condemners	It is not wrong to fail to report certain income on your tax return since the government passes laws which allow other people to do it.
Appeal to Higher Loyalties	It is okay to claim undeserved tax deductions or fail to report certain income when you have donated more to charities and worthy causes than you are allowed to deduct.
Defense of Necessity	It is okay not to report income since inflation requires that you hold onto every dollar possible.
Metaphor of the Ledger	It is all right to occasionally fail to report certain income or claim an undeserved tax deduction since you are generally a very loyal and law-abiding citizen.[7]

[7]Source: Thurman, St. John, and Riggs (1984).

Obtained results, similar to those found by Minor (1981), offer strong support for neutralization techniques but only tentative support for the entire theory. Although both the threat of self-imposed sanctions and the ability to neutralize were significantly related to anticipated evasion, the interaction between guilt and ability was not related. One explanation for this outcome, as discussed by the authors, is the absence of a learning effect (cheating on personal taxes is limited to one occurrence annually). If the number of opportunities for noncompliance were increased, individuals might become more adept at using neutralizing strategies. Another possible reason, however, stems from their measurement of anticipated evasion. Thurman et al. obtain (1984) data for their dependent variable by asking respondents if they would ever fail to report income or claim undeserved deductions on their income tax return. This may result in understating the number of expected noncompliers, thereby hindering the power of their test.[8]

Both of these points possess relevance for the current study. Specifically, practitioners are likely confronted with more than an annual opportunity to use neutralization strategies and, therefore, may be more adept at using them. With regard to the second point, despite the recent attention

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[8]Noncompliance, for example, may be an inadvertent result of taxpayer behavior, occurring simply because the taxpayer did not know better (Smith and Kinsey 1987).

of practitioner organizations on practitioner responsibilities, it is plausible that some practitioners may not be thoroughly cognizant of their legal responsibilities. Thus, some practitioner noncompliance may be attributable to lack of knowledge.

Hite (1989) employed a mail questionnaire to investigate the relative effectiveness of a moral appeal, an anti-neutralization appeal, and a combined moral/anti-neutralization appeal on deterring anticipated individual taxpayer evasion. Although the fundamental thrust of Hite's research is of only tangential interest, three empirical observations possess relevance for the current study. First, in contrast to Minor (1981) and Thurman et al. (1984), Hite finds evidence supporting an interaction between guilt and neutralization strategies. However, analysis suggests this interaction is not one of use/disuse depending on the level of guilt perceived, but of differing strengths of use. With regard to practitioners, the presence of an interaction between self-imposed sanction and use of neutralization strategies could significantly impact the effectiveness of enacted sanctions. If, for example, an interaction exists, the likelihood of neutralization eliminating (or reducing) the effect of self-imposed sanctions on behavior is improved, thereby also improving the likelihood of neutralization negatively impacting the effectiveness of practitioner penalties.

A second observation concerns the issue of causality. After controlling for prior behavior, neutralization strategies were still found to be relevant for both groups of taxpayers. As with Minor (1981), controlling for prior behavior tests for a casual relationship between neutralization and subsequent behavior (or, anticipated behavior). The counter argument (i.e., the relation is spurious) strikes at the most fundamental premise of neutralization theory. A third contribution concerns the differing importance of alternative neutralization strategies. Specifically, Hite finds evidence suggesting that two strategies, metaphor of the ledger and denial of responsibility, achieved preeminent importance relative to the remaining strategies. In its current form, neutralization theory fails to address the possibility of differentially important techniques. However, there is also no reason to expect techniques to be of equal importance, and intuition suggests equal importance is unlikely.

The reliability of Hite's findings can be questioned due to research design limitations. Relying on a mail questionnaire to obtain data on taxpayer compliance matters has been subject to considerable criticism (see Hessing, Elffers, and Weigel 1988; and Kerlinger 1986, 380). The principal difficulty is nonresponse bias, affecting both sample size and demographic representation.

In sum, research has not provided unequivocal support for neutralization theory. Although evidence concerning the

association between neutralization strategies and either subsequent or anticipated behavior is consistent, this evidence is weakened by methodological limitations present in each study. In contrast, the evidence concerning an interaction between guilt and neutralization strategies is not consistent. The question of causality was only empirically addressed by Minor (1981) and Hite (1989), and their results can only be considered tentative. The importance of causality, however, cannot be overstated. Hamlin (1988, 435), for example, argues that it is just as plausible for neutralization strategies to be after-the-fact rationalizations:

> The real question is: Do techniques, drawn from existing motives, really suspend moral constraints for the character prior to or after the action is committed?

The implications of norm neutralization for practitioner behavior are significant. As discussed in Section II, the practitioner is confronted with both a responsibility to the client and to the tax system. Although in most instances reconciliation of the two poses no difficulty, inevitably conflicts arise. In these events reconciliation may involve neutralization techniques leading to an erosion in practitioner support for the system. Thus, when viewing penalty effectiveness from a deterrence doctrine perspective, the presence of norm neutralization can lead to counterintuitive results.

3.4 A Model of Practitioner Decision-Making

The results of prior research, combined with the implications of neutralization theory, suggest the practitioner decision model displayed in Figure 1. Practitioner non-conformity (PNC) is dependent on six variables: interpersonal (group-imposed) sanctions supporting the tax system (GS), interpersonal sanctions supporting the client (GC), self-imposed sanctions supporting the tax system (SS), self-imposed sanctions supporting the client (SC), neutralization techniques (N), and enacted sanctions (P). Practitioner non-conformity is defined as supporting or recommending undisclosed return positions lacking substantial authority.

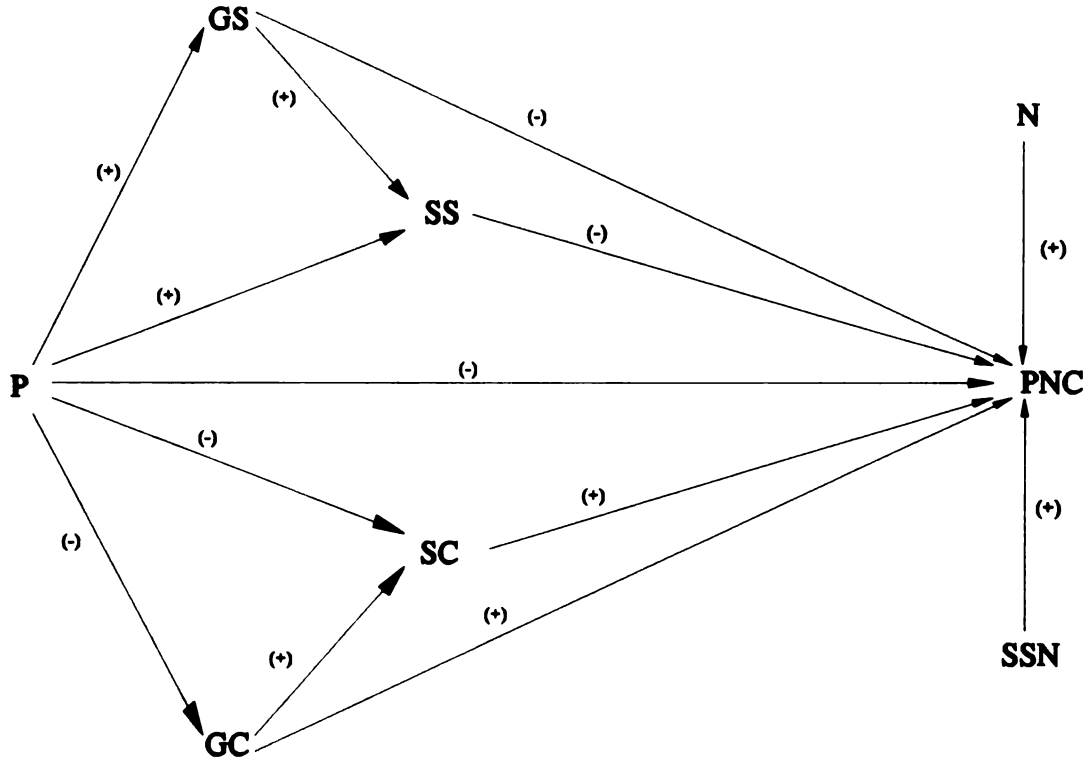

Figure 1

PRACTITIONER'S DECISION MODEL

Where:

- GS = Interpersonal Sanctions Supporting the Tax System
- SS = Self-Imposed Sanctions Supporting the Tax System
- GC = Interpersonal Sanctions Supporting the Client
- SC = Self-Imposed Sanctions Supporting the Client
- P = Enacted Penalties
- N = Neutralization
- SSN = Interaction between SS and N
- PNC = Practitioner Non-Conformity

The practitioner model embraces two potentially conflicting norms. The IRS sponsored duty to uphold the tax system is reflected in four variables (GS, P, SS, and N). The obligation to assist the client in paying no more taxes than are legally due is reflected in two variables (GC and SC). Each responsibility will be discussed in turn.

3.4.1 Duty to Uphold the Tax system

The existence of a negative relation between the three sanction forms (enacted, interpersonal, and self-imposed) and behavior is supported by many studies (Schwartz and Orleans 1967; Tittle 1980; Grasmick and Scott 1982). Consistent with these studies, the decision model predicts a negative relation between enacted (P), self-imposed (SS), and interpersonal (GS) sanctions supporting the tax system and practitioner non-conformity (PNC). The linkages between each sanction form, however, have not been subjected to extensive empirical review. Theorists suggest that societal norms must be acquired by the individual before self-imposed sanctions can become effective (Smith and Kinsey 1987). Acquisition of an internalized norm occurs by witnessing the imposition of sanctions (both enacted and interpersonal) and through interaction with other members of the profession (including training seminars, etc.). Consistent with these propositions, interpersonal and enacted sanctions are predicted to positively influence self-imposed sanctions. Finally, enacted sanctions are predicted to play a determinative (and positive)

role in the setting of interpersonal sanctions. This role is consistent with Tittle and Logan (1973), who argue that the less inviolable a particular norm is considered, the greater the importance of the enacted sanction in establishing the societal norm.

Minor (1981), Thurman et al. (1984), and Hite (1989) each find evidence supporting the relevance of neutralization techniques to behavior. According to theory, neutralization works by mitigating the effect of self-imposed sanctions on behavior. Mitigating self-imposed sanctions supporting the tax system can result in a minimum required threshold level for enacted sanctions to have an effect. Given the conflict in internalized norms, the effectiveness of neutralization techniques can only be expected to improve. Thus, neutralization is predicted to be positively related to practitioner non-conformity.

Neutralization is also expected to interact with self-imposed sanctions supporting the system. As argued by Minor (1981), neutralization should only be needed by practitioners who intensely perceive their obligation to the system. To the extent this interaction exists, neutralization's effectiveness in offsetting self-imposed sanctions should be further enhanced. Thus, the interaction is expected to be positively related to practitioner non-conformity.

