Chapter 3: Ethics

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

WHAT'S NEW

On March 6, 2006, the IRS released additional proposed regulations to Section 330 of Title 31 of the United States Code. Section 330 allows the IRS to regulate the practice of representatives before the Treasury Department. This is the second major release of regulation changes and additions. The statute states:

Sec. 330. Practice before the Department

STATUTE

a. *Subject to section 500 of title 5, the Secretary of the Treasury may:*

  1. *regulate the practice of representatives of persons before the Department of the Treasury; and*

  2. *before admitting a representative to practice, require that the representative demonstrate:*

    A. *good character;*

    B. *good reputation;*

    C. *necessary qualifications to enable the representative to provide to persons valuable service; and*

    D. *competency to advise and assist persons in presenting their cases.*

b. *After notice and opportunity for a proceeding, the Secretary may suspend or disbar from practice before the Department a representative who:*

  1. *is incompetent;*

  2. *is disreputable;*

  3. *violates regulations prescribed under this section; or*

  4. *with intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented.*

c. *After notice and opportunity for a hearing to any appraiser with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code of 1986, the Secretary may:*

  1. *provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service, and*

  2. *bar such appraiser from presenting evidence or testimony in any such proceeding.*

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The regulations regarding Section 330 are contained in CFR Subtitle A, Part 10. They are published in a pamphlet entitled Circular 230. This circular was completely revised and released June 20, 2005. The IRS is serious about regulating tax preparers. When the current IRS Commissioner, Mark Everson, made his initial address to Congress in 2003, he emphasized the need to increase taxpayer compliance. He said that the IRS needed to start at the top if taxpayers were to regain faith in the tax system. Consequently, his first priority was looking at the tax returns of IRS personnel and then tax preparers.

To further accomplish his goals, he changed the name of the Office of the Director of Practice to the **Office of Professional Responsibility (OPR),** and then increased the OPR budget to pay for additional personnel which allows investigation of more allegations.

GAO STUDY

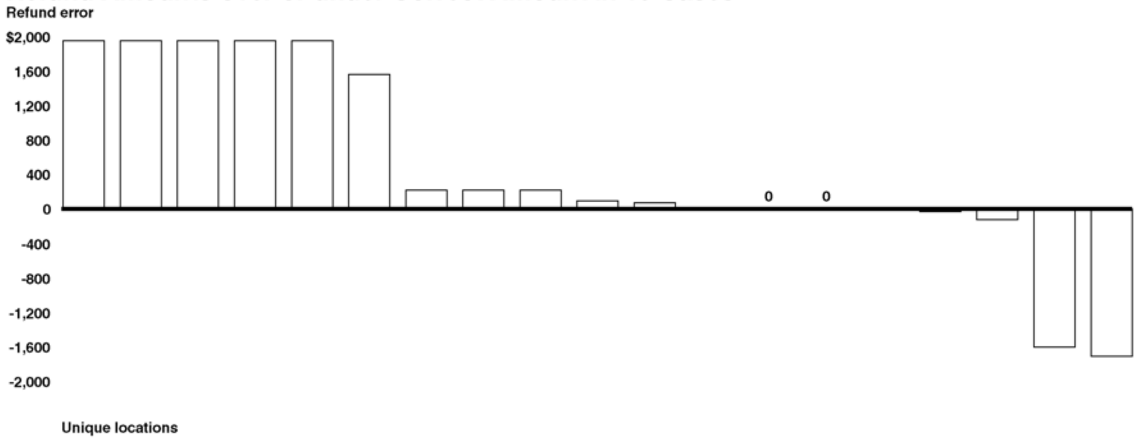
On April 4, 2006, the United States Government Accountability Office (GAO) presented a report to the Senate Finance Committee. This report discussed the results of a project in which the GAO sent employees to 19 different tax offices in a metropolitan area. These offices were owned by various national tax preparation chains and the tax returns were prepared by unenrolled tax preparers.

In all 19 situations, the tax return was incorrectly prepared. In five instances, the tax refund was overstated by almost $2,000. In two instances, the return reported almost $1,500 excess tax. While two returns reported the correct tax liability, there were errors on the return. Some of the most serious problems involved preparers failing to:[1]

- Report business income in 10 of 19 situations;
- Ask where a child lived, or ignoring the GAO's answer to the question, and therefore claiming an ineligible child for the EIC in five out of the ten applicable situations;
- Take the most advantageous postsecondary education tax benefit in three out of nine situations; and
- Itemize deductions or failing to claim all available deductions in seven out of nine situations.

The following graph shows the amounts of underpaid and overpaid income tax on the 19 returns.

Refund Amounts over or under Correct Amount in 19 Cases[2]



Source: GAO.

[1] *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors,* Government Accountability Office, April 4, 2006

[2] Ibid

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