

2021 NATIONAL INCOME TAX WORKBOOK

CHAPTER 1: ETHICS



ETHICS - TOPICS

P. 1

- Working Remotely
- Unauthorized Practice of Law
- Volunteering for a Nonprofit
- Abusive Tax Evasion Schemes
- Judicial Tax Doctrines
- Case Studies

WORKING REMOTELY - CONFIDENTIALITY

PP. 2-3

- Duty** of Confidentiality-Protect client Information
- Having a **Dedicated Office Space?**
 - Arrangements for children who are at home?
 - ❑ I.R.C. §7216 nondisclosure rules – can be held criminally & civilly liable (fine & prison)-see discussion in 2017 National Tax Workbook
 - ❑ Be aware of Smart Devices (IE. Echo & Nest) in work area
 - ❑ State confidentiality laws
 - ❑ Professional organization standards
- Protect Paper Files
Protect Electronic Files

WORKING REMOTELY – PROTECT CLIENT INFO

PP. 3-4

Telephone calls**Text messages****Emails****Video conferencing – See for example, Figure 1.1 Zoom Privacy Recommendations**

- Prevent video hijacking
- Tips from the FBI – See list page 4

WORKING REMOTELY – PROTECT CLIENT INFO

P.P. 3-4

In a Growing Digital Environment:

- Importance of a **Review of Controls and hardware - Have a Policy/Plan in Place for power outages, internet speed, plan for mission critical assets, etc.**
- Consider the trust that clients place in the security & privacy of their data;

IRS Pub. 4557, Safeguarding Taxpayer Data, IRS Pub. 5293, Data Security Resource Guide for Tax Professional's, and Small Business Information Security: The Fundamentals by the National Institute of Standards and Technology are resources for developing a data security plan.

WORKING REMOTELY – PROTECT CLIENT INFO.

P.P 3-4

SOME SURVEY INFORMATION ON REMOTE WORKING:

POST PANDEMIC – EMPLOYEES & EMPLOYERS ARE RECONSIDERING FLEXIBILITY TOWARD REMOTE WORKING

MORE THAN 1/2 OF EMPLOYERS ARE CONSIDERING REMOTE WORK A PERMANENT ARRANGEMENT FOR ALL OR SOME OF THERE WORKFORCE POST-PANDEMIC

MORE THAN 1/2 OF EMPLOYEES SAY THEIR PRODUCTIVITY HAS INCREASED DUE TO REMOTE WORKING

2/3 OF EMPLOYEES SAY THEY WOULD WANT TO WORK REMOTELY AT LEAST PART OF THE TIME

COMPETENCY AND DUE DILIGENCE

PP. 4-6

Technological Competence- Practitioner Note Pg. 5Circular 230 § 10.22 **Due Diligence** – in all IRS matters

- **Clear communication w/client** – **Cross Reference** – *Client w/diminished capacity discussion 2019 National Income Tax Workbook, pg.(s) 84-96*
- **Promptly address pending matters- calendars, software, file systems to track deadlines**
- **Standards for electronic communication-plan for interruption of service, etc.**
- Security, proficiency (practitioner **AND** client), verify identity, preserve interpersonal relationships, backup plan

UNAUTHORIZED PRACTICE OF LAW - TESTS

PP. 7-8

Circular 230 § 10.32, tax practitioners who are not attorneys must not give legal advice

Okla./Federal - practicing law without a license is a crime.

WHAT IS LEGAL ADVICE?

Examples – drafting documents; interpreting law, offering specific legal advice to a client

Difficult question of law test – difficult legal questions-pg. 7**Commonly understood test** – commonly the practice of law pp-7-8

UNAUTH. PRACTICE OF LAW - CHOICE OF ENTITY

P. 8

TAX ADVICE vs. LEGAL ADVICE**Figure 1.2 pg. 8**Columbus Bar v. Verne - CPA

- ☐ Drafted Articles of Organization but no operating agreement
- ☐ Business partners had a dispute
- ☐ Tax and financial on how to structure is valuable
- ☐ Liability protection and governance – refer to attorney

UNAUTH. PRACTICE OF LAW – BUSINESS FORMS

PP. 9-11

- Articles of Incorporation – **Check state law**
- May require knowledge of legal issues – Figure 1.3
- Clerical forms – okay if entry of info that client has provided

AUTHORIZED ACTIVITIES

P. 11-13

Representation before the IRS – attorneys, public accountants, and enrolled agents

AFSP limited representation rights

Tax Court – attorneys and non-attorneys who pass a test. (2018=15.38% Pass rate)

Tax Advice/Submissions – tax practitioners

VOLUNTEERING FOR A NONPROFIT

PP. 13-14

1. **Identify** Possible Conflict of Interest
2. **Evaluate** Possible Conflict of Interest
3. **Disclose** Possible Conflict **and** Get Written Informed Consent w/ 30 days

Example 1.1 (p. 14) – Ginger is a CPA on the community foundation board. Ginger's client, Trails West, applies for a grant from the foundation. Ginger has a conflict of interest if she participates in the board vote to approve or deny the grant.