3.4.2 Duty to Assist the Tax Client

Inclusion of a conflicting norm adds a unique aspect to the current study. One implication of this conflict, the potential effect on neutralization of self-imposed sanctions supporting the tax system, was mentioned above. Another implication is the possibility of a direct effect on practitioner non-conformity. To the extent the norm "duty to the tax client" has been adopted by practitioners, interpersonal and self-imposed sanctions supporting this norm are developed. Given a conflict in norms, these sanctions may work to the detriment of the competing norm (i.e., duty to uphold the tax system), further increasing the possibility of a minimum required threshold level for the enacted penalty to be effective. Hence, as can be seen in Figure 1, interpersonal (GC) and self-imposed (SC) sanctions supporting the client are predicted to be positively related to practitioner non-conformity. Also, as before the enacted sanctions are expected to play a leading role in the setting of interpersonal sanctions. Given the conflict in norms, however, the relation is expected to be negative.

3.4.3 Other Variables

Although client fees (not shown in Figure 1) are not explicitly considered in deterrence theory, the theory assumes an element of rational behavior in individuals (Smith and Kinsey 1987). This suggests the size of client fees will positively influence practitioner non-conformity. This

implication, as discussed earlier, has empirical support (Renfer 1982; Klepper et al. 1990; Reckers et al. Forthcoming). Demographic data and prior behavior (also not shown in Figure 1) have also been consistently argued and proven relevant to decisions. In particular, Renfer (1982), Ayres et al. (1989), and Jackson and Milliron (1986) have identified several demographic variables that are considered. These include age, sex, professional position, type of employer, years of experience, and participant education. Prior behavior is included in an effort to control for a spurious relation between use of neutralization strategies and practitioner non-conformity. Demographic and prior behavior variables are also considered in the regression model.

3.5 Hypotheses

The extent of practitioner responsibilities has generated considerable discussion among practitioners and Congress. The Treasury believes that an erosion in the reasonable basis standard has contributed to problems with taxpayer compliance. Hence, adhering to the tenets of deterrence theory, efforts have been expended to heighten practitioner compliance with the system by raising practitioner tax return preparation standards. The Treasury's success at achieving this objective is unclear. At least three difficulties potentially bar the Treasury from success: competing norms, neutralization strategies, and client importance.

3.5.1 Competing Norms

Smith and Kinsey (1987) argue that norms are internalized by witnessing the imposition of sanctions and through interactions with contemporaries. Given, however, the presence of a competing norm (e.g., duty to assist the tax client), interactions with peers may have the effect of reinforcing the competing norm at the expense of other norms. In the current context, the presence of the practitioner's duty to assist the client may negate support for the practitioner's responsibility to the tax system. Ultimately, this may reduce the effectiveness of penalties upholding the IRS preferred norm. Alternatively stated, interpersonal and self-imposed sanctions supporting the practitioner's duty to the client may have the effect of encouraging the practitioner to continue representing the client, even though this may violate the duty to the system. The first hypothesis, stated in alternate form, tests for this possibility:

> H1: Interpersonal and self-imposed sanctions supporting the practitioner's duty to the client are positively associated with practitioner non-conformity.[9]

3.5.2 Neutralization Strategies

The use of neutralization strategies also hinders or prevents the Treasury from successfully increasing

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[9]All subsequent hypotheses are stated in alternate form.

practitioner support for the tax system. That is, in resolving the conflict between internalized norms the practitioner employs strategies to neutralize the self-imposed sanction associated with violating the duty to the system. If extensively used, neutralization strategies mitigate the effects of sanctions supporting the tax system to result in sanctions supporting the client becoming dominant. Under these circumstances, the effectiveness of sanctions in supporting the tax system depends on their ability to overcome the positive effects on practitioner non-conformity of sanctions supporting the tax client.

Results obtained by earlier research offer implicit support for this possibility. Prior research generally has assumed a negative monotonic relation between severity of the penalty and probability of non-conformity (Tittle 1980), ignoring the possibility of a minimum required threshold. The use of neutralization strategies may require a minimum penalty in order for a deterring effect. Results nonsupportive of deterrence theory may have employed sanctions below this minimum penalty level. The following hypothesis investigates for the possibility that neutralization strategies can contribute to a threshold effect:

H2: Neutralization strategies are positively associated with practitioner non-conformity.

Note that although support of either of the above hypotheses indicates a possible threshold effect, the results will not specifically identify a threshold. Identification of a

threshold can only be obtained by comparing the total effect of sanctions supporting the tax system versus the total effect of sanctions supporting the client.

The question of a causal ordering between the use of neutralization strategies and deterrence must also be considered. Thurman et al. (1984) argue that the question of causality is resolved by using a "future-oriented variable" (e.g., anticipated behavior). However, if some unidentified third variable (e.g., prior behavior) is driving the results, then the observed results are spurious. Since research has identified prior behavior as a determinant of deterrence (Minor 1981; Hite 1989), the effect of the practitioner's prior behavior (i.e., has the practitioner been assessed a practitioner penalty before) on non-conformity must be considered:

H3: Neutralization strategies are positively associated with practitioner non-conformity after controlling for prior behavior.

3.5.3 Interactive Effect

As developed by Minor (1981), neutralization strategies should only be needed by individuals with strong bonds to the prevailing norm. Hence, only practitioners who intensely perceive their duty to uphold the tax system should possess the need to neutralize. If this relation between the practitioner's duty to the tax system and neutralization exists, the effectiveness of neutralization in offsetting self-imposed sanctions supporting the system becomes enhanced.

Thereby improving the likelihood of neutralization positively impacting practitioner non-conformity.

Empirical support for a relation between neutralization strategies and internalization of the prevailing norm, however, is contradictory. Minor (1981) and Thurman et al. (1984) failed to detect an interactive effect, whereas Hite (1989) observed an interaction inconsistent with Minor's proposition. Thurman et al. and Hite, however, focus on taxpayer noncompliance wherein the opportunities to use neutralization are limited to one occurrence annually. Practitioners confront their obligation to the tax system with considerably greater frequency. Consequently, practitioners should be more adept at using neutralization techniques. The following hypothesis investigates for an interactive effect between neutralization strategies and the practitioner's duty to support the tax system.

H4: Neutralization strategies are only used by practitioners who strongly perceive their obligation to support the tax system.

3.5.4 Client Importance and Risk Compensation

The importance of a client's fee to a practitioner may also frustrate the Treasury's efforts. Although not explicitly addressed in deterrence theory, participants are presumed to act rationally (i.e., consciously weigh the pros and cons of alternative outcomes). Thus, when confronted with the possible loss of a client and ambiguous tax laws, a

practitioner may be more aggressive in recommending positions if the client is financially valuable. Renfer (1982) and Reckers et al. (Forthcoming) lend support for this possibility. Scotchmer (1989) and Klepper et al. (1990) further raise the possibility of increased fees compensating for additional assumed risk. The fifth hypothesis of this research investigates the effect of client fees on practitioner behavior:

H5: Client importance (as measured by client fees) is positively associated with practitioner non-conformity.

Chapter Four

METHODOLOGY

The objective of this chapter is to describe the empirical procedures employed to examine the model and test the hypotheses developed in the prior chapter. Satisfaction of this objective requires three steps. First, the chapter describes the instrument employed and the measurement or manipulation of variables included in the instrument. Second, the sample selection method is described as well as the resulting respondent sample. Finally, the chapter describes procedures used to estimate directly unmeasured variables and test hypotheses.

4.1 Variable Manipulation and Measurement

The instrument consists of six sections and can be found in Appendix D. Part one begins with an introductory letter to the respondent describing the nature and purpose of the research. Part two provides a summary of the four most commonly discussed practitioner accuracy related comfort levels including: (1) reasonable basis, (2) realistic possibility of success, (3) substantial authority, and (4) more likely than not. The summary includes both a review of the history and a description of each standard. Inclusion of this section was deemed necessary to avoid a potentially confounding difficulty due to practitioner unfamiliarity with

the standards. Pre-test results of the instrument, without the summary, indicated considerable unfamiliarity with the alternative standards among respondents.

The third section ("Responsibilities Data") assesses the practitioner's perception of self-imposed and interpersonal sanctions (both those supporting the duty to uphold the tax system and those supporting the duty to assist the client). Responses were marked on five point Likert scales ranging from "Very Important" to "Very Unimportant." Two questions were asked of the respondent in order to measure the perceived interpersonal sanction for violating the duty to uphold the tax system (Table 4.1). However, instead of directly asking respondents for the importance their associates attach to upholding the tax system, respondents were asked for the importance their associates attach to only adopting positions for which substantial support exists. This surrogate was used to avoid the difficulty inherent in interpreting "duty to uphold the tax system." "Substantial support" was selected since this is the level of assurance necessary to avoid taxpayer penalties or supplemental disclosures.

Table 4.1

MEASURES OF INTERPERSONAL AND SELF-IMPOSED SANCTIONS

Duty to Uphold the Tax System	
Interpersonal Sanctions	How important does your firm consider your responsibility to only adopt tax return positions for which you have at least substantial authority?
	How important do the five practitioners you know best consider your responsibility to only adopt tax return positions for which you have at least substantial authority?
Self-Imposed Sanctions	How important do you consider your responsibility to only adopt tax return positions for which you have at least substantial authority?
Duty to Assist the Client	
Interpersonal Sanctions	How important does your firm consider your responsibility to only adopt tax return positions for which you have at least a realistic possibility of success?
	How important do the five practitioners you know best consider your responsibility to only adopt tax return positions for which you have at least a realistic possibility of success?
Self-Imposed Sanctions	How important do you consider your responsibility to only adopt tax return positions for which you have at least a realistic possibility of success?

Similarly, two questions were asked which assess the respondent's perceived interpersonal sanctions for violating the duty to assist the client (Table 4.1). Similar to the above, directly asking respondents about the importance their associates attach to assisting the tax client was abandoned in favor of the importance their associates attach to only adopting positions for which a realistic possibility of success exists. The realistic possibility standard allows the practitioner some client aggressiveness without threat of penalty. Questions assessing the threat of self-imposed sanctions were constructed similarly to those assessing interpersonal sanctions, and for similar reasons (Table 4.1). However, where uncertainty concerning the best measure of interpersonal sanctions led to the construction of two measures for each norm, prior research and pre-tests results indicated no such uncertainty exists for self-imposed sanctions.

Section three assesses the extent of norm neutralization practiced by the respondent. Responses to section three questions are marked on five point Likert scales ranging from "Strongly Disagree" to "Strongly Agree." The 14 neutralization measures were based on the seven neutralization strategies identified by Sykes and Matza (1957). Each measure is matched with its related strategy in Table 4.2.

Table 4.2

NEUTRALIZATION STRATEGY MEASURES

It is ethically acceptable for a practitioner to recommend to a client an undisclosed tax return position lacking substantial authority (but possessing a realistic possibility of success) because...

