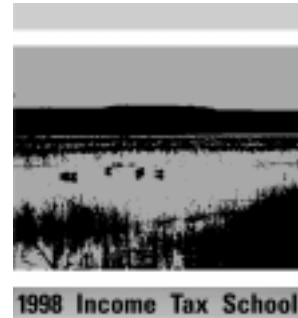


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ETHICS

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ETHICS

OVERVIEW

With the ever-increasing complexity of the Internal Revenue Code, return preparers are faced with decisions affecting both their clients' tax situations and their own liability in terms of both malpractice and preparer penalties.

Competent and sincere preparers find themselves "sandwiched" between the client's desire for the lowest possible tax and the "correct" tax as determined through the preparer's knowledge and research capabilities. Unfortunately, given the same facts, it is entirely possible that three different practitioners can prepare a tax return and arrive at three different tax amounts. A good example of this problem is the annual *Money* magazine challenge in which 20–25 preparers "compete" for the correct answer in preparing a return based on the same facts. Needless to say, few preparers arrive at the "correct" tax, but what is surprising is the significant disparity between the low and high amounts of resulting tax. An additional consideration is the somewhat lower IRS audit coverage nationally. Thus, we have a problem both from the preparation and enforcement standpoints. In short, many clients **and** preparers are simply becoming more aggressive.

As a result, the issue of ethics in tax preparation is becoming a more significant issue. To properly cover this topic, we have segmented our discussion into the following subject areas:

1. Return preparer penalties
2. Other assessable penalties against preparers
3. Practice before the IRS issues
4. Use of Form 8275, disclosure statement
5. Practical situational analysis
6. Scenarios of disciplinary actions by the IRS Director of Practice

RETURN PREPARER PENALTIES

Section 6694. Understatement of taxpayer's liability by income tax return preparer.

Statutory Authority:

a. Understatements due to unrealistic positions. If—

1. any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits,
2. any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and
3. such position was not disclosed as provided in §6662(d)(2)(B)(ii) or was frivolous, such person shall pay a penalty of \$250 with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

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- b. **Willful or reckless conduct.** If any part of any understatement of liability with respect to any return or claim for refund is due—
1. to a willful attempt in any manner to understate the liability for tax by a person who is an income tax return preparer with respect to such return or claim, or
 2. to any reckless or intentional disregard of rules or regulations by any such person, such person shall pay a penalty of \$1000 with respect to such return or claim. With respect to any return or claim, the amount of the penalty payable by any person by any reason of this subsection shall be reduced by the amount of the penalty paid by such person by reason of subsection (a).

I.R.C. §6694(a) provides a \$250 penalty for understatements of tax due to an “unrealistic position” taken on a tax return. Circular 230, §10.34(a)(4)(i) defines “realistic possibility”:

A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. The authorities described in 26 [*31528] CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a position will not be challenged by the Service (e.g., because the taxpayer’s return may not be audited or because the issue may not be raised on audit) may not be taken into account.

I.R.C. §6694(b) provides a \$1,000 penalty for understatements of tax due to “willful or reckless” conduct.

OTHER ASSESSABLE PENALTIES AGAINST PREPARERS

Statutory Authority:

Section 6695, Other assessable penalties with respect to the preparation of income tax returns for other persons.

- a. **Failure to furnish copy to taxpayer.** Any person who is an income tax return preparer with respect to any return or claim for refund who fails to comply with §6107(a) with respect to such return or claim shall pay a penalty of \$50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed \$25,000.
- b. **Failure to sign return.** Any person who is an income tax return preparer with respect to any return or claim for refund, who is required by regulations prescribed by the Secretary to sign such return or claim, and who fails to comply with such regulations with respect to such return or claim, shall pay a penalty of \$50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed \$25,000.
- c. **Failure to furnish identifying number.** Any person who is an income tax return preparer with respect to any return or claim for refund and who fails to comply with §6109(a)(4) with respect to such return or claim shall pay a penalty of \$50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed \$25,000.