CONFLICT OF INTEREST – DISCLOSURE & CONSENT P. 14

Circular 230 § 10.29

Disclose conflict**Obtain Informed written consent**

- What is involved
- Scope of the risk

Within 30 days**Retain for at least 3 years from the end of representation**

VOLUNTEERING – DUTY OF CONFIDENTIALITY P. 15

Confidentiality duty extends to clients and info obtained volunteering

Example 1.2 pg. 15 – Ginger is still on the foundation board. Homes for Humanity submits a request for a grant. Ginger has confidential information that the executive director of Homes for Humanity is mismanaging funds. Ginger cannot disclose confidential info (and likely has a conflict of interest).

VOLUNTEERING – INTEGRITY AND OBJECTIVITY PP. 15-16

Acting as both board member and service provider must maintain integrity and objectivity

Differences of Opinion – AICPA steps to reduce threat of material misrepresentation or violation of laws

Gifts and Entertainment – OK if reasonable (7 factors)-**see list pg. 16**

Example 1.3 – Nonprofit gives Jacob a crystal bowl to recognize 5 years of service on the board. Occasion and one-time frequency indicate the gift is reasonable.

VOLUNTEERING – DUE DILIGENCE

PP. 15-20

Before volunteering on a board consider:

Bylaws – indemnification of directors (Figure 1.4)

Insurance – general liability and D&O

Conflict of interest policy (Figure 1.5)

VOLUNTEERING – DUE DILIGENCE

P.P 15-20

Effective November 1, 2019, Oklahoma - Senate Bill 642,

(Oklahoma General Corporation Act) made numerous and substantial changes to the Oklahoma General Corporation Act (the "Act") **primarily related to nonprofit Corporations.**

The Act provided favorable corporate governance improvements.

ABUSIVE TAX EVASION SCHEMES

P. 21

Goal is to Reduce Taxes – But Not by Abusive Schemes

How to recognize abusive schemes

- Common recommendations
- Promoter claims (**Figure 1.6**)

Example 1.4 – Ashley went to a tax seminar. Promoter advised forming 4 tiers of entities to funnel income to a foreign trust that has only foreign income and no US tax liability. Appearance of giving up control but does not. Tax practitioner should recognize abusive scheme and advise to not participate. **IRS CID is on to this scheme!**

ETHICAL DUTIES

P. 22

Circular 230 § 10.34 - **do not** willfully, recklessly, or through gross incompetence advise or take a position that

- ☐ Lacks reasonable basis
- ☐ Is an unreasonable position
- ☐ Willfully understates tax liability/ recklessly disregards rules

Practitioner Note: Listed Transactions Defined- **Not all are tax evasion.**

ABUSIVE TAX SCHEMES - REPORTING

PP. 22-24

Form 14242 (Figure 1.7) Page 23

IRS Hotline (Figure 1.8) Page 24

ABUSIVE TAX SCHEMES - PENALTIES

PP. 24-25

Understatement of Liability – Penalty is > \$1,000 or 50% of income derived by preparer from return or claim. Page 24
 ◦ Unreasonable position = >50% possibility position not sustained.

Promoting Abusive Tax Shelters – **Fine** - Page 25

Aiding and Abetting an Understatement – **Fine** -Page 25

Fraud and False Statements – Willful- **Fine and/or Prison.**
(Willfulness burden of proof is on IRS) - Page 25

Fraudulent Returns, Statements, or other Documents – **Willful - Fine and/or Prison** -Page 25

JUDICIAL DOCTRINES

P. 26

Circular 230 § 10.33 evaluate the reasonableness of any assumptions or representations, relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arrive at a conclusion supported by the law and the facts.

STEP-TRANSACTION DOCTRINE

PP. 26-27

Collapse a series of transactions into one end result

End Result Test

- Are separate steps prearranged to achieve the ultimate result?

Interdependence Test

- Would the taxpayer have completed one transaction without the others?

Binding Commitment Test

- Was there a binding commitment to take the later steps?

