

Tax Practice Innovations

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Introduction

- Analyze Emerging Trends in Tax Technology
- Manage Technology in the Tax Department
- Explore Ethical and Business Considerations
- Benefits and Pitfalls
 - CPA firm
 - Our clients

Topics of Discussion

- Looking back to the CPA Firm of 1998
- Look forward to the CPA Firm of the Future
- The Paperless Office
- Outsourcing
- E-filing
- Data Mining
- Application Service Providers (ASPs)
- Final Thoughts

Typical CPA Firm / Tax Department in 1998

- Windows 1995 or 1998 operating systems
- DOS applications
- No high-speed Internet access
- No Microsoft Outlook and Exchange server
- No Adobe reader or PDF files
- No antivirus software
- No Citrix server
- No scanners

Typical CPA Firm / Tax Department of the Future

- Tax software and data files running on a remote server (ASP model)
- Tax records retrieved electronically from payers or central repositories
- Tax records organized in electronic files or “binders”
- Tax files stored in a web-based document management system
- Outsourcing of tax preparation and other related professional services
- Mandatory e-filing of all federal and state returns
- Mandatory e-payment of taxes

Why will these innovations become standard business practice?

- The Simple Answer:
 - Faster
 - Better
 - Cheaper
- Query: Do “good” business practices necessarily conform with a CPA’s Code of Professional Conduct?
- Remember, as a professional, we hold our clients’ best interests before our own self-interest.

Our clients' best interests are served when we:

- Improve the quality of our service
- Shorten turnaround time
 - 2 weeks instead of 2 months
 - April 15 instead of October 15
- Pass cost savings to clients
- Attract and retain qualified staff
- Improve security over client data

Paperless Office

- Better Description – “Less Paper Office”
- Firm-wide Acceptance and Application
- Requirements
 - Directive from executive management
 - Implementation team consisting of computer-proficient tax and audit partners, managers and staff
 - Purchase additional hardware and software
 - Implementation plan

Paperless Office (cont)

- Cost – Benefit Analysis
 - **Benefit** – 10% increase in productivity (conservative assumption)
 - Ave staff cost \$65,000
 - Annual benefit **\$6,500 per staff**

Paperless Office (cont)

- Cost – Benefit Analysis
 - **Costs** on a per employee basis
 - Dual 17” FP Monitors \$ 700 (5 yr life)
 - Desktop Scanner 300 (3 yr life)
 - Training 300 (once)
 - Paperless engagement software 300 (annual)
 - Web-based storage site 500 (annual)
 - Client conversion costs 1,600 (once)
 - Total Costs **\$3,700**

Other Hardware / Software Enhancements

- Scanning capability on networked copiers
- Voice mail and fax integration with Microsoft Outlook
- In-house paperless software integration with Microsoft Outlook
- Windows XP
- T-1 internet access
- Adobe Acrobat (not just the free Reader)

Implementation Plan

- 2 year plan starting on April 16
 - Year 1 (assume start on 4/15/05)
 - “Back-scan” prior year tax files (2003)
 - “Front-scan” certain current year tax files (2004)
 - Easy – Business returns
 - Difficult – Individual returns
 - Back-scan remainder current year tax files
 - Year 2
 - Front-scan all tax files
 - Pre-April 15 jobs will be back-scanned

Back-scan Process

- Using prior year tax control, admin staff will scan physical files to secured website
- Professional staff will test each scanned file for completeness
- Original signed documents to be removed and saved
- Physical files to be marked (“red-dotted”) and “boxed”
- After a period of time, physical files to be warehoused or destroyed

Front-scan Process

- **Driven by paperless engagement software**
- **Leading software providers**
 - Caseware
 - CCH
 - RIA

Front-scan Process (cont)

- **Automate workflow**
 - Trial balance
 - Financial statements
 - Tax return
- **Standardize workfiles**
 - Standard indexing system
 - Standard chart of accounts
 - Standard financial statement format
 - Workpaper templates
- **Working from scanned documents**
- **User friendly paperless files**
 - Schedules and documents linked to trial balance

Front-scan Process (cont)