Strategy	Measure
Denial of Responsibility	Where tax law is uncertain, the recommended position should favor the client. Ultimately, it is the taxpayer's responsibility to adopt positions on the return.
Denial of Injury	If the position is contested, clarification of the law will improve subsequent voluntary compliance. By itself, a recommendation will not adversely affect voluntary compliance.
Denial of the Victim	Taxpayers who only take "IRS Approved" positions will overpay their taxes. The unfairness of the tax system already hurts voluntary compliance.
Condemnation of the Condemners	Often the IRS ignores the practitioner's duty to assist the client. The IRS is primarily interested in maximizing revenues collected.
Appeal to Higher Loyalties	The practitioner's obligation to the client takes priority over IRS preferences. The role of a tax practitioner includes more than just supporting the voluntary compliance system.
Defense of Necessity	My office needs our continuing clients. If the practitioner does not assist the client, the client may pay too much (or too little) in taxes.
Metaphor of the Ledger	The practitioner works to improve compliance and therefore need not worry over one incident. In general, tax clients comply with tax laws.

The next section is concerned with respondent experience and demographic characteristics. Experience was assessed on several levels including: (1) experience with client questions involving the substantial understatement penalty, (2) experience with clients who have been assessed a substantial understatement penalty, (3) experience of both the respondent and the respondent's office with penalties for violating the realistic possibility or reasonable basis standards, (4) respondent willingness to adopt positions that could lead to a substantial understatement penalty, (5) familiarity with AICPA Statement on Responsibilities in Tax Practice No. 1 (offering guidance concerning the adoption of tax return positions), (6) familiarity with Circular 230 (regulations governing practice before the IRS), and (7) familiarity with IRS Notice 90-20 (IRS guidance concerning the realistic possibility standard, (1990-1 C.B. 328)). Responses to each of these items were marked on four point Likert scales ranging from "Frequently" (more than eight times a year) to "Never."

Experience was also assessed in section six of the instrument, subsequent to the client description found in section five. In this final section participants were asked if they had ever been involved in a tax situation similar to that described in the preceding section. Responses were marked on a two point (yes or no) scale.

Demographic characteristics assessed include the respondent's gender, age, professional position, years of tax experience, type of employer, educational background, and willingness to take positions not satisfying the substantial authority standard. Questions assessing practitioner experience serve two purposes. First, they serve as the basis for measuring prior practitioner behavior. Second, despite Chang and McCarty's (1988) results that imply knowledge differences with respect to standards may not be material, the possibility that such differences do exist, and may impact behavior, should be considered.

Section five introduces a vignette concerning a fictitious corporate client and tax issue. This information was abstracted from an actual court case that involved several ambiguous tax issues (Danville Plywood, 16 ClsCt 584, 3/31/89).[1] The principal issues in the adapted case concern the deductibility of travel and entertainment costs incurred during a weekend sales seminar held in conjunction with the Super Bowl. The client (Panel World Inc.), who has been a client of the respondent's for several years, invited several customers to participate in this seminar. Participating customers were rewarded with all expenses paid plus two

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[1]In the actual case inadequate evidential support prevented the court from fully addressing the key issues. To circumvent this difficulty, and enable variable manipulation, respondents were informed that the client had "taken pains to scrupulously document each activity."

tickets to the Super Bowl. The specific tax issues concern the deductibility of expenses for Panel World's employees and customers, as well as for the spouses and children of both employees and customers.

Six versions of the case reflected three penalty and two fee levels. Client fees were described as significant or insignificant. Enacted penalties were severe, moderate, or mild (Table 4.3).[2] In all cases the financially strained client was described as determined to take some minimum deduction; to the point of being willing, if need be, to find another preparer willing to accede to his wishes. The client was equally adamant in his opposition to additional disclosures ("red flags"). Finally, to facilitate completion of the instrument, the vignette concludes with a discussion of the relevant tax authorities.

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[2]Although it may be argued that the taxpayer oriented Section 6662(b)(2) penalty is not a sanction against the preparer, it is also reasonable to expect, at least in some cases, an unfavorable reaction from the client against the preparer after imposition of this penalty. In addition, while more severe penalties than those found in Section 6701 exist (e.g., criminal penalties), they lie were not considered in this research.

Table 4.3

PENALTY SEVERITY LEVELS

Penalty Level	Description
Mild	Client Section 6662(b)(2) penalty (substantial understatement penalty).
Moderate	Preparer Section 6694(b) penalty (understatement attributable to willful or reckless conduct).
Severe	Preparer Section 6701 penalty (aiding and abetting an understatement of tax liability), Possible referral to the IRS Director of Practice (Circular 230), and practitioner disciplinary proceedings (Circular 230).

The dependent variable, practitioner non-conformity, was assessed by measuring the responses to eight questions reflective of the practitioner's propensity to deviate. These decision questions are listed, along with their response scales, in Table 4.4.

Table 4.4

PRACTITIONER DECISION VARIABLES

Decision Question	Response Scale
What do you believe is the probability that the IRS will allow the entire amount of the expense on audit (assuming the relevant facts are discovered during the audit)?	0% to 100%
What do you believe is the probability that the IRS will discover these facts on audit?	0% to 100%
Prior to filing the return, would you advise disclosure if the client did not impose any preconditions?	Yes/No
If you would not advise disclosure, why not?	Law is clear to Law is unclear, but I will favor the client.
The strength of authority for the entire non-disclosed deduction (including expenses for spouses and children) is sufficient to avoid a taxpayer penalty.	Strongly Agree to Strongly Disagree
I feel comfortable with not disclosing additional information on the return.	Strongly Agree to Strongly Disagree
Discontinuing the engagement would not violate my ethical standards.	Strongly Agree to Strongly Disagree
Continuing the engagement would not violate my ethical standards.	Strongly Agree to Strongly Disagree

The final section of the instrument includes several debriefing questions intended to serve as control items and alternative measures. Control items include questions assessing the (1) sufficiency of provided information, (2) realism of the described tax scenario, and (3) effectiveness of penalty manipulation. Alternate measures include questions assessing the practitioner's experience with tax situations similar to that described in the vignette, and the importance of the described client to the respondent's firm. Directly assessing the described client's importance also serves to check the effectiveness of manipulating client paid fees.

4.2 The Respondent Sample

Testing the practitioner decision model and related hypotheses requires selection of an appropriate respondent sample. An inappropriate, or biased, sample can result in misleading and incorrect inferences. Thus, steps were taken to minimize the threat of a biased sample. These steps include construction of a sample selection technique designed to minimize the threat of a non-response bias, and subsequent analysis of the participating sample to search for self-selection bias.

4.2.1 Sample Selection Procedures

Discussions with participants in a pre-test of the instrument indicated practitioner concerns regarding the sensitivity of the issues and the difficulty in making informed or knowledgeable responses. Based on these

discussions, an unusual sample selection technique was devised to both assure respondents of complete confidentiality and exploit office-specific knowledge of individuals qualified to participate. The technique involved identification of one willing participant who would coordinate the distribution of instruments to other qualified participants. Office coordinators were informed of the objective of the study and the nature of the instrument. Instruments were hand delivered or mailed to the office coordinator after the coordinator indicated both an availability of time and a willingness to participate. The number of individual case studies delivered was based on the coordinators in-house knowledge of available and qualified participants. Coordinators distributed case studies at their respective offices or at continuing education seminars. Where possible, office coordinators were limited to partners or managers. Individual participants would then return their completed questionnaires directly to the researcher using an enclosed postage-paid envelope. Follow-up calls were employed, but could only be directed to office coordinators.[3]

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[3]In addition to assuring participants of confidentiality and exploiting the coordinator's in-house knowledge of qualified participants, this technique also served to effectively obtain in-house authorization for respondent participation.

4.2.2 Respondent Characteristics

Of the 1,150 surveys distributed, 262 were returned, for a 22.8% response rate.[4] Thirty-seven of the received surveys comprised the pre-test sample, leaving a final sample of 225 participants. The median respondent was a male between 31 and 40 years of age, with 7 to 10 years of tax experience, who possessed a bachelors degree (Table 4.5, Panels C, D, E and F). Partners/Owners accounted for 34% of the sample, managers 51%, and seniors the remaining 14% (Panel B). Respondents from "Big 6" firms comprised 48% of the sample (Panel A).

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[4]Kerlinger (1973, 380) has observed that returns of this magnitude are not uncommon in research employing survey methods.

Table 4.5

RESPONDENT CHARACTERISTICS

Panel A. CPA Affiliation

	N	%
"Big 6"	109	48.4
Other National	43	19.1
Regional	30	13.3
Local	41	18.2
Other	2	.9
Total	225	100

Panel B. Position

	N	%
Owner or Partner	77	34.4
Manager	115	51.3
Senior	32	14.3
Total	224	100

Panel C. Tax Experience

	N	%
1-3 yrs.	17	7.6
4-6	55	24.4
7-10	64	28.4
11-16	49	21.8
17-24	25	11.1
>25	15	6.7
Total	225	100

Panel D. Education

	N	%
Bachelors	133	59.6
Masters	82	36.8
Doctorate	8	3.6
Total	223	100

Panel E. Age

	N	%
21-30	67	29.8
31-40	104	46.2
41-50	37	16.4
>50	17	7.6
Total	225	100

Panel F. Sex

	N	%
Male	179	79.6
Female	46	20.4
Total	225	100

Participants familiarity with guidance regarding practitioner responsibilities varied considerably. For example, while 9% regularly consider AICPA Statement on Responsibilities in Tax Practice No. 1 in their practice, 11% of the participants have never read it (Table 4.6, Panel A). Similarly, while 8% of the respondents stated they regularly consider Circular 230 in practice, 23% responded that they have never read it (Panel B). A similar distribution exists for familiarity with Internal Revenue Notice 90-20.

Table 4.6

FAMILIARITY WITH PRACTITIONER GUIDANCE

Frequency	Panel A AICPA SRTP #1		Panel B Treasury Circular 230		Panel C IRS Notice 90-20	
	N	%	N	%	N	%
Never Read	25	11.1	51	22.7	52	23.1
Reviewed Once	84	37.3	77	34.2	91	40.4
Reviewed More Than Once, But Not Often	95	42.2	80	35.6	65	28.9
Regularly Used in Practice	21	9.3	17	7.6	17	7.6
Total	225	100	225	100	225	100

Diversity was also evident in participant experience with penalties. When asked about the frequency with which the practitioner engaged in discussions with clients involving the substantial understatement penalty, 45.3% responded that such discussions occurred with some regularity (at least 4 times a year), 47.6% responded that they occurred somewhat less frequently (1 to 3 times per year), and 7.1% stated that they never participated in such discussions (Table 4.7). The results for the follow-up question addressing discussions with other practitioners indicates that these discussions occur with less frequency than client discussions. However, considerable diversity still exists. This diversity all but disappeared, however, when asked how often the participant, or the participant's office, had been assessed a penalty for violating the realistic possibility (or reasonable basis) standard. At least 87% stated that neither they nor their office had ever been assessed a penalty.