SUBSTANCE OVER FORM/BUSINESS PURPOSE

P. 27

Economic substance controls if different from legal form.

Example 1.5 – Jenny, age 76, wants to do estate tax planning. She transfers \$15,000 stock to each of her 4 kids and to 20 friends who then gift the stock to Jenny's children. The form of the gifts qualifies for the annual exclusion, but the substance is that all the gifts were intended for Jenny's children. *Heyen v U.S.*, 945 F2d (10th Cir. 1991)

CASE STUDY 1: NEGATIVE ONLINE REVIEW

P. 28

Ronald prepared a return for Naomi. He told her she couldn't claim the home office deduction because she used her home office for a gym (spin bike, kettle bells, yoga mat). The deduction would have saved her \$3,000. Naomi posted bad reviews.

Client review of Ronald Frank
Ft. Myers, Florida
Rating 1 out of 5

Do not trust this person with your taxes
Posted by Naomi53@aol.com

Client Review of Ronald Frank
Ft. Myers, Florida
Rating 1 out of 5

Ronald Frank is an incompetent tax return preparer and he made lots of mistakes on my return. He missed the home office deduction, and it would have cost me \$3,000. Fortunately, my new return preparer caught the mistake and claimed the deduction. Do not use Ronald Frank to prepare your taxes.
Posted by Naomi C.

CASE STUDY 1 CONT.

P. 28

The sites won't take down the negative reviews.

QUESTIONS:

1. Can Ronald post rebuttals?
2. What information can he post?
3. What information can't he post?

CASE STUDY 1 RESPONSE

P. 34

Naomi posted negative reviews about Ronald because he told her she couldn't claim a home office deduction for her home gym. He could:

1. Ask her to remove or edit her posts.
2. If she won't, he can make a curative post. But be careful of confidentiality. See the Oregon Bar case – no self defense objection. Note, Naomi didn't disclose her full name in the review.
3. Keep it general and factual.

CASE STUDY 2: WORKING REMOTELY

P. 29

Eddie is a CPA, working remotely has its perks – with no long commute from NJ to NY he has time to clean the house, make dinner, and bake banana bread. He has a home office but shares the printer and internet with his family. He **got a 30-day notice for his client, Elisha, who is also the children's orthodontist**. He left the notice in the scanner tray where his daughter could see it. He emailed the notice to Elisha but **didn't calendar it**. Elisha called 45 days later, upset that the IRS had levied her bank account, Eddie's wife overheard. **Questions:**

1. What are Eddie's duties to safeguard info?
2. Has he violated those duties?
3. Has he violated any other duties?
4. What could he have done differently?

CASE STUDY 2 RESPONSE

PP. 34-35

Eddie is trying to work from home, but he disclosed a document, missed a deadline, and allowed a confidential conversation to be overheard.

1. Eddie has a duty to safeguard Elisha's info under I.R.C. § 7216, state law, and any professional societies that he belongs to (e.g., the AICPA).
2. Eddie violated those duties by leaving the notice in the scanner, emailing unencrypted sensitive information, and failing to keep his conversation with his client confidential.
3. Eddie also violated his duties to competently and diligently represent Elisha. He didn't calendar the notice, emailed it, and didn't follow up.
4. Eddie needs some policies and procedures about safeguarding info, emailing, and calendaring.

CASE STUDY 3: UNAUTHORIZED PRACTICE OF LAW P. 29

John and Jeff are starting a business to rent ATVs in the summer and snowmobiles in the winter. Their **tax return preparer Luke** suggested that an S corporation could save them money. Luke **prepared the Articles of Incorporation and filed them** with the state. 2020-2021 was a low snow season and **2 customers** from Florida were injured trying to ride a snowmobile up a steep slope. They **are suing the S corp., and John and Jeff personally**. **QUESTIONS:**

1. Did Luke engage in the unauthorized practice of law by recommending an S corp. and preparing the Articles?
2. What advice should Luke have given John and Jeff?

CASE STUDY 3 RESPONSE

P. 35

John and Jeff are getting sued by customers who claim that they did not follow corporate formalities.

1. Luke gave good advice when he advised about taxation of an S corp. Advice about liability protection is likely legal advice. Filing Articles may be the practice of law under state law, or if the forms require legal knowledge.
2. Luke could have advised John and Jeff to talk to their attorney about bylaws, shareholder's agreements, and other docs that can help protect against disputes and personal liability.