- Paperless Engagement and Tax Software to support “end-to-end” paperless process
 - Business Returns
 - 1) Client emails year-end trial balance in Excel format
 - 2) Import trial balance into paperless engagement software
 - 3) Engagement software generates financial statements and electronic accounting file
 - 4) M-1 entries are posted to engagement software
 - 5) Tax basis balances are bridged into tax program
 - 6) Tax software “prints” a bookmarked PDF file to engagement software

Front-scan Process (cont)

- Paperless Engagement and Tax Software to support “end-to-end” paperless process (cont.)
 - Individual Returns – currently, a time-consuming task involving scanning, organizing, and reviewing 1040 tax data
 - Preparers have turned to outsourcing companies who use cheap labor and advanced technologies to create and organize reviewer-friendly electronic workpapers
 - Paperless engagement software helps create and organize electronic workpapers

Front-scan Process (cont)

- **Individual Returns paperless preparation will become easier with emerging technologies**
 - Outsourcing companies will
 - develop software to hyperlink tax data to tax files
 - sell this technology to CPA firms
 - Open Financial Exchange (OFX) technology will allow tax preparer to download W-2 and 1099 information directly into tax software

Front-scan Process (cont)

- **Individual Returns paperless preparation will become easier with emerging technologies (cont.)**
 - Eventually all computer generated tax information (K-1s, itemized deductions) will be imported directly from source into tax software
 - The IRS Electronic Tax Administration vision for future e-filing includes central repositories for all data filed electronically to be accessed by taxpayers and their authorized representatives

The Outsourcing Craze

- | | <u># or returns</u> |
|--------|---------------------|
| • 2002 | 1,000 |
| • 2003 | 20,000 |
| • 2004 | 200,000 |
| • 2005 | ??????? |

Outsourcing Process

- CPA reviews client documents and makes notes for outsourcer
- Admin scans client documents into a PDF
- Admin uploads PDF file to outsourcer
- Outsourcer reorganizes and bookmarks documents – creates an electronic tax file
- Outsourcer prepares tax return using CPA's tax software
- Admin download electronic file and open points which are given to staff
- CPA reviews prepped return from the electronic file
 - Dual monitors for on-screen review
 - On-screen review tools include tick marks, notes, lock-down fields
- CPA *may* print-out electronic file and tax return, and reviews from hard copy

Security Issues

THE CPA'S OFFICE

The CPA may have some control over “inside the box” security issues

- “Outside the box” security issues are not under the control of the CPA

Inside the Box Security Issues

- Stealing client information from physical files
 - Employees
 - Temporary help
 - Cleaning service
 - Background checks may reduce risk
- Discarded tax returns and other important documents are not shredded
- Digital copy machines store jobs
- Computer break-ins – Citrix servers, mail servers, Microsoft products are subject to attack
- Desktop computers are not logged-off
- Query: Are we currently taking appropriate steps to protect our and our clients' data?

Outside the Box Security Issues

- Clients identity and financial accounts reside on third party computer system
 - We have no control over data
 - We are unclear of consequences of sending data outside of USA

Outside the Box Security Issues

- Outsourcers use superior security procedures
 - Same data centers used by banks
 - Data is encrypted
 - Servers are monitored
 - No printing
 - No saving to local drives
 - No purses, briefcases or notebooks allowed
- Note: business returns can be prepared without disclosing private information

The Key Security Issue

- Does outsourcing increase or decrease security of my clients' data?
 - If your tax department is not focused on security, your clients data may be safer under the outsourcing model
 - AICPA/CICA Privacy Framework provides 10 components essential to the proper protection and management of personal information
 - See AICPA Enterprise-Wide Privacy Solutions homepage at www.aicpa.org/innovation/baas/ewp/homepage.htm
 - CPA Firms and Outsourcing Firms should use this framework as a benchmark in maintaining state-of-art privacy practices

Ethics of Outsourcing

CODE OF PROFESSIONAL CONDUCT OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

Composition, Applicability, and Compliance

The Code of Professional Conduct of the American Institute of Certified Public Accountants consists of two sections - (1) the Principles, and (2) the Rules. The Principles provide the framework for the Rules, which govern the performance of professional services by members.