Table 4.7

PENALTY EXPERIENCE

	Frequency Per Year				
	Never	1 to 3 times	4 to 8 times	> 8 times	Total
Client Discussions Involving Substantial Understatement Penalty	16 (7.1)[5]	107 (47.6)	72 (32.0)	30 (13.3)	225 (100)
Practitioner Discussions Involving Substantial Understatement Penalty	50 (22.2)	97 (43.1)	56 (24.9)	22 (9.8)	225 (100)
Willingness to Assume Positions Possibly Leading to a Penalty	81 (36.2)	123 (54.9)	17 (7.6)	3 (1.3)	224 (100)
Returns for Clients Who Have Been Assessed a Substantial Understatement Penalty	155 (70.1)	55 (24.9)	7 (3.2)	4 (1.8)	221 (100)
Office Penalties for Lacking Realistic Possibility or Reasonable Basis	169 (87.6)	23 (11.9)	1 (0.5)	0 (0)	193 (100)
Respondent Penalties for Lacking Realistic Possibility or Reasonable Basis	221 (98.2)	4 (1.8)	0 (0)	0 (0)	225 (100)

[5]Number of Responses (Percentage of Total Responses)

Perhaps the most insightful response involves the frequency with which respondents are willing to adopt positions that could lead to a penalty if audited. Although 36.2% stated they would never be willing to adopt such positions, a minority (8.9%) were willing to take such positions at least 4 times annually. Over 54% of the respondents were willing to take the risk from 1 to three times per year. Thus it appears that although a relatively aggressive minority of practitioners exists, the majority are willing to incur the risk at least occasionally.

In summary, respondent demographic characteristics offer no evidence of a self-selection bias. In contrast, the data indicate that participants possess considerable diversity in experience with tax practice, penalties, and practitioner guidance. As will be seen later, this diversity contributes extensively towards explaining practitioner behavior.

4.3 Statistical Procedures and Hypothesis Testing

Data analysis proceeded in three steps. First, confirmatory factor analysis was used to estimate two directly unmeasured variables: practitioner non-conformity and neutralization. Second, both forward and backward stepwise analysis were employed to identify the optimal decision model. Additional variables considered include firm affiliation, professional position, years of tax experience, education, age, gender, familiarity with practitioner guidance, client importance

(both measured and manipulated), penalty experience, and experience with similar tax situations. Finally, the resultant optimal equation was used to investigate each hypothesis. Analysis of each hypothesis proceeded as follows.

The first hypothesis predicted that as the severity of sanctions supporting the practitioner's duty to the client increased, practitioner non-conformity, defined as supporting or recommending undisclosed positions lacking substantial support, would also increase. Testing this hypothesis required (1) identifying the optimal estimation of practitioner non-conformity, and (2) investigating the relation between sanctions supporting the duty to the client (both interpersonal and self-imposed) and the dependent variable practitioner non-conformity. Significantly negative relations, assessed via t-statistic, are consistent with the hypothesis.

The second hypothesis investigates a de minimis requirement for neutralization strategies to result in a threshold effect. That is, unless the use of neutralization strategies is significantly negatively related to practitioner non-conformity, then use of these strategies cannot contribute to non-conforming behavior. In order to test this hypothesis, however, neutralization strategy usage, an unmeasured variable, must be estimated via factor analysis. Similar to the prior hypothesis, the significance of the relation between neutralization and practitioner non-conformity is assessed via

t-statistic. Hypothesis three seeks to eliminate the possibility of incorrect causal ordering. Although it is not possible to prove a causal ordering, it is possible (and necessary) to eliminate the most plausible alternatives. If a correct ordering has been posited above, then controlling for prior behavior should have no effect on the use of neutralization strategies or their relation with practitioner non-conformity.

The fourth hypothesis tests the theoretical proposition that only those practitioners who intensely perceive their obligation to the tax system use neutralization strategies. Testing this hypothesis requires two steps. First, the significance of a neutralization by self-imposed sanction supporting the tax system interaction variable is tested via t-statistic. If the relation is significant, the respondent sample is divided into two subsamples. The first subsample includes respondents who do not perceive a strong obligation to the tax system. The second subsample includes respondents who do perceive a strong obligation to the tax system. The relation between neutralization and practitioner non-conformity is then investigated in both subsamples. The theoretical proposition suggests that neutralization is significantly related to practitioner non-conformity in the second subsample only.

Hypothesis five seeks to investigate the possibility of a relation between client importance, as measured by client

fees, and non-conforming behavior. If the model developed is accurate, then client fees are significantly positively related to practitioner non-conformity. As with the prior hypotheses, significance is determined via t-statistic.

Chapter Five

ANALYSIS OF RESULTS

Chapter five reviews and analyzes the results of the statistical procedures employed in this study. The chapter consists of three sections. Section one presents and summarizes the results of factor analysis on two variables: practitioner non-conformity and neutralization. In the second section results obtained during hypothesis testing are presented and summarized. Section three discusses the implications of all regression model results on the practitioner's decision model and the questions posed at the outset of this research.

5.1 Factor Analysis

Confirmatory factor analysis was used to estimate two variables: practitioner non-conformity and neutralization. Eight decision variables were used in an effort to estimate practitioner non-conformity (Table 4.4). After eliminating items that did not satisfy standards of internal consistency or parallelism, three items remained. Further difficulties with measurement error forced a subsequent reduction to one item. This item, "Continuing the engagement would not violate

my ethical standards," was used as the measure of practitioner non-conformity for all subsequent analyses.[1]

Of the fourteen items devised to estimate the use of neutralization strategies (Table 4.2), six, representing three neutralization strategies, remained (Table 5.1). Thus, responding practitioners demonstrated a preference for three neutralization strategies: denial of responsibility, defense of necessity, and appeal to higher loyalties. In contrast, Hite (1989) obtained evidence suggesting two strategies (metaphor of the ledger and denial of responsibility) were of preeminent importance to taxpayers. This difference may be attributable to different sample populations (taxpayer vs. practitioner behavior). The lack of theoretical guidance, however, reduces further interpretation to conjecture.

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[1]Descriptive statistics for all variables are in Appendix C.

Table 5.1

NEUTRALIZATION FACTOR LOADINGS

Strategy	Measure	Loading
Denial of Responsibility	Where tax law is uncertain, the recommended position should favor the client.	.3813
	Ultimately, it is the taxpayer's responsibility to adopt positions on the return.	.4714
Defense of Necessity	If the practitioner does not assist the client, the client may pay too much (or too little) in taxes.	.3932
	My office needs our continuing clients.	.3640
Appeal to Higher Loyalties	The practitioner's obligation to the client takes priority over IRS preferences.	.4427
	The role of the practitioner includes more than just supporting the voluntary compliance system.	.3865

5.2 Tests of Hypotheses

The regression model used to investigate hypotheses one and two (Model 1) can be found in Table 5.2. This model includes all practitioner decision model variables (as depicted in Figure 1) plus experience with similar tax situations (EXP), client importance (IMP), penalty experience (PEN), and practitioner education (EDUC).[2] All other demographic variables (respondent's age, firm affiliation, professional position, gender, and familiarity with practitioner guidance) were not significantly associated with practitioner non-conformity.

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[2]Appendix B summarizes the variables used in this chapter.

Table 5.2

REGRESSION MODELS

Model 1	Coefficient		
Variable	b_i	β_i	t
β_0	1.5012		2.03**
SS	-0.2287	-0.2647	1.66*
GS	-0.0056	-0.0063	0.04
SC	0.1760	0.1622	0.83
GC	-0.0751	0.0780	0.36
N	0.3401	0.6585	2.84**
SSN	-0.0759	-0.5128	2.17**
EXP	0.4629	0.2311	2.72**
IMP	0.4688	0.2076	2.50**
PEN	0.2516	0.2394	2.83**
EDUC	-0.2762	-0.1562	1.91*
P	-0.0026	-0.0021	0.02

Adjusted R^2 = 0.1982 F(p<) = 5.599 (0.0000)

Model 2	Coefficient		
Variable	b_i	β_i	t
β_0	1.6934		2.95**
SS	-0.218	-0.2522	3.15**
N	0.3294	0.6378	2.83**
SSN	-0.0691	-0.5019	2.18**
EXP	0.4942	0.2467	3.03**
IMP	0.5404	0.2393	2.98**
PEN	0.2472	0.2351	2.86**
EDUC	-0.2616	-0.1479	1.86*

Adjusted R^2 = 0.2094 F(p<) = 8.152 (0.0000)

** significant at .05
* significant at .10

As is apparent from the relevant t-statistics, neither interpersonal (GC) nor self-imposed (SC) sanctions supporting the client are significantly associated with practitioner non-conformity. Thus, no support exists for hypothesis one. Interpersonal and self-imposed sanctions supporting the client do not encourage the practitioner to violate the duty to the tax system. Neutralization (N), self-imposed sanctions supporting the tax system (SS), and the interaction between neutralization and self-imposed sanctions supporting the practitioner's duty to the tax system (SSN), however, are significantly associated with practitioner non-conformity. Thus, hypothesis two, which predicts a positive association between neutralization and practitioner non-conformity, is supported.

As discussed in Chapter 3, the existence of a significantly positive association between neutralization and practitioner non-conformity raises the possibility that neutralization strategies may lead to a penalty threshold effect. Identification of a threshold's existence, however, requires comparing the total effect of sanctions supporting the client versus the total effect of sanctions supporting the tax system. This comparison is discussed below in conjunction with regression model 2.

Model 2 (Table 5.2) displays the resulting re-estimation of model 1 after eliminating variables not significantly associated with practitioner non-conformity. In addition to

the neutralization, self-imposed sanction, and interaction terms, several other variables remain significantly associated with practitioner non-conformity. These variables include situation specific experience (EXP), client importance (IMP), penalty experience (PEN), and respondent education (EDUC). All four terms are measured variables. Note, specifically, that client importance does not represent client fees. As shown in Model 4 (Table 5.3), no support exists for a positive association between fees and practitioner non-conformity. Thus, hypothesis 5 is not supported. In model 2, three of the four additional variables are positively associated with practitioner non-conformity (EXP, IMP, and PEN). One variable (EDUC) is negatively associated with the dependent variable. Summing the standardized coefficients found in Model 2 indicates that the total effect of variables supporting the client exceeds the total effect of variables supporting the tax system. Thus, support is found for the existence of a penalty threshold effect.