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- d. **Failure to retain copy or list.** Any person who is an income tax return preparer with respect to any return or claim for refund and who fails to comply with §6107(b) with respect to such return or claim shall pay a penalty of \$50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed \$25,000.
- e. **Failure to file correct information returns.** Any person required to make a return under §6060 who fails to comply with the requirements of such section shall pay a penalty of \$50 for—
 - 1. each failure to file a return as required under such section, and
 - 2. each failure to set forth an item in the return as required under the section, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any return period shall not exceed \$25,000.
- f. **Negotiation of check.** Any person who is an income tax return preparer who endorses or otherwise negotiates (directly or through an agent) any check made in respect of the taxes imposed by subtitle A which is issued to a taxpayer (other than the income tax preparer) shall pay a penalty of \$500 with respect to each check. The preceding sentence shall not apply with respect to the deposit by a bank (within the meaning of §581) of the full amount of the check in the taxpayer's account in such bank for the benefit of the taxpayer.
- g. **Failure to be diligent in determining eligibility for earned income credit.** Any person who is an income tax preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by §32 shall pay a penalty of \$100 for each such failure.

The penalties under I.R.C. §6695 are, for the most part, procedural in nature, with the exception of (g), the earned income credit diligence penalty. This penalty is new for 1997 returns and later years, and requires additional scrutiny by return preparers when preparing returns with the earned income credit. The IRS provides a checklist for use by preparers, a copy of which can be found in chapter 15.

ISSUES OF PRACTICE BEFORE THE IRS

Treasury Department Circular No. 230 includes the regulations governing the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, and appraisers before the Internal Revenue Service. Circular 230 also governs certain actions by representatives who are not so licensed in representation before the IRS Examination Division.

Circular 230 provides specific guidance to practitioners in matters pending before the IRS.

§10.20. Information to Be Furnished

- a. **To the Internal Revenue Service.** No attorney, certified public accountant, or enrolled agent shall neglect or refuse promptly to submit records or information in any matter before the Internal Revenue Service, upon proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, or shall interfere with any proper and lawful effort by the Internal Revenue Service or its officers or employees to obtain any such record or information, unless he believes in good faith and on reasonable grounds that such record or information is privileged or that the request for, or effort to obtain, such record or information is of doubtful legality.

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- b. **To the Director of Practice.** It shall be the duty of an attorney or certified public accountant who practices before the Internal Revenue Service, or enrolled agent, when requested by the Director of Practice, to provide the Director with any information he may have concerning violation of the regulations in this part by any person, and to testify thereto in any proceeding instituted under this part for the disbarment or suspension of an attorney, certified public accountant, or enrolled agent, unless he believes in good faith and on reasonable grounds that such information is privileged or that the request therefor is of doubtful legality.

§10.21. Knowledge of Client's Omission

Each attorney, certified public accountant, or enrolled agent who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client is required by the revenue laws of the United States to execute, shall advise the client promptly of the fact of such noncompliance, error, or omission.

§10.22. Diligence as to Accuracy

Each attorney, certified public accountant, or enrolled agent shall exercise due diligence:

- a. In preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
- b. In determining the correctness of oral or written representations made by him to the Department of the Treasury; and
- c. In determining the correctness of oral or written representations made by him to clients with reference to any other matter administered by the Internal Revenue Service.

§10.23. Prompt Disposition of Pending Matters

No attorney, certified public accountant, or enrolled agent shall unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

§10.24. Assistance from Disbarred or Suspended Persons and Former Internal Revenue Service Employees

No attorney, certified public accountant, or enrolled agent, shall, in practice before the Internal Revenue Service, knowingly and directly or indirectly:

- a. Employ or accept assistance from any person who is under disbarment or suspension from practice before the Internal Revenue Service.
- b. Accept employment as associate, correspondent, or subagent from, or share fees with, any such person.
- c. Accept assistance from any former government employee where the provisions of §10.26 of these regulations or any Federal law would be violated.