Principles of Professional Conduct

Article I - Responsibilities

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

Principles of Professional Conduct

Article V - Due Care

A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

- Act in the best interest of the client
- Render services with a high level of competency, promptly and carefully
- Plan and supervise adequately any activity for which he or she is responsible.

Rules

Rule 102: Integrity and Objectivity. In the performance of any professional service, a member shall;

- maintain objectivity and integrity
- shall be free of conflicts of interest
- shall not knowingly misrepresent facts
- shall not subordinate his or her judgment to others

Rules

Rules 201 and 202: Standards of Performance. A member shall:

- exercise due care while performing professional services.
- adequately plan and supervise the performance of professional services
- comply with the technical standards of services performed (Statements of Standards for Tax Services for tax preparation)

Rules

Rule 301-Confidential client information. Subject to certain exceptions, a member in public practice shall not disclose any confidential client information without the specific consent of the client.

ET Section 391

Ethics Rulings on Responsibilities to Clients

1. Computer Processing of Clients' Returns

.001 Question—May a member make use of an outside service bureau for the processing of clients' tax returns? The member's firm would control the input of information and the computer service would perform the mathematical computations and print the return. Is there any violation of the confidential relationship in the fact that client information leaves the member's office?

.002 Answer—A member may utilize outside services to process tax returns. He must take all necessary precautions to be sure that the use of outside services does not result in the release of confidential information.

AICPA ETHICS COMMITTEE EXPOSURE DRAFT ON OUTSOURCING AUGUST 9, 2004

- AICPA response to the outsourcing debate by Congress, the media, and state and federal regulators
- The document can be downloaded at http://www.aicpa.org/members/div/ethics/ed_outsourcing.htm

Key Points of Exposure Draft

1) Client disclosure of outsourcing under Rule 102

- The member should inform the client that he or she may be using a third-party service provider when providing professional services to the client, prior to sharing confidential client information with the service provider
- If client objects, the member should not use third-party or should decline engagement
- Disclosure not required for administrative support services
 - Record storage
 - Software application hosting services (ASPs)

Key Points of Exposure Draft

2) Member is responsible for all work performed by outsourcer

- The proposed ethics ruling under Rule 201, *General Standards*, and Rule 202, *Compliance With Standards*, would clarify the application of rules 201 and 202 to members who use a third-party service provider in providing professional services to clients, and make clear the committee's position that the member is responsible for all work performed by the service provider.

Key Points of Exposure Draft

3) “Computer Processing” under Rule 301 is expanded

- applicable to any third-party service provider used by the member (both professional and administrative providers)
- the member should enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the client’s information
- the member should use reasonable care in determining that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information.

Accountancy Regulations Title 8-Education Law Rules of the Board of Regents

Part 29 Unprofessional Conduct

Section 29.1 General provisions.

(8) revealing of personally identifiable facts, data or information obtained in a professional capacity without the prior consent of the patient or client, except as authorized or required by law;

(10) delegating professional responsibilities to a person when the licensee delegating such responsibilities knows or has reason to know that such person is not qualified, by training, by experience or by licensure, to perform them;

Gramm-Leach-Bliley Act P.L. 106-102, Subtitle A of Title 5

The GLB Act:

- Requires “financial institutions” to provide their customers with an annual notice of their privacy policies and practices
- Subject to certain exceptions, prohibits financial institutions from disclosing nonpublic personal information about a client to nonaffiliated third parties
- FTC regulations require a written information security plan

Gramm-Leach-Bliley Act (cont.)

- Financial institutions include accountants who are engaged in the business of completing personal income tax returns, and financial planners
 - CPA firms involved in personal income tax preparation or financial planning must describe its privacy policies and practices to its clients with respect to information sharing with both affiliates and nonaffiliated third parties

Gramm-Leach-Bliley Act (cont.)

Exception from the disclosure rule

CPA is allowed to disclose nonpublic personal information to affiliates of the firm or nonaffiliated third parties that perform services or functions for the firm pursuant to a contractual agreement that prohibits the nonaffiliated third party or affiliate from disclosing or using the information other than for the purposes for which the information was disclosed. (16 CFR 313.13)

Gramm-Leach-Bliley Act (cont.)

Safeguard requirements:

Written information security plan that describes CPA's program to protect client information.

