

Case 2-3

The Tax Return

Brenda Sells sent the tax return she prepared for the President of Purple Industries, Inc., Harry Kohn, to Vincent Dim, the manager of the tax department at her accounting firm. Dim asked Sells to come to his office at 9:00 am on Monday, April 10, 2007. Sells had no idea why Dim wanted to speak to her. The only reason she could come up with was the tax return for Kohn.

“Brenda, come in,” Vincent said.

“Thank you, Vincent,” Brenda responded.

“Do you know why I asked to see you?”

“I’m not sure. Does it have something to do with the tax return for Mr. Kohn?” asked Brenda.

“That’s right,” answered Vincent.

“Is there a problem?” Brenda asked.

“I just spoke with Kohn. I told him that you want to report his winnings from the lottery. He was incensed.”

“Why?” Brenda asked. You and I both know that the tax law is quite clear on this matter. When a taxpayer wins money by playing the lottery, then that amount must be reported as revenue. The taxpayer can offset lottery gains with lottery losses, if those are supportable. Of course, the losses can not be higher than the amount of the gains. In the case of Mr. Kohn, the losses exceed the gains so there is no net tax effect. I don’t see the problem.”

“Let me tell you the problem,” Vincent stated sharply. “It’s taken me years to gain the trust of Kohn. Our firm now audits his company’s books, prepares its annual tax

return, prepares Kohn's personal tax return, and provides financial planning services for both. Kohn and Purple Industries together is the largest client in our office. I can't afford to lose any of the business the client provides for our firm. As you know, we are under increasing competition from larger regional firms that are looking for new clients. If we don't support Kohn, some other firm will step in and do it. Poof, there goes 20 percent of our revenues."

Brenda didn't know what to say. Vincent seemed to be telling her the lottery amounts shouldn't be reported. But that was against the law. She turns to Vincent and asks: "Are you telling me to forget about the lottery amounts on Mr. Kohn's tax return?"

"I want you to go back to your office and think carefully about the situation. Consider that this is a one-time request and we value our staff members who are willing to be flexible in such situations. Let's meet again in my office tomorrow at 9:00am.

This case has the student consider the ethics of keeping a tax client happy, particularly when that tax client is providing other business for the office.

Many students will know that gambling losses are allowed up to the extent of gambling winnings. However, it does not mean that there is not an effect. Gambling winnings are included as other income on the 1040. This amount is included in the sum of the adjusted gross income (AGI). Gambling losses are deducted on Schedule A, other itemized deductions.

Most CPAs would not be aware of a client's gambling winnings and losses unless told about them. However, once a taxpayer wins more than \$600 in one gambling or lottery winnings, then the taxpayer will receive a 1099G and will have 10% withheld for federal income taxes. In the above situation, most likely there was a 1099G with the winnings included in the tax information of the client.

Ethical Issues

The students should consider the special roles of being a tax advocate for clients versus being an auditor for clients. This case also concerns truth telling or disclosure, since the tax burden is not changed for the taxpayers. The CPA has an obligation to follow tax

laws and regulation but support the client if there are reasonable supportable positions. The CPA can face preparer penalties for underreporting income.

Questions

- 1. Assume Brenda has no reason to doubt Vincent's veracity with respect to the statement that it is "a one-time request." Should that make a difference in what Brenda decides to do? Why or why not?**

An ethically person acts ethically at all times, not after a one time unethical lapse. If it should not be a one-time request, the next time will be easier to go along. Saying that an incident will be one-time thing is a rationalization.

- 2. Analyze the alternatives available to Brenda using Kohlberg's six stages of moral development. That is, what would Brenda's position be when she meets with Vincent assuming that it is determined by each of the six different stages of moral development on an independent basis?**

Vincent is reasoning at stage 3 and 4 trying to keep the client happy first and foremost. Brenda was reasoning at stages 5 and 6. Brenda should use reasoning, and consider the force of tax laws and regulations on the situation.

- 3. Assume Brenda decides to go along with Vincent and omits the lottery losses and gains. Next year the same situation arises but now it's with gambling losses and gains. If you were Brenda, and Vincent asked you to do the same thing you did last year regarding omitting the lottery losses and gains, what would you do this second year? Why?**

From a tax preparer's point of view if the non reporting is not understating the tax liability or significantly underreporting income, then these situations are a reality of society in the U.S. right. Many states have laws against betting on sports games. The law does not prevent the betting from happening, and I'm sure that the winnings and losses are underreported.