Table 5.3

REGRESSION MODELS

Model 3	Coefficient		
Variable	b_i	β_i	t
B_0	1.8579		3.45**
SS	-0.2063	-0.1948	2.60**
N	0.2794	0.4416	2.09**
SSN	-0.0661	-0.3919	1.80**
EXP	0.6664	0.2716	3.56**
IMP	0.5377	0.1944	2.53**
Adjusted R^2 = 0.1560	F(p<) = 6.547	(0.0000)	

Model 4	Coefficient		
Variable	b_i	β_i	t
β_0	1.6641		2.75**
SS	-0.2172	-0.2027	3.12**
N	0.3294	0.5142	2.82**
SSN	-0.069	-0.4043	2.17**
EXP	0.4938	0.1988	3.02**
IMP	0.5341	0.1907	2.87**
PEN	0.2469	0.1893	2.84**
EDUC	-0.2662	-0.1195	1.86*
FEE	0.0258	0.0104	0.16
Adjusted R^2 = 0.2094	F(p<) = 8.152	(0.0000)	

** significant at .05
* significant at .10

The possibility of an incorrect causal ordering (H3) is assessed in Model 3 (Table 5.3). This model represents the re-estimation of model 2 after eliminating from the sample those respondents who admitted to at least one personal or office penalty assessment. As can be seen by viewing the t-statistics for N in both models, neutralization remains significantly positively associated with practitioner non-conformity. Thus, hypothesis three is supported and neutralization does not appear to be spuriously related to practitioner non-conformity.

Models five and six (Table 5.4) address the differing use of neutralization strategies by practitioners. Based on the respondent's self-imposed sanction supporting the tax system (SS), the participant sample was further divided into two sub-samples. Model five is the estimated regression equation for respondents with relatively low self-imposed sanctions supporting the tax system ("Unimportant" or "Very Unimportant"). Model six is based on respondents with relatively high self-imposed sanctions supporting the tax system ("Important" or "Very Important"). Respondents who marked "Neutral" on the five point Likert scale measuring the sanction were not included in these tests.

Table 5.4

REGRESSION MODELS - DIVIDED SAMPLE

Model 5	Coefficient		
Variable	b_i	β_i	t
β_0	0.9565		0.62
LSS	-0.2091	-0.0773	0.44
N	0.2285	0.3658	2.33**
EXP	0.5033	0.2026	1.17
IMP	0.4419	0.1578	0.85
PEN	0.3302	0.2532	1.63
EDUC	0.0180	0.0082	0.05

Adjusted R^2 = 0.1412 F(p<) = 3.433 (0.0080)
N = 84

Model 6	Coefficient		
Variable	b_i	β_i	t
β_0	2.588		2.45**
HSS	-0.4844	-0.1844	2.38**
N	-0.0032	-0.0050	0.06
EXP	0.5872	0.2364	2.95**
IMP	0.5794	0.2069	2.62**
PEN	0.3195	0.2451	2.98**
EDUC	-0.3779	-0.1723	2.16**

Adjusted R^2 = 0.1717 F(p<) = 5.808 (0.0001)
N = 138

** significant at .05
* significant at .10

Of particular interest in these regression models is the significance of neutralization. Specifically, although neutralization is significantly associated with practitioner non-conformity for respondents who considered the self-imposed sanction unimportant, it is not significantly associated for respondents who considered the sanction important. This directly contradicts hypothesis four, which predicted neutralization strategies would be used by those practitioners who strongly perceive their obligation to support the tax system.

5.3 Model Evaluation

Figure 2 displays the original practitioner's decision model and observed correlation coefficients.[3] Comparing the observed correlation coefficients with the predicted relations found in Figure 1 results in only mixed support for the decision model. Specifically, while all but one correlation is of the correct sign, only seven correlations are significantly different from zero.

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[3]A table of simple correlations for all measured and manipulated variables can be found in Appendix A.

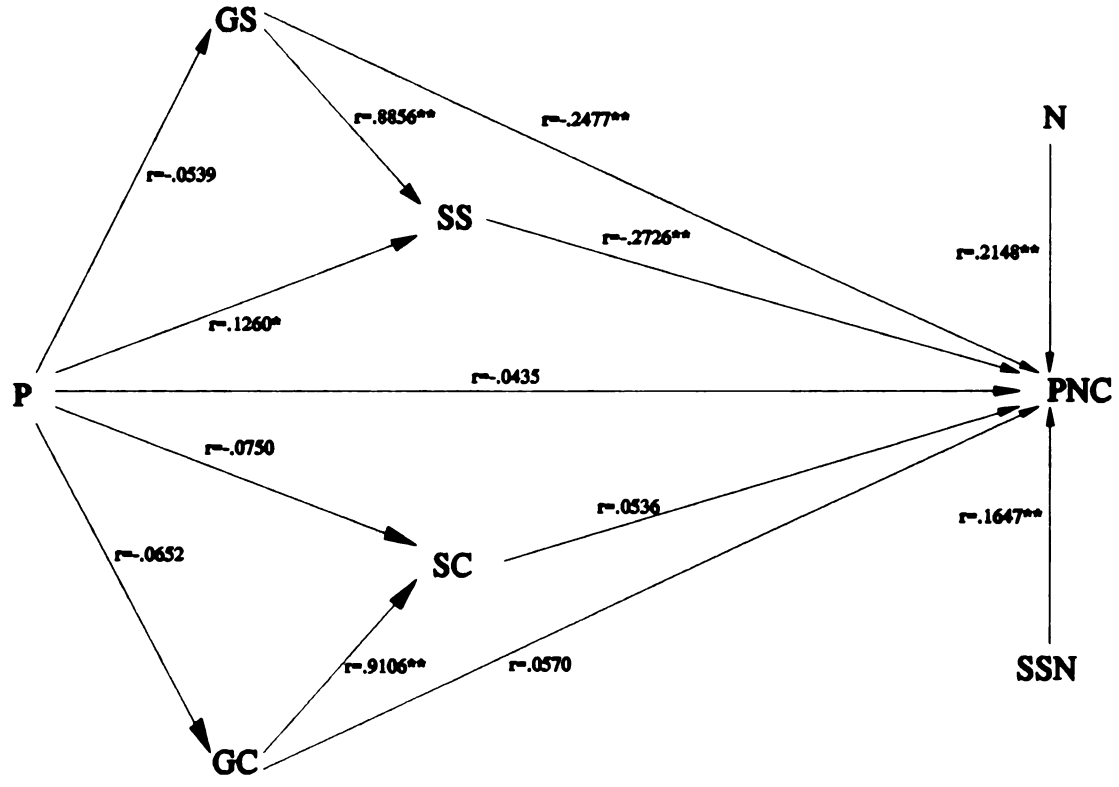


Figure 2

DECISION MODEL CORRELATION COEFFICIENTS

** significant at .05
* significant at .10

Where:
GS = Interpersonal Sanctions Supporting the Tax System
SS = Self-Imposed Sanctions Supporting the Tax System
GC = Interpersonal Sanctions Supporting the Client
SC = Self-Imposed Sanctions Supporting the Client
P = Enacted Penalties
N = Neutralization
SSN = Interaction between SS and N
PNC = Practitioner Non-Conformity

The results evident in Tables 5.2 through 5.4 also offer only mixed support for the practitioner's decision model developed above. Consistent with this model is the negative association between practitioner non-conformity (PNC) and self-imposed sanctions supporting the tax system, and the positive association between practitioner non-conformity and neutralization. Evidence inconsistent with the decision model includes an insignificant association between interpersonal and self-imposed sanctions supporting the client and the dependent variable, and a similarly insignificant association between enacted sanctions and PNC.

Perhaps the most puzzling result, however, is the interaction between neutralization and self-imposed sanctions supporting the tax system. Although the existence of an interactive effect is consistent with Minor's (1981) development of neutralization theory, the results found in Table 5.4 do not support the proposition that only those who strongly perceive an obligation to comply with the system will have a need to neutralize. In contrast, the results suggest that neutralization is irrelevant to those who perceive the greatest obligation to the tax system.

One possible explanation, first raised by Thurman et al. (1984), is the existence of a learning effect (i.e., neutralization may be a learned skill). With regard to taxpayers, Thurman et al. argued that the relative infrequency with which taxpayers complete their tax returns suggests a

lack of skill in using neutralization strategies, thereby contributing to a lack of an observed interaction between neutralization and self-imposed sanctions. Practitioners, in contrast, confront their obligation to the tax system with considerably greater frequency. As a result, practitioners are so adept at using neutralization strategies that the strategies are already internalized, thereby offsetting any perceived obligation to support the tax system. This explanation, however, is inconsistent with Hite (1989), who found a stronger association between neutralization and anticipated behavior for inexperienced neutralization users (taxpayers) who perceived a lower obligation to the system.

Obtained results also suggest that neither client fees nor enacted sanctions (at least for the ranges of fees and sanctions tested here) influence practitioner behavior. This conclusion, however, must be interpreted with caution since precisely the same result would be expected for an ineffective manipulation. Evidence supporting this latter point can be found in the questions asked respondents in the final section of the instrument.

In the final section, questions were asked specifically to ascertain the effectiveness of manipulations in the instrument. Two questions in particular inquired "[d]id you consider the potential Internal Revenue Code penalty severe or mild?" and "[a]ssuming the case was real, would [the client] be an important client to your firm?" The correlation

coefficient between the responses to the first question and the manipulated penalty is .1086. The correlation coefficient between the second response and client fee is -.1147. Both clearly suggest manipulations were ineffective. Finally, further insight can be gleaned from a comment made by a participant confronted with the threat of a moderate penalty. This particular respondent stated that he did not feel the enacted penalty to be as threatening as the possibility of being placed on the IRS's "watch list."

Several other conclusions from these tests can be drawn by considering the standardized regression coefficients in regression model 2 (Table 5.3). For each variable the coefficient is quite small, and in conjunction with the small R^2 statistic (Adjusted R^2 = .2094) they strongly suggest other factors (outside the scope of this study) impact practitioner decisions. However, accepting this as indisputable, several other observations are pertinent.

First, the standardized regression coefficient for neutralization (N) is more than twice the size of the coefficient for the practitioner's duty to the tax system (SS) (Table 5.2, Model 2). Given the insignificance of enacted sanctions, this suggests the possibility of a threshold effect stemming from neutralization. Second, client importance (IMP), practitioner situation specific experience (EXP), and penalty experience (PEN) are similarly positively associated with non-conformity, and possess far greater effect than the

negatively associated educational effect (EDUC). This furthers supports the existence of a threshold effect. Together, these observations suggest that the practitioner's obligation to support the tax system (consistently espoused by the IRS), is not extremely constraining on the practitioner.

A final intriguing result concerns the significant positive association between penalty experience and practitioner non-conformity. Taken to the extreme, this suggests that the more experienced the practitioner becomes with threatened penalties (both taxpayer and preparer), the more aggressive (s)he becomes. Although this result is consistent with Chang and Schultz (1989), we must first concede that enacted sanctions are ineffectual, otherwise such a conclusion in counterintuitive.