1. designate the person to coordinate the safeguards,
2. identify and assess the risks to client information in each relevant area of operation, and evaluate the effectiveness of current safeguards for controlling these risks,
3. design a safeguards program, and detail the plans to monitor it,

Gramm-Leach-Bliley Act (cont.)

Safeguard requirements (cont.):

4. **select appropriate service providers and require them (by contract) to implement the safeguards, and**
5. evaluate the program and explain adjustments in light of changes to your business arrangements or the results of security tests.

IRC Section 7216

Prohibits paid tax preparers from disclosing tax return information without the client's consent, other than for the specific purpose of preparing, assisting in preparing, or obtaining and providing services in connection with preparing any income tax return of the taxpayer.

IRC Section 7525

Provides a client with a privilege similar to an attorney-client privilege when the client makes certain tax-related disclosures to his or her CPA.

The Golden Rule

The Golden Rule or the ethic of reciprocity is found in the scriptures of nearly every religion. It is often regarded as the most concise and general principle of ethics:

- Treat others as you would like to be treated**

For the Tax Professional's Golden Rule

- Outsource your clients' tax returns only if you are willing to outsource your own return!**

Summary of Ethical Considerations

- CPA firm may use outside firms to process tax returns – CPA must be assured by the outside firm that there will be no release of confidential information
- CPA may delegate tax preparation to only those who are qualified by training and experience to prepare returns
- CPA is allowed to disclose nonpublic personal information to nonaffiliated third parties pursuant to a contractual agreement that prohibits the third party from disclosing or using the information other than the intended purpose

Summary of Ethical Considerations (cont.)

- CPA must disclose to its clients the sharing of client information with nonaffiliated third parties
- Third party service provider must have a written safeguard program

Benefits of Outsourcing

- Lower tax preparation costs (\$50 -\$150 per return)
- Lower fees to clients
- Higher profits to firm
- Reduce staff hours creating better work environment
- Eliminate hiring of temporary preparers
- Meet deadlines
- Faster turn-around
- Paperless work file
- Disaster Recovery – returns and documents stored on off-site fileserver and backup tapes
- Bookmaking, hyper-linking, and indexing facilitate better review of return

Pitfalls of Outsourcing

- Tax file structure will change
- Workflow will change – admin staff will scan documents and will check-in prepped returns and documents
- Eliminating the tax prep function may reduce qualified reviewers
- Review process will change
 - On screen review and review notes
- Documents may be omitted in the scan process (e.g., 2-sided documents)
- Documents may be deleted in the prep process
- Hidden Costs – Investment in equipment

Pitfalls (cont.)

- **Potential Public Relations Nightmare:**
 - Surprisingly, the coverage has been balanced
 - 60 Minutes Episode – 12/23/03
 - NYT Article – 2/15/04
 - MSNBC.com – 2/22/04
 - CNNMONEY – 2/25/04
 - WSJclassroom.com – 3/5/04 and 3/9/04
- **Unpatriotic – Exporting Employment – a political “hot potato”**
 - “I want to repeal every tax break and loophole that rewards any Benedict Arnold CEO or corporation for shipping American jobs overseas”

Pitfalls (cont.)

- Congressional proposals
 - Defending American Jobs Act
 - United States Workers Protection Act
 - USA Jobs Protection Act
 - Jobs for America Act
- Foreign Accounting Firms will market directly to our clients
- Identity Theft Issues

Due Diligence Checklist

- Client types to be outsourced
 - Individuals, Estates and Trusts
 - Corporations and Partnerships
- Partners' returns
 - Partners using outsourcing is an affirmation of the process
- Cost savings
 - 100% to clients
 - Shared with clients
 - 100% to CPA firm

Due Diligence Checklist (cont.)

- Disclosure
 - Minimum – one liners in annual privacy notice – see example
 - Maximum – “Dear Client” letter on outsourcing
- Selection of outsourcing firm
 - Referrals and references
 - Copy of safeguards and security procedures
 - Third party assessment of privacy practices
 - Documenting staffing and training procedures for US and foreign employees
 - Copy of confidentiality clause
 - Testing on actual returns

Due Diligence Checklist (cont.)