CASE STUDY 4: JUDICIAL TAX DOCTRINES

P. 30

In 2019, Richard's attorney advised him to gift the family farm to his son George, to protect it in case Richard needed assisted living. **Richard gifted the farm and died in 2021**. George wants to sell the farm to a developer. His accountant Tiffany estimates \$230,000 federal income on the sale. George calls Richard's attorney who tells him that he can judicially "undo" the 2019 gift so George instead **inherits** the farm. George asks Accountant, Tiffany if the judicial action would reduce his tax obligation. **QUESTIONS:**

1. How should Tiffany respond?
2. Does she have an ethical duty to consider any tax doctrines?

CASE STUDY 4 RESPONSE

P. 36

George asked Tiffany about setting aside a gift so he could instead inherit the family farm.

1. In form, Tiffany may conclude that the proposed transactions would result in a step-up in basis.
2. However, Tiffany has a duty to consider the step-transaction doctrine and the economic substance of the proposed transactions. Tiffany may conclude that George would not set aside the gift if it did not lead to him inheriting the farm, and that the sole purpose of a judicial action is to avoid federal income tax. Thus, the transactions lack economic substance. **See next slide**

CASE STUDY 4 RESPONSE

A gift is a **transfer of property for less than full value**. Under some states & IRC Sec 2037, a gift will be set aside if it is given within 3 years of donee's death.

Transfers of Real Property (Farm) must be accompanied by a registered instrument signed & witnessed (deed). If the farm was in fact deeded to George **it would raise other legal questions**. *I.E.*, George could have sold it during the 2-year period before Richard's death in 2021 to a bonafide purchaser for value & involve challenges that a deed be set aside.

If Tiffany answers George's questions, she may be practicing law. **Unless she is a lawyer, she should not answer.**

CASE STUDY 5: VOLUNTEERING FOR A NONPROFIT P. 30

Alex is a new accounting grad who opened his own office in Polson. He agreed to **serve on the board** of the **Polson food pantry**, hoping it could enhance his reputation and generate business. The CEO of the food pantry had Alex review the payroll and deposit schedule, prepare quarterly financials, and prepare the annual return based on info from the CEO. The IRS later assessed unpaid payroll taxes and found that the tax return overreported contributions and underreported expenses.

1. Do Alex's dual roles as CPA and director violate any ethical duties?
2. What is his liability for the unpaid taxes and errors on the return?
3. What could he have done differently?

CASE STUDY 5 RESPONSE

PP. 36-37

Alex is a volunteer director at the Food Pantry. The IRS assessed unpaid payroll taxes and an audit showed errors on the tax return.

1. Alex is a director of the nonprofit and also provided tax and accounting services. He may have a conflict of interest. If the CEO does not tell the board about the IRS notice and audit findings, he may have a hard time maintaining confidentiality. He may also violate his duties of objectivity and integrity if the CEO doesn't pay the taxes and amend the return.
2. Alex is likely not a responsible person for purposes of the payroll taxes. However, he prepared the erroneous return, and as a director, likely had access to the correct information.
3. Alex should have evaluated the possibilities for conflicts and ethical issues at the beginning. Maybe it would have been better to volunteer to provide free tax and accounting services, and not serve on the board.

CASE STUDY 6: ABUSIVE TAX SCHEMES

P. 31

Sunny's client Sasha owns profitable yoga studios. Sasha shows Sunny a brochure for an investment in a conservation easement that promises to give Sasha a \$3 deduction for every dollar that she invests.

1. How can Sunny investigate if the scheme is legitimate?
2. How should she advise Sasha?
3. Does Sunny have a duty to report the scheme?

CASE STUDY 6 RESPONSE

PP. 37-38

Sunny's client Sasha is thinking about investing in a tax scheme.

1. If it sounds too good to be true it probably is – Sunny should investigate whether the scheme is legitimate. She starts by reviewing the IRS list of abusive transactions and finds a notice detailing the scheme and concluding that the IRS will challenge the scheme.
2. Under Circular 230 § 10.34 Sunny has a duty to not advise Sasha to take a position that lacks reasonable basis, to take an unreasonable position, or to enter into an abusive tax shelter. Sunny must tell Sasha to not invest in the scheme and advise her about potential penalties.
3. Sunny does not have an obligation to report the scheme, but the IRS encourages tax practitioners to report abusive tax schemes.