Chapter 6

CONCLUSIONS

The evidence obtained in this dissertation supports the existence of thresholds in penalty effectiveness. These thresholds result, at least in part, from the use of neutralization strategies. Evidence also suggests that neutralization strategies may facilitate the reconciliation of conflicting practitioner norms, although a direct measure of the practitioner's obligation to assist the client was not found. The existence of an interaction between neutralization and self-imposed sanctions is also supported. However, it is unclear whether neutralization is most useful to practitioners who feel less obligated to the tax system or if neutralization was internalized prior to measuring self-imposed sanction supporting the tax system. Evidence is not found supporting the importance of fees or legal sanctions. Finally, the evidence most strongly supports the conclusion that other unidentified variables also impact the practitioner's decision not to conform.

Every research endeavor, especially those that seek to explore largely undiscovered areas of knowledge, suffers from limitations. This study is no exception. One such limitation follows from the simplified relation assumed to exist between the taxpayer and practitioner. Most importantly, the relation allowed in this study does not permit personal interactions.

Thus, generalizations of obtained results to actual client/practitioner relations are tentative at best. Another limitation stems from the sample of practitioners participating in this study. In an effort to increase the response rate, direct contact with practitioners was selected over an anonymous mailing. Unfortunately, this resulted in a sample of participants heavily biased towards the "big 6" CPA firms. Whether these results are generalizable to a more representative sample of practitioners is unknown. Finally, the existence of a non-response bias cannot be ruled out. However, demographic data shows no clear bias in the participant sample.

The true value of a research study may be in its ability to raise more questions than answers. In this respect, the current work is quite successful. Unanswered questions include, for example, the validity of the decision model derived herein. While several relations predicted by the model were not confirmed, it is eminently possible that these results may be due to inadequate measures. The decision model was derived from deterrence and neutralization theories. Both theories have been supported in other, occasionally conflicting, research. Thus, further research into this decision model must be pursued.

Additional unanswered questions include the precise meaning of "client importance." It can be concluded from this research that it is, at least partially, measured by client

fees. But, other aspects of importance should be explored. For example, is importance relative to the practitioner? What role does the identity of the client (corporate, individual, or other) play? Does importance depend on the practitioner's perception of the client's need for professional assistance? The role of penalty experience in practitioner decisions is also puzzling. The positive association between penalty experience and practitioner non-conformity suggests familiarity breeds indifference, or even aggressiveness. The counter-intuitive nature of this result demands corroboration.

Finally, the observed interaction between neutralization and self-imposed sanctions supporting the tax system counters theoretical expectations. Although the possibility of a learning effect is plausible, replication is necessary to verify this explanation. Interestingly, Hite (1989) obtained similar results with a respondent sample where such a learning effect is improbable (i.e., taxpayers).

To conclude, the increasing IRS attempts to improve practitioner compliance with IRS objectives represent a dramatic shift from earlier years. The consequences of these attempts must be determined if we are to understand the behavior of practitioners, and the environment within which they operate.

APPENDICES

Appendix A

SIMPLE CORRELATIONS

	PNC	N	SS	GS1	GS2	SC	GC1	GC2
PNC[1]	1.00							
N	.214	1.00						
SS	-.273	-.041	1.00					
GS1	-.247	-.051	.855	1.00				
GS2	-.276	-.063	.837	.861	1.00			
SC	.054	.013	.059	.043	.041	1.00		
GC1	.057	.001	.023	.045	.026	.911	1.00	
GC2	.037	-.041	.078	.072	.155	.829	.842	1.00
P	-.044	-.105	-.126	-.054	-.027	-.075	-.065	-.115
FEE	.093	-.017	-.068	-.123	-.156	.011	-.002	-.076
PEN	.279	.143	-.200	-.217	-.187	.010	.031	.024
EXP	.199	.019	-.086	-.046	-.040	.052	.098	.026
IMP	.195	.100	-.018	-.033	-.071	.025	.015	-.058
EDUC	-.065	.116	-.029	-.043	-.043	.117	.086	.080
SSN	.165	.926	-.038	-.034	-.058	.054	.044	-.002

	P	FEE	PEN	EXP	IMP	EDUC	SSN
P	1.00						
FEE	.052	1.00					
PEN	.040	.034	1.00				
EXP	-.159	.060	.103	1.00			
IMP	-.030	.232	.024	.049	1.00		
EDUC	.037	.044	.042	.117	.004	1.00	
SSN	-.061	-.018	.139	.053	.119	.085	1.00

[1]See Variable Summary (Appendix B).

Appendix B

VARIABLE SUMMARY

Var.	Description	Def.	Instr. Ref.
PNC	Practitioner Non-Conformity	Ms[1]	V,8[2]
N	Neutralization	F[3]	III,7-20
SS	Self-Imposed Sanction Supporting the Tax System	Ms[4]	III,3
LSS	Low Self-Imposed Sanction Supporting the Tax System	Ms[5]	III,3
HSS	High Self-Imposed Sanction Supporting the Tax System	Ms[5]	III,3
GS1	Interpersonal Sanction Supporting the Tax System	Ms[4]	III,1
GS2	Interpersonal Sanction Supporting the Tax System (alternate)	Ms[4]	III,2
SC	Self-Imposed Sanction Supporting the Client	Ms[4]	III,6
GC1	Interpersonal Sanction Supporting the Client	Ms[4]	III,4
GC2	Interpersonal Sanction Supporting the Client (alternate)	Ms[4]	III,5
P	Enacted Penalty	Mp[6]	V
FEE	Client Paid Fee	Mp[6]	V

Appendix B

VARIABLE SUMMARY (cont'd)

Var.	Description	Def.	Instr. Ref.
PEN	Penalty Experience	Ms[4,7]	IV,3&4
EXP	Situation Specific Experience	Ms[4]	VI,5
IMP	Client Importance	Ms[4]	VI,6
EDUC	Respondent Education	Ms[4]	IV,15
SSN	Interaction Between N and SS	[8]	

[1]Measured variable (Ms). See Chapter 5, Section 1.

[2]Instrument Section, Item Number (See Appendix D).

[3]Factor variable (F) measured by factor scores. See Chapters 4 and 5.

[4]Measured variable (Ms). See Chapter 4, Section 1.

[5]Variable extracted from SS. See Chapter 5, Section 2.

[6]Manipulated variable (Mp). See Chapter 4, Section 1.

[7]Represents the sum of Items 3 and 4, Instrument Section 5.

[8]Represents the product of SS and N.

Appendix C

DESCRIPTIVE STATISTICS

Var.	Mean	Std. Dev.	95% Confidence Interval	
			Lower	Upper
PNC	2.971	1.240	2.802	3.140
N	0.000	1.936	-0.256	0.256
SS	3.586	1.157	3.433	3.739
LSS	1.711	0.458	1.573	1.849
HSS	4.362	0.482	4.281	4.444
GS1	3.611	1.117	3.463	3.759
GS2	3.399	1.065	3.257	3.541
SC	4.427	0.921	4.305	4.550
GC1	4.395	0.943	4.270	4.521
GC2	4.227	0.899	4.106	4.347
P	2.031	0.826	1.923	2.140
FEE	1.524	0.500	1.459	1.590
PEN	3.114	0.951	2.987	3.240
EXP	1.455	0.499	1.387	1.523
IMP	1.734	0.443	1.674	1.795
EDUC	1.439	0.565	1.365	1.514
SSN	0.058	7.265	-1.024	0.907

Appendix D

SURVEY INSTRUMENT

The Conflict in Practitioner Responsibilities: A Research Study

Conducted by

Geoffrey J. Gurka
Ph.D. Student

Michigan State University
Graduate School of Business Administration
Department of Accounting
Eppley Center
East Lansing, MI 48824-1121

All responses to this questionnaire will be kept strictly confidential and anonymous. Should you have any questions about the survey, please call: (517) 355-7486

Appendix D (cont'd)

The Conflict in Practitioner Responsibilities:
A Research Study

Dear Practitioner:

Before enactment of the 1989 Omnibus Budget Reconciliation Act the Treasury interpreted a practitioner's obligation to support the voluntary compliance system as requiring practitioner verification that all adopted undisclosed tax return positions possess "substantial authority." Practitioners, however, also possess a responsibility to assist the client. This responsibility, as interpreted by the AICPA, only requires a "realistic possibility of success" for undisclosed return positions. The duality in practitioner standards raised the possibility of a conflict between the practitioner's obligation to the system versus his responsibility to the client.

In 1989, the Omnibus Budget Reconciliation Act substantially revised practitioner responsibilities in the voluntary compliance system. Consistent with the standards of the accounting profession, tax law now requires practitioners to verify that adopted undisclosed return positions possess a "realistic possibility of success" (section 6694(a)). However, taxpayers are still required to disclose all positions not satisfying the "substantial authority" standard.

This research investigates the tradeoff between practitioner responsibilities to the client and to the tax system. The instrument enclosed consists of five sections. The first section provides a brief summary of the four practitioner accuracy-related comfort levels currently under debate. Sections two and three assess your role in this conflict and tax experience. Section four presents a hypothetical case involving the deductibility of entertainment expenses. Assume you are the preparer in this case. Information is also provided regarding relevant tax authorities. The client and tax authority information in this section is necessarily brief, and is not intended to mislead. After this, questions are asked based on the case. The questions have no predetermined answer. In addition, you are encouraged to refer to the case as needed. The final section assesses the completeness and clarity of the client information.

Appendix D (cont'd)

All information obtained will be strictly confidential and anonymous. Results will be presented only in summary form. The information requested in part two is intended to provide a basis for comparison between groups of respondents.

Only partners/owners, managers, or seniors who are frequently involved in client tax matters should respond to this survey. By completing and returning this questionnaire you indicate your voluntary agreement to participate in this study. You will need an estimated 30 to 45 minutes to complete this task.

If possible, please complete and return by December 15, 1990.

Thank you for your assistance.

Sincerely,

Geoffrey J. Gurka
Michigan State University

Appendix D (cont'd)

Practitioner Accuracy-Related Standards

Recent discussion concerning practitioner support for the voluntary compliance system has focused on four accuracy-related assurance levels:

Reasonable Basis

The 1989 Omnibus Budget Reconciliation Act repealed the practitioner's "reasonable basis," or negligence, standard of former IRC section 6694(a) (understatement of a taxpayer's liability by a return preparer due to negligent disregard of rules and regulations). That standard required prudent and reasonable conduct from a practitioner and was more easily met than the three standards discussed below. Violation of the "reasonable basis" standard, if penalized, resulted in a $100 penalty.

Dissatisfaction with the effectiveness of the reasonable basis standard in promoting the practitioner's duty to support the voluntary compliance system led the Treasury to advocate a new, stricter standard. In proposed revisions to Circular 230 (Treasury Department's Proposed Modification of Regulations Governing Practice before Internal Revenue Service 1986), the Treasury argued that the standard had "eroded" in recent years resulting in taxpayer compliance problems. Hence, the Treasury advocated replacing "reasonable basis" with "substantial authority." However, the 1989 act did not adopt the "substantial authority" standard. Instead, the "realistic possibility of success standard" was enacted.