- Workflow assessment
 - Less staff to prepare
 - More administrative to scan and print PDF files
- Equipment and software assessment
 - Internet bandwidth
 - Scanners
 - Moved to Windows XP platform
 - Adobe Acrobat program
 - High-end tax software – consider using remote server software
- Check with insurance carrier

ANNUAL PRIVACY DISCLOSURES

For current and former clients, we do not disclose any nonpublic personal information obtained in the course of our practice except as required or permitted by law. Permitted disclosures include, for instance, providing information to our employees, and to unrelated third parties who need to know that information to assist us in providing services to you. In all such situations, we stress the confidential nature of information being shared.

**WARNING: AICPA ETHICS COMMITTEE
EXPOSURE DRAFT ON OUTSOURCING
MAY REQUIRE “LOUD AND CLEAR” DISCLOSURE
OF OUTSOURCING PRIOR TO THE TAX
ENGAGEMENT**

Electronic Filing

- The Good News: IR-2004-65, May 10, 2004 – Strong Filing Season Produces E-file Records
 - As of April 30, 2004, 60 million out 121 million individual returns were E-filed
- The Bad News: ETAAC Report to Congress 2003
 - 30 million returns computer-prepared by practitioners but submitted on paper
- Tax professionals hold the primary key to increased e-filing and electronic tax administration

Carrot and Stick Approach

- IRS
 - Carrot – IRS is offering “E-services” to tax practices that e-file more than 100 individual tax returns
 - **Disclosure Authorization**
 - **Electronic Account Resolution**
 - **Transcript Delivery System**
 - Stick – Mandatory filing for partnerships with more than 100 partners

Carrot and Stick Approach

- States
 - Stick – For 2004 filing season (in 2005)
 - Mandatory filing for tax practices that file a volume of individual returns in the following states:
 - Alabama (250 or more returns)
 - California (more than 100 returns)
 - Connecticut (200 or more returns)
 - Michigan (200 or more returns)
 - Minnesota (more than 100 returns)
 - Oklahoma (more than 50 returns)
 - Virginia (100 or more returns, or bar coded paper returns)

Carrot and Stick Approach

- Preparers required to e-file state returns will likely e-file federal returns
- Conclusion: State filing requirements will push tax professionals into the e-file era

Data Mining

- Accountants Love Data
 - Compile data
 - Present data
 - Analyze data
 - Make money from data
 - Commonly referred to as “Database Management” or “Data Mining”
 - Data mining feature is included in high-end tax preparation software

Mining Tax Return Data

- **Every field on every tax form is loaded into a searchable database**
- **Data is automatically loaded on a timely basis**
- **Queries are easy to formulate**
- **Results are downloaded into Excel**

Tax Planning Queries

- Identify all individuals subject to AMT and making #4 estimated tax payments
- Identify all individuals having SE income and not claiming Keogh Contributions
- Identify all individuals born before 01/01/1935

Practice Management Queries

- Create 1040 tax control lists by signers of tax returns
- Identify partnerships containing a particular partner (whose address needs to be changed)
- Identify all partnerships with more than 100 partners
- Identify all individuals filing in Connecticut

Application Service Providers (ASPs)

- Tax software and data files reside on remote servers accessed through the Internet
 - Software is updated automatically
 - Data files are backed-up on multiple servers in multiple locations
 - Servers are monitored 24/ 7
 - High level of encryption
 - Tax returns can be accessed from any PC – at work or at home

Application Service Providers (ASPs)

- Tax software and data files reside on remote servers accessed through the Internet (cont.)
 - Software support staff can review return with you, and make immediate fixes
 - Provide Outsourcers access to your returns
 - Free-up resources on your in-house server
 - Very fast computations

Application Service Providers (ASPs)

- Pitfalls
 - When the Internet is down, you are down
 - Need to establish back-up plan when Internet is down
 - Back-up DSL and dial-up capabilities
 - Work-at-home alternatives

Final Thoughts

- As Yogi Berra said: “The future ain’t what it used to be”
- New concepts sound strange at first
 - “All things must change to something new, to something strange”, Henry Wadsworth Longfellow (1807-1882)

Final Thoughts

- Best way of coping with the unknown is keeping an open mind
- Today's strange new concepts may be tomorrow's great success stories