§10.31. Negotiation of Taxpayer Refund Checks

No attorney, certified public accountant, or enrolled agent who is an income tax return preparer shall endorse or otherwise negotiate any check made in respect of income taxes which is issued to a taxpayer other than the attorney, certified public accountant, or enrolled agent.

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§10.51. Disreputable Conduct

Disreputable conduct for which an attorney, certified public accountant, or enrolled agent may be disbarred or suspended from practice before the Internal Revenue Service includes, but is not limited to:

- a. Conviction of any criminal offense under the revenue laws of the United States, or of any offense involving dishonesty or breach of trust.
- b. Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement, written or oral, are included in the term "information."
- c. Solicitation of employment as prohibited under §10.30 of this part, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or officer or employee thereof.
- d. Willfully failing to make a Federal tax return in violation of the revenue laws of the United States, or evading, attempting to evade, or participating in any way in evading or attempting to evade any Federal tax or payment thereof, knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof, or concealing assets of himself or another to evade Federal taxes or payment thereof.
- e. Misappropriation of, or failure properly and promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.
- f. Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by use of threats, false accusations, duress, or coercion, by the offer of any special inducement or promise of advantage or by the bestowing of any gift, favor, or thing of value.
- g. Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, possession, territory, Commonwealth, the District of Columbia, any Federal court of record, or any Federal agency, body, or board.
- h. Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person. Maintaining a partnership for the practice of law, accountancy, or other related professional service with a person who is under disbarment from practice before the Service shall be presumed to be a violation of this provision.
- i. Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations and statements knowing them to be false, or circulating or publishing malicious or libelous matter.
- j. Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph include those which reflect or result from a knowing misstatement of fact or law; from an assertion of a position known to be unwarranted under existing law; from counseling or assisting in conduct known to be illegal or fraudulent; from concealment of matters required by law to be revealed; or from conscious disregard of information indicating that material facts expressed in the tax opinion or offering material are false or misleading. For the purpose of this paragraph, reckless conduct is a highly unreasonable omission or misrepresentation, involving not merely simple or inexcusable negligence, but an extreme departure from the standards of ordinary care

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that is either known or is so obvious that the competent practitioner must or should have been aware of it. Gross incompetence includes conduct that reflects gross indifference, preparation that is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

USE OF FORM 8275

I.R.C. §6662 imposes a 20% accuracy-related penalty **on the taxpayer** for negligence or disregard of the rules or regulations or any substantial understatement of income tax. The term “understatement” is reduced by items for which the taxpayer has substantial authority, or has a reasonable basis that is adequately disclosed on the return.

I.R.C. §6694(a) (the \$250 preparer penalty) is similarly offset by items the taxpayer has adequately disclosed.

Although it is not required as an attachment to the return, the authors strongly recommend use of Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement. This form specifically satisfies the “adequate disclosure” rule of §§6662 and 6694.

Many practitioners feel that the use of this form is a red flag to the IRS. However, there is no anecdotal evidence to support this attitude.

SITUATION ANALYSIS

Many organizations, including the Internal Revenue Service, either have conducted or intend to conduct serious ethics training sessions for their employees or members. In an effort to do the same, several ethics problems are presented to you, the practitioner. These situations are not uncommon. The purpose of these problems is to encourage you to think and respond in a professional and ethical manner.

Situation 1

A new client comes to you in January 1999, and asks you to prepare his 1998 tax return. He is in the salvage business and has been for 20 years. You ask him for copies of his three prior years' tax returns and depreciation schedules. He gives them to you. Following is the information reported on his 1995, 1996, and 1997 tax returns and the information for 1998 as presented by him.