Realistic Possibility of Success

The "realistic possibility of success" standard became the standard of practitioner conduct with the enactment of new IRC section 6694(a) in 1989. As stated in the House Ways and Means Committee report, this standard was adopted "because it generally reflects the professional conduct standards applicable to lawyers and certified public accountants." Violation of this standard can result in a $250 practitioner penalty. While Congress did not provide a definition for this standard, the IRS has indicated a one-in-three likelihood of success will be considered a realistic possibility (Notice 90-20). This likelihood, however, is not established as the minimum acceptable.

Appendix D (cont'd)

In contrast, the AICPA believes that the "realistic possibility" standard cannot be expressed in terms of percentage odds. Instead, it defines the "realistic possibility" standard as "a good faith belief that the [tax return] position [being recommended] has a realistic possibility of being sustained..." (Statement on Responsibility in Tax Practice (1988 Rev.) No. 1). Whichever definition is applied, the new standard is considered stricter than the previous "reasonable basis" standard, but not as strict as either the "substantial authority" or "more likely than not" standards.

Substantial Authority

The taxpayer substantial understatement penalty (IRC Sec. 6662(b)(2)) establishes the "substantial authority" standard. This standard never applied to practitioner conduct, although it had been proposed. Instead, the "substantial authority" standard applies to the taxpayer for undisclosed positions adopted on the return by the taxpayer . Practitioners are free to recommend (and prepare) return positions that do not possess substantial support, unless, of course, the recommended position also fails the "realistic possibility" standard. The taxpayer penalty for not disclosing return positions lacking substantial authority is 20% of the amount of the substantial understatement.

No definition exists for "substantial authority." Regulation section 1.6661-3(b)(1) states only that "[t]here is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions." With regard to the other standards of conduct, however, Regulation section 1.6661-3(a)(2) specifies that the standard is stricter than "reasonable basis," but not as strict as "more likely than not."

More Likely Than Not

The "more likely than not" standard represents the strictest standard advocated by the IRS to date (Executive Task Force for Internal Revenue Commissioner's Penalty Study). This standard requires something more than a 50% likelihood of success. If enacted as proposed, violation would result in a $100 penalty.

Appendix D (cont'd)

Responsibilities Data

Use the following scale when responding to questions 1 through 6:

Very Important	1
Somewhat Important	2
Neutral	3
Somewhat Unimportant	4
Very Unimportant	5

If you are uncertain of any response, please leave it blank.

	(CIRCLE ONE FOR EACH)				
	Very Important		**Neutral**		**Very Unimportant**
1. How important does YOUR FIRM consider your responsibility to <u>only</u> adopt tax return positions for which you have at least SUBSTANTIAL AUTHORITY? . . .	1	2	3	4	5
2. How important do the FIVE PRACTITIONERS YOU KNOW BEST consider your responsibility to <u>only</u> adopt tax return positions for which you have at least SUBSTANTIAL AUTHORITY? . . .	1	2	3	4	5
3. How important do YOU consider your responsibility to <u>only</u> adopt tax return positions for which you have at least SUBSTANTIAL AUTHORITY?	1	2	3	4	5

Appendix D (cont'd)

	(CIRCLE ONE FOR EACH) Very Important				Very Unimportant
4. How important does YOUR FIRM consider your responsibility to only adopt tax return positions for which you have at least a REALISTIC POSSIBILITY OF SUCCESS?	1	2	3	4	5
5. How important do the FIVE PRACTITIONERS YOU KNOW BEST consider your responsibility to only adopt tax return positions for which you have at least a REALISTIC POSSIBILITY OF SUCCESS? . . .	1	2	3	4	5
6. How important do YOU consider your responsibility to only adopt tax return positions for which you have at least a REALISTIC POSSIBILITY OF SUCCESS? . . .	1	2	3	4	5

Appendix D (cont'd)

While a taxpayer may be penalized for any adopted undisclosed tax return position lacking substantial authority, a practitioner will be penalized only if the position lacks a realistic possibility of success.

Many reasons exist for a practitioner to recommend to a client an undisclosed tax return position lacking substantial authority, but possessing a realistic possibility of success. Using the following scale as a guide, circle the extent of your agreement or disagreement to each reason below:

Strongly Disagree 1
Somewhat Disagree 2
Neutral 3
Somewhat Agree 4
Strongly Agree 5

Statements 7 through 20 complete the following phrase:

It is ethically acceptable for a practitioner to recommend to a client an undisclosed tax return position lacking substantial authority (but possessing a realistic possibility of success) because...

	(CIRCLE ONE FOR EACH) Strongly Disagree		Neutral		Strongly Agree
7. Where tax law is uncertain, the recommended position should favor the client . . .	1	2	3	4	5
8. If the position is contested, clarification of the law will improve subsequent voluntary compliance	1	2	3	4	5
9. Taxpayers who only take "IRS approved" positions will overpay their taxes	1	2	3	4	5
10. The practitioner works to improve compliance and therefore need not worry over one incident	1	2	3	4	5

Appendix D (cont'd)

It is ethically acceptable for a practitioner to recommend to a client an undisclosed tax return position lacking substantial authority (but possessing a realistic possibility of success) because...

	(CIRCLE ONE FOR EACH) Strongly Disagree		Neutral		Strongly Agree
11. If the practitioner does not assist the client, the client may pay too much (or too little) in taxes . .	1	2	3	4	5
12. Often the IRS ignores the practitioner's duty to assist the client	1	2	3	4	5
13. The practitioner's obligation to the client takes priority over IRS preferences	1	2	3	4	5
14. Ultimately, it is the taxpayer's responsibility to adopt positions on the return	1	2	3	4	5
15. By itself, a recommendation will not adversely affect voluntary compliance	1	2	3	4	5

Appendix D (cont'd)

It is ethically acceptable for a practitioner to recommend to a client an undisclosed tax return position lacking substantial authority (but possessing a realistic possibility of success) because...

	(CIRCLE ONE FOR EACH) Strongly Disagree		Neutral		Strongly Agree
16. The unfairness of the tax system already hurts voluntary compliance	1	2	3	4	5
17. The IRS is primarily interested in maximizing revenues collected	1	2	3	4	5
18. The role of a tax practitioner includes more than just supporting the voluntary compliance system .	1	2	3	4	5
19. My office needs our continuing clients	1	2	3	4	5
20. In general, tax clients comply with tax laws	1	2	3	4	5

Appendix D (cont'd)

Experience & Personal Data

Use the following scale in answering questions 1 through 6:

Never 1
Rarely (1 to 3 times a year) 2
Occasionally (4 to 8 times a year) . . . 3
Frequently (more than 8 times a year) . . 4

		(CIRCLE ONE FOR EACH) Never			Frequently
1.	How often do you deal with client questions in which the possibility of a substantial understatement penalty (IRC Sec. 6662(b)(2)) is discussed with the CLIENT?	1	2	3	4
2.	How often do you deal with client questions in which the possibility of a substantial understatement penalty is discussed with another PRACTITIONER?	1	2	3	4
3.	How often are you willing to take a position that you believe would lead to a substantial understatement penalty if audited?	1	2	3	4
4.	How often do YOU prepare returns for clients who have been <u>assessed</u> a substantial understatement penalty?	1	2	3	4
5.	How often has YOUR OFFICE been assessed a penalty for understating a client's tax liability by including in a return a position lacking a realistic possibility of success or reasonable basis (as under prior law)(IRC Sec. 6694(a))? . . .	1	2	3	4

Appendix D (cont'd)

	(CIRCLE ONE) Never			Frequently
6. How often have YOU been assessed a penalty for understating a client's tax liability by including in a return a position lacking a realistic possibility of success or reasonable basis (as under prior law) (IRC Sec. 6694(a))?	1	2	3	4

Use the following scale definitions in answering the 7 through 9:

Very Unfamiliar (never read it) 1
Unfamiliar (reviewed it once) 2
Familiar (reviewed it more than once, but not often) 3
Very Familiar (regularly consider it in practice) . . 4

	(CIRCLE ONE FOR EACH) Very Unfamiliar			Very Familiar
7. How familiar are you with AICPA Statement on Responsibilities in Tax Practice No. 1 (Tax Return Positions)?	1	2	3	4
8. How familiar are you with Treasury Circular 230 (Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries before the IRS)?	1	2	3	4
9. How familiar are you with Internal Revenue Service Notice 90-20 (guidance pertaining to positions satisfying the "realistic possibility" standard)?	1	2	3	4

Appendix D (cont'd)

10. Are you:

(CIRCLE ONE)

male 1

female 2

11. What is your age?

(CIRCLE ONE)

21 - 30 1

31 - 40 2

41 - 50 3

51 - 60 4

Over 60 5

12. What is your professional position? (CIRCLE ONE)

Owner/Partner 1

Manager 2

Senior 3

Other 4*

*Please describe (if you circled "other"):_____

_____

_____

Appendix D (cont'd)

13. What TYPE OF FIRM are you affiliated with?

(CIRCLE ONE)

"Big 6" CPA firm 1
Other National CPA firm 2
Regional CPA firm 3
Local CPA firm 4
Self-employed 5
Other 6*

*Please describe (if you circled "other"):_____

_____

_____

14. How many years of TAX EXPERIENCE do you have? (Include only those years in which 25% or more of your time was devoted to taxpayer client matters.)

(CIRCLE ONE)

1 - 3 years 1
4 - 6 years 2
7 - 10 years 3
11 - 16 years 4
17 - 24 years 5
25 - 35 years 6
Over 35 years 7

Appendix D (cont'd)

15. What is your highest educational degree obtained?

(CIRCLE ONE)

Bachelors (BA/BS/BSBA) 1
Masters (MBA/MS/Macc) 2
Doctorate (Phd/DBA) 3
Other 4*

*Please describe (if you circled "other")_____

_____

_____

Appendix D (cont'd)

Tax Case

INSTRUCTIONS

Below you will find information concerning a corporate tax client. Please read this data carefully. It will provide you with material necessary to complete the remainder of the instrument.

After the client information you will find several questions based on the client data. Read each question carefully. Indicate your response on the scale immediately following the question. When answering the questions assume that you are the corporation's tax preparer. You are encouraged to refer back to the client information as needed.

Panel World Inc., a closely held corporation owned by Thomas and Rose Buchanen, has been a client of your firm for several years. Panel World manufactures and sells custom veneered plywood for use in kitchen cabinets, furniture, store fixtures, and other specific customized applications. Orders are filled according to customer specifications, thus a finished goods inventory is generally not maintained. Customers are typically wholesale distributors who in turn sell the product to cabinet shops, architects, etc. Because of the firm's customer base (e.g., wholesalers), Panel World has not previously advertised in trade journals or magazines. For similar reasons product prices have not proven stable, often fluctuating on a monthly basis. Marketing firm products has traditionally involved personal visits by sales personnel coupled with follow-up telephone solicitation. The cost of such personal visits has never exceeded $48,000 in any given year.