CASE STUDY 7: CLIENT W/ DIMINISHED CAPACITY

P. 31

Lilah is a CPA working mostly from home. She has prepared returns for Brian for over 20 years. Brian's wife died recently, and Lilah has noticed a decline in his health. Lilah emailed Brian a tax organizer to gather information for his 2020 return. She did not get it back, so she left him a voice mail. Lilah got an email from Brian's address stating that he doesn't own the house anymore, his only income was \$21,000 social security, and he paid his caregiver Linda \$100,000. The email directs Lilah to have any refund deposited in Linda's account.

1. Can Lilah prepare a return based on the info Brian provided?
2. Does Lilah have a duty to confirm the info or the identity of the sender?

CASE STUDY 7 RESPONSE

P. 38

Lilah suspects that he client Brian has diminished capacity.

1. The email that Lilah got from Brian is concerning. What happened to the house? And \$100,000 is a lot to give to his caretaker Linda. If Lilah thinks the information is inconsistent or incomplete, she can't rely on it, and must request additional substantiation.
2. Lilah called Brian, but she did not get a return call. She suspects that the email may have come from the caregiver who is influencing Brian. Lilah should try to video conference with Brian or meet with him in person to confirm what is going on. If there is a risk of harm to Brian, she may have to take further action.

CASE STUDY 8: TAX ADVICE

P. 32

Samantha works as a chairlift engineer at the local ski resort. A cable snapped and hurt her wrist. She went to the hospital and later filed an injury report. Earlier that week Samantha had posted a picture of herself snowboarding and holding a beer. Samantha's employer saw the post, claimed she faked the on-the-job injury, and fired her. Samantha sued for wrongful termination. They settled out of court for \$250,000 and the employer withheld \$15,000 in federal income tax. On April 14, 2021, Samantha texted her tax advisor, Jake with a "quick question" about including the settlement proceeds in her income.

1. Should Jake respond to a text message?
2. If so, how much info should he include?
3. Does he have any other due diligence obligations?

CASE STUDY 8 RESPONSE

P. 39

Samantha has texted Jake a "quick question" about the taxation of settlement proceeds.

1. Giving substantive tax advice in a short and informal text message isn't recommended because it's hard to fully explain the basis for the advice, and difficult to document.
2. Even a text must comply with Circular 230 § 10.37 requirements for written advice (ascertain relevant facts and relate the applicable law). Jake must consider that this is an important transaction and a complex issue.
3. Jake can rely on furnished info, without verification. But here, he needs more info about the underlying claim in the lawsuit and the basis for the settlement to determine if the proceeds were paid on account of physical injury. Lucky for Samantha, the 2020 filing deadline was extended. Jake can briefly respond by text and follow up with an email and conference later.

CASE STUDY 9: CONFLICT OF INTEREST

P. 32

Jeff prepares individual returns for Donna and Henry and also a partnership return for their dog grooming/vet business. They are divorcing but will continue to own and operate the business together. Donna runs the vet business, Jeff runs the grooming business, and they share a side business selling CBD pet supplements. They asked Jeff about how to structure compensation for their services.

1. Can Jeff continue to provide services for Donna, Henry, and the business?
2. If so, what should he do before he provides those services?

CASE STUDY 9 RESPONSE

P. 40

Jeff provides tax services for Donna and Henry (who are getting divorced) and their business.

1. Jeff may have a conflict of interest if he continues to represent Donna, Henry, and the business. The vet business is an SSTB and the grooming and supplement businesses are not. They have asked for advice about compensation, which will impact the QBI deduction and each owner's income and deductions.
2. If Jeff reasonably believes that he can provide competent and diligent representation, he must get a signed written conflict disclosure/waiver.

CASE STUDY 10: DATA PROTECTION

P. 33

During tax season, Raymond is working 16 hours a day. Several of his firm associates are still working from home. At 1:00 a.m. Raymond is at his home computer responding to upset clients who were still waiting for refunds. He got an email that appeared to come from the IRS and asked for sensitive information. Raymond suspects that it is a phishing email that was sent to everyone in the firm. He calls the IT person.

1. What should Raymond do to ensure that his employees don't fall for the scam and give out sensitive information?
2. What best practices should Raymond have in place for his employees working from home?

CASE STUDY 10 RESPONSE

P. 41

Raymond's firm got a phishing email seeking information that would allow the cyberthieves to file fraudulent returns.

1. Raymond should report the email to the IRS and TIGTA and immediately warn his employees about the scam. The IT person should update the security software and check for viruses. If any employees fell for the scam, Raymond must take additional action.
2. Raymond has a duty to ensure that he and his staff safeguard client info. Raymond must have an information security plan and train his employees. Employees working from home need security software that automatically updates and need to know how to recognize phishing scams.

QUESTIONS?