Year	Interest Dividend		Sch. C	Sch. C
	AGI	Income	Receipts	Net Loss
1995	\$7,274	\$10,200	\$1,350	\$364,700 (\$4,276)
1996	7,277	11,780	1,710	410,000 (6,213)
1997	7,219	11,102	1,450	410,000 (5,333)
1998	4,195	10,101	1,320	423,300 (7,226)

He is single and age 50, lives in a \$175,000 house, and has an antique auto collection of five valuable vehicles. He brings you the 1998 Forms 1099-Int. and -Div. He gives you a single piece of paper prepared in pencil for the 1998 Sch. C income and expenses. When you inquire about the books and records for the business, he tells you that his girlfriend keeps the records and he doesn't have time to be a bookkeeper. You ask if he does a lot of business in cash, and he says, “Yes, that's the way all junkyards operate.”

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Discussion Questions and Comments

1. What are the issues presented by these facts?
2. What are the practitioner's duties in this situation?
3. Do you want this client? What are the implications of keeping him?
4. Are there circumstances under which you would accept this engagement?
5. If you accept this engagement, what precautions might you take to protect yourself?

Review Circular 230 ¶10.34(a)(3), Reliance upon Taxpayer Furnished Records; and ¶10.34(a)(2), Duty to Advise Client of Potential Penalties. Penalties to consider are I.R.C. §6662(b)(1), Negligence, and I.R.C. §6663, Fraud. Also, there might be criminal sanctions if the facts warrant.

Situation 2

Your client is in the construction business. You have prepared her income tax and employment tax returns for over 10 years. She employs nonunion workers. She attended a business convention and tells you about a seminar topic she heard. She said the speaker advised that all workers should be treated as independent contractors and that written contracts should be prepared and signed by her and each worker. She also commented that "this area is economically depressed, and anyone should feel lucky to be able to work for me," and that "I'm tired of paying IRS, the state, and worker's compensation on all these people." She asks you to take care of this for her.

Discussion Questions and Comments

1. What are the issues presented in these facts?
2. Should you do what your client asks?
3. What advice would you give her?
4. If she tells you she is going to go forward and change the status of her workers to independent contractors, what advice should you give her?

See Circular 230, ¶10.34(a)(1), Standard for Return Positions. Positions reported on returns must meet the "substantial possibility of success if challenged" standard, or, if not frivolous, disclosed. Possible penalties arising from reporting a position on a return for which there is not substantial authority are I.R.C. §6662(b)(1), Negligence, and I.R.C. §6662(b)(2), Substantial Understatement. In addition, the preparer may be subject to I.R.C. §6694, Unrealistic Position.

Situation 3

Your client's 1996 return is examined by an inexperienced revenue agent. The agent spent three days at your office, which you feel is excessive. You constantly had to explain to the agent about incorrect positions and conclusions he raised. At the closing conference, the agent presented you with a work paper showing a proposed increase in Sch. F grain sales of \$14,000. This is the only proposed adjustment. After the agent leaves, you analyze the work paper and the client's farm record book, deposit slips, and elevator sales sheets. You conclude that the agent's work paper is correct with the exception that there is a glaring math error made in totaling 25 separate grain sales. Instead of a \$14,000 understatement of grain sales, the actual understatement is \$34,000. The agent told you to let him know if you agree with the proposal so he can prepare the exam report.

Discussion Questions and Comments

1. What is the issue presented in these facts?
2. What is the practitioner's duty?
3. May you notify the agent of the error without your client's consent?
4. If your client refuses to allow you to discuss the error with the agent, how are you to proceed?

See Circular 230, ¶10.21, Knowledge of Client's Omission.

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Situation 4

You have prepared the returns of a client for many years. While preparing the 1998 Form 1040, you learned that the client was not entitled to claim her youngest child as a dependent. The daughter left college in March 1997 and got a full-time job immediately. She was married in December 1997. You were not aware of this information when you prepared the 1997 Form 1040. It appears that the daughter should not have been claimed as a dependent on the 1997 return.

