

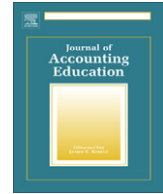


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Educational Case

An ethical tax dilemma: Support of hobby versus trade or business in the presence of competing incentives and client pressure

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ABSTRACT

The tax law treats hobbies and businesses in a significantly different manner. The ability to discern when an activity is a business and when it is a hobby is critically important. Unfortunately, tax practitioners face an additional challenge when making judgment decisions: competing incentives and pressure from the client. Practitioners not only have obligations to their clients but are also obligated to uphold the tax system. Balancing professional responsibilities with other incentives and pressures introduces an ethical dimension to the issue. In this case, you will have the opportunity to explore the hobby versus business question in the presence of client pressure and competing incentives. You will be required to research the technical tax issues and make appropriate recommendations. Rather than this being a mere tax law analysis, however, you also need to look deeper into the decision making process and examine the ethical issues involved. At the conclusion of the case, you will have demonstrated an understanding of both the technical tax issues and the ethical issues involved.

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1. Background

Jim Cornell graduated from Standard University in 2007 with both his undergraduate and graduate degrees in accounting. He excelled as a student and quickly became recognized for his leadership abilities. Of all the classes that Jim was required to take, ethics was one of his favorites. The course provided a safe environment in which he and his peers could discuss their opinions on how best to

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resolve an ethical dilemma. During one lecture the professor asked, “Is it ethical for life insurance companies to deny beneficiary proceeds to victims of terror attacks and acts of war?² What do you think?”

One student smartly replied, “It is up to the individual to read the life insurance contract. Terrorist attacks are tragic but the life insurance companies can’t be held responsible. If we force life insurance companies to pay claims then in the event of a major attack or act of war some of them would have to file for bankruptcy.”

Another student was listening and remarked, “I feel that the life insurance companies have an ethical obligation to at least contribute some of the proceeds to the victims’ families. I bet a lot of companies don’t even mention such exclusions when they sell policies to clients.”

After a brief pause, Jim offered his own analysis, “Before today I believed that every decision had a black and white answer. I am realizing, though, that ethical decisions are not always easy to determine.”

The professor was excited to hear this exchange among his students. “That’s a very interesting analysis,” he said. “It is true that ethical decisions are not always black and white. This course is meant to give each of you a basic framework that can be consistently applied when approaching difficult decisions. If there aren’t any other comments, let’s move on.”

2. Relationships

Jim graduated and moved to Big City to work for one of the leading accounting firms, where he became CPA-qualified. With a reputation as a hard worker, he found himself being given increasing responsibilities and on the fast track to partnership. After just 5 years, he was being considered for promotion to manager. Nonetheless, Jim was not happy. At a homecoming event a year ago, he had met and fallen in love with Mallory, and Mallory lived in Small College Town, Texas. After 12 months of long-distance dating, Jim accepted a job at a local CPA firm in Small College Town. Eager to impress his new employers, Jim worked long hours and many weekends during his first busy season. He became more and more convinced that he and Mallory were ‘meant to be’ and he began planning a creative way in which to propose to her in the Fall.

Although tradition dictated that Jim ask Mallory’s dad for her hand in marriage, that was not going to be an option. Mallory’s father was a business analyst and had often traveled to New York City. He was in the World Trade Center on the morning of September 11, 2001 and lost his life trying to help others evacuate. Mallory had turned 13 the next day but they skipped the celebrations. Her mother, broken-hearted, never recovered from the stress and passed away almost exactly 1 year later of an accidental overdose of sleeping pills.

“I didn’t get any help from the insurance companies,” Mallory confided to Jim. “Losses due to terrorism are not covered under some policies. I had lost both parents, and I was all alone. If it had not been for my uncle and aunt, I’d have been on the streets. They took me in and treated me as if I were their own daughter. They even paid for my college education and that was not cheap. I owe them everything.” It was for that reason that Mallory had gone to work in her uncle’s small business after she graduated from college. She was a loyal and dedicated employee. She knew that she would do anything to help her uncle’s business succeed.

3. Responsibilities

Jim was also ready for the next step in his career. Nick Mayer, his senior manager, had been training Jim on how to increase the firm’s client base. Jim learned the importance of researching market trends

² For example, some life insurance companies have denied beneficiary claims. See for example, the CBS video story, “Life insurance benefits often denied” (<http://www.cbsnews.com/video/watch/?id=7363750n>). 9/11 was declared an act of war, and most life insurance policies contain a War clause (<http://www.term-life-insurance-quotes.com/articles/the-standard-terms-of-a-war-clause-in-a-life-insurance-contract.html>) which voids the life insurance contract if death is caused by an act of war. Insurance companies contend that \$2.7 billion in life insurance proceeds were still paid as a result of claims due to 9/11 (<http://www.lifehealthpro.com/2011/09/19/unhealthy-skepticism>), but rumors of unpaid 9/11 claims persist.

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