In an effort to spur sales Panel World adopted a new marketing technique recently employed with some success in a related industry. The technique involves inviting both regular and potential customer representatives to participate in a two-day weekend sales seminar offered in conjunction with a major entertainment event. Customers who are willing to send two representatives to attend special seminars on both Saturday and Sunday morning are offered free air fare, overnight accommodations, meals, ground transportation, and tickets to the entertainment event (e.g., the Super Bowl or a World

Appendix D (cont'd)

Series game). The only restrictions placed on the offer are (1) either both customer representatives be employed by the customer in a "decision-making" capacity, or the individual who is not so employed be the spouse of the attending representative, and (2) the representative be willing to attend both seminars and consider the possibility of future purchases from Panel World. During the seminars customer representatives were shown new products and techniques employed by Panel World in the manufacturing of veneered wood products, and introduced to alternative applications for Panel World's products. At the close of the Saturday seminar an informal "refreshment hour" was held where sales representatives and upper management of Panel World individually approached potential customers in the effort to obtain additional sales and learn of specific customer needs. Arrangements were made with the host facility to provide suitable space for all functions.

Thirty firms sent representatives to Panel World's first weekend sales seminar, which was held in conjunction with the 1989 Super Bowl. Twenty-two made purchases either during or subsequent to the weekend. Of the attending firms only fourteen sent two customer representatives. Fourteen of the remaining representatives were accompanied by their spouse; two representatives were accompanied by children. Representatives arrived Friday evening and were greeted by employees of Panel World. Saturday's seminar began at 9:00 a.m. and ended at 5:00 p.m., with a two hour break allowed for lunch. The refreshment hour commenced at 6:00 p.m. and spouses were actively encouraged to attend. During formal seminars spouses were offered the option to participate in a sight-seeing tour of the host (in this case, New Orleans) city. Sunday's seminar began at 9:30 a.m. and ended at 12:30 p.m.. Transportation was provided at 3:00 p.m. to the Super Bowl. No business was discussed either at or after the game. Return flights for customers to their home city were scheduled to depart Monday morning.

As the company controller, Thomas has taken pains to scrupulously document each activity engaged in, and dollar amount incurred, during the weekend. Twenty representatives of Panel World attended the seminars, including Thomas Buchanen and nineteen salespersons. To staff a hospitality desk, pass out name tags and agendas, accompany non-participating attendees, and perform other tasks necessary to free Panel World's employees, all twenty of Panel World's employees were accompanied by their spouse and ten employees brought a total of twenty children (ages 14 through 19). The

Appendix D (cont'd)

total cost for the weekend was $204,000 and was incurred as follows:

	Total	Customer Reps.	Spouses of Reps.	Children of Reps.
Tickets[a]	$ 3,000	$ 2,200	$ 700	$ 100
Airfare	45,000	33,000	10,500	1,500
Accommodations[b]	54,000	39,600	12,600	1,800
Total	$102,000	$74,800	$23,800	$3,400

	Total	Employees	Employee Spouses	Employee Children
Tickets[a]	$ 3,000	$ 1,000	$ 1,000	$ 1,000
Airfare	45,000	15,000	15,000	15,000
Accommodations[b]	54,000	18,000	18,000	18,000
Total	$102,000	$34,000	$34,000	$34,000

[a]Amounts stated at 80% of the actual expense incurred.
[b]Amounts include 80% of the actual expenses for food, beverages, and entertainment, and souvenirs not exceeding $25 per person.

However, despite the extensive marketing efforts, the year has not been a good one for Panel World. A general decline in sales has reduced gross income to $10,000,000. The revised estimate of taxable income, not including any deductions for the sales seminar, is $900,000. Facing a temporary, but significant, cash flow problem, Thomas has indicated to you a need to take every deduction for which some support exists, including those that may be challenged by the IRS (if detected). In addition, he does not want any additional disclosures (or "red flags" as he terms them) calling attention to Panel World's tax return. Thomas, a CPA, realizes that this could result in penalties assessed against Panel World and, as Panel World's preparer, you. However, he is quite adamant about taking these deductions and, you believe, will compensate you for any penalties incurred. Similarly, you also believe that if you do not assume an aggressive stance on Panel World's return, Thomas will obtain a new preparer.

Appendix D (cont'd)

A review of the client's history with your firm indicates that in prior years Panel World's returns have proven uncomplicated. FEES FROM COMPLETING EARLIER RETURNS WERE A HIGHLY SIGNIFICANT PERCENTAGE OF YOUR OFFICE GROSS REVENUES, with time spent by office personnel commensurate with the fee received. Upon reviewing the relevant tax authorities you have determined that consenting to the client's wishes raises the possibility of a preparer Section 6701 penalty relating to the aiding and abetting of an understatement of tax liability, and possible referral to the IRS Director of Practice for disciplinary proceedings.

Discussion of Authorities

IRC section 162 provides the initial test of deductibility for these expenditures. Under this section entertainment, meal, and travel expenditures are deductible if they are ordinary and necessary expenses incurred in the operation of a trade or business. Regulation section 1.162-2(a) further specifies that traveling expenses must be "reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it." If the trip includes both business and personal activities, the travel expenses will only be deductible if the primary purpose of the trip is business; a facts and circumstances test (Reg. Sec. 1.162-2(b)(1)). One fact that must be considered is the amount of time devoted to each activity (Reg. Sec. 1.162-2(b)(2)). IRC section 162(a)(2) and Regulation Sec. 1.274-1 require the expended amounts for meals, lodging, and entertainment be neither "lavish [n]or extravagant under the circumstances."

Upon satisfaction of IRC section 162, section 274 further specifies that meal and entertainment expenses be either "directly related to" or "associated with" the active conduct of business. The "associated with" test requires a substantial and bona fide business discussion, with a clear business purpose, directly following or preceding the entertainment (Reg. Sec. 1.274-2(d)). "Substantial and bona fide" requires that the taxpayer's purpose be to obtain income or other specific business benefit, but this does not preclude goodwill expenditures. The meeting must also be substantial in relation to the entertainment. However, this will be satisfied if the principal character of the combined business and entertainment activity was the active conduct of business (Reg. Sec. 1.274-2(d)(3)(i)(a). Regulation Sec. 1.274-2(d)(3)(ii) also specifies that entertainment occurring on the same day as the business discussion will be considered to directly proceed or follow the discussion.

Appendix D (cont'd)

In order for the expense to be considered "directly related": (1) the taxpayer must have more than a general expectation of deriving income or benefit, (2) during the period of entertainment the taxpayer must actively engage in business activity, (3) the principal character of the combined business and entertainment activity must be the active conduct of the taxpayer's business, and (4) the expenditure must be allocable to the taxpayer and person(s) engaged in the active conduct of business (Reg. Sec. 1.274-2(c)(3)). It is not necessary that more time be devoted to business than entertainment. In addition, the regulations clearly specify that, absent clear proof, expenses incurred with regard to sporting events will generally not be considered directly related.

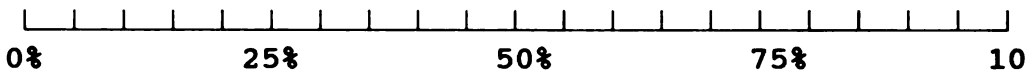
With regard to family members of Panel World's employees, Regulation Sec. 1.162-2(c) allows a deduction for travel expenditures only if a bona fide business purpose existed for their presence. In Weatherford (418 F.2d at 879), this required that the member provide "substantial services directly and primarily related" to the business function of the trip. In Danville Plywood (90-1 USTC 50,161), this required that their primary function be more than "socially gracious." In Warwick (236 F.Supp. 761) travel deductions were allowed for a spouse who extensively socialized with customers thereby directly contributing to sales. For family members of both Panel World's employees and customers, Reg. Sec. 1.274-2(d) allows the treatment of entertainment expenditures as "associated" entertainment if the cost of entertaining the customer is deductible as either "associated" or "directly related" entertainment and the recipient is closely connected with a person engaged in a substantial and bonafide business discussion. The regulation clearly states that spouses are "closely connected."

For all attendees, the amount of deduction allowed for meals and entertainment expenses meeting either of the above tests is limited to 80% of the expense incurred (IRC Sec. 274(n)). In addition, IRC section 274(b)(1) limits the annual total of business gifts to $25 per person and IRC section 274(l) limits the deductible amount for tickets to their face value.

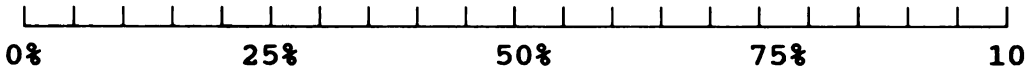
Appendix D (cont'd)

Mark your response to the following questions based on the client information above. Assume you are currently preparing Panel World's tax return.

1. What do you believe is the probability that the IRS will allow the entire amount of the expense on audit (assuming the relevant facts are discovered during the audit)? (marked response can be at <u>any</u> point on the scale)



2. What do you believe is the probability that the IRS will discover these facts on audit?



3. Prior to filing the return, would you advise disclosure if the client did not impose any pre-conditions?

(CIRCLE ONE)

Yes 1

No 2

4. If you would not advise disclosure, why not? (CIRCLE the ONE primary reason only)

The law is clear; amount is definitely deductible 1

Substantial authority exists for the deduction 2

A realistic possibility of success exists . . 3

The law is unclear but, I will favor the client 4

Appendix D (cont'd)

Using the following scale as a guide, circle the extent of your agreement or disagreement to each of statements 5 through 8:

Strongly Disagree 1
Somewhat Disagree 2
Neutral 3
Somewhat Agree 4
Strongly Agree 5

	(CIRCLE ONE FOR EACH) Strongly Disagree		Neutral		Strongly Agree
5. The strength of authority for the entire non-disclosed deduction (including expenses for spouses and children) is sufficient to avoid a taxpayer penalty	1	2	3	4	5
6. I feel comfortable with not disclosing additional information on the return . .	1	2	3	4	5
7. Discontinuing the engagement would not violate my ethical standards	1	2	3	4	5
8. Continuing the engagement would not violate my ethical standards	1	2	3	4	5

Appendix D (cont'd)

Debriefing Questions

1. Was sufficient information provided to respond to the questions asked?

(CIRCLE ONE)

Yes 1

No 2

2. If not, what was missing?_____

_____

_____

3. In your opinion, was the case realistic?

(CIRCLE ONE)

Yes 1

No 2

4. If not, what specifically was not realistic?_____

_____

_____

5. Have you been involved in a actual tax situation similar to the one described in the case?

(CIRCLE ONE)

Yes 1

No 2

Appendix D (cont'd)

6. Assuming the case was real, would Panel World be an important client to your firm?

(CIRCLE ONE)

Yes 1
No 2

7. Did you consider the potential Internal Revenue Code penalty severe or mild?

(CIRCLE ONE)

Severe 1
Mild 2

8. Any other comments?_____

_____

_____

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BIBLIOGRAPHY

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