Discussion Questions and Comments

1. What is the issue presented in these facts, and how does it differ from that in Situation 3?
2. What is your duty in this case?

See Circular 230, ¶10.21, Knowledge of Client's Omission.

Situation 5

Your client is a prosperous farmer. He received a newsletter that advised him about hedging losses being deductible on Schedule F. You have prepared his returns for many years. Your preparation fee has averaged \$800 for the last several years. In 1998, the farmer had a net loss of \$36,000 in his commodity futures trading. Since he was trading only corn and soybeans, he is convinced that he was hedging and not speculating. You explain the law to him and tell him that he was speculating, not hedging, and the \$36,000 loss is not allowable on his 1998 Schedule F. He says, "If you don't put the loss on my Schedule F, I'll find someone who will."

Discussion Questions and Comments

1. What are the issues presented by these facts?
2. What are you to do?

See Circular 230, ¶10.34(a)(1), Standards for Return Positions; and ¶10.34(a)(2), Advice as to Potential Penalties. Possible penalties for the taxpayer are I.R.C. §6662(b)(1), Disregard of Rules or Regulations, and/or I.R.C. §6662(b)(2), Substantial Understatement.

Situation 6

You have been contacted by a new client who has not filed returns for the last five years. In the interview of this person, you determine that during the tax years that have not been filed, the client was single and traveled around the United States doing odd jobs. The client informs you that he was always paid in cash, had no bank accounts, and never received any W-2's or 1099's for the tax years involved. The client shows you a letter from the IRS Service Center inquiring as to his nonfiling for 1996 and 1995.

Discussion Questions and Comments

1. What would you do to reconstruct income?
2. What are your duties?
3. Do you want this client? What are the implications of keeping him?
4. What interest (examination level) do you think the IRS has in the returns you will be filing?

Situation 7

A new neighbor has contacted you in March 1998 asking if you would take him as a client. After saying you would, the neighbor brought the 1099's, W-2's, mortgage interest statement, and other relevant tax

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return data to you for preparation of the return. In interviewing the new client, you determine that the client has been married for nine years, and that both he and his wife have one child by a previous marriage, and they have one child of their own. The clients just moved from Washington, D.C.

Upon completion of the return, you indicate that a refund of \$628 is due to them. Your client looks very disappointed and you ask why. The client informs you that in the previous year, they received a refund in excess of \$3,600. You ask to see a copy of the previous year's return, and you notice that the tax return preparer had filed two returns as Head of Household instead of Married Filing Jointly. Both the husband and wife lived together for both the current and the previous year. In looking more closely at the addresses shown on the previous year's returns, you notice that on one return the street name was Kilroy, and on the other return Kill Roy.

Discussion Questions and Comments

1. What are the issues presented by these facts?
2. How would you approach these prior years with your client?
3. What advice would you give to the client?
4. What would you do about the preparer whose name and address is shown on the previous return?
5. What kind of predicament does this situation place you in?

Situation 8

You were engaged over 12 months ago to prepare delinquent returns for a new client. You had started on the returns, but because of both your schedule and the client's procrastination, the returns have not been completed. You have in your possession the client's bank statements, canceled checks, cash receipts, and disbursements journal, and several boxes of invoices and miscellaneous records. The client has not contacted you in over three months, and you have an outstanding receivable on this client for \$575.

Another practitioner in the area calls and informs you that she is now representing the client. She also informs you that an IRS Revenue Officer (Collection Division) has given her just 30 days in which to complete the returns. She requests that you turn over the client's records to her so that she can complete the returns. You inquire as to the unpaid receivable of \$575, and she indicates that the matter is between you and the client.

Discussion Questions and Comments

1. What are your responsibilities in this matter?
2. What should you do to resolve the account receivable?
3. Do you have the right to withhold the records pending payment?
4. Could the IRS demand release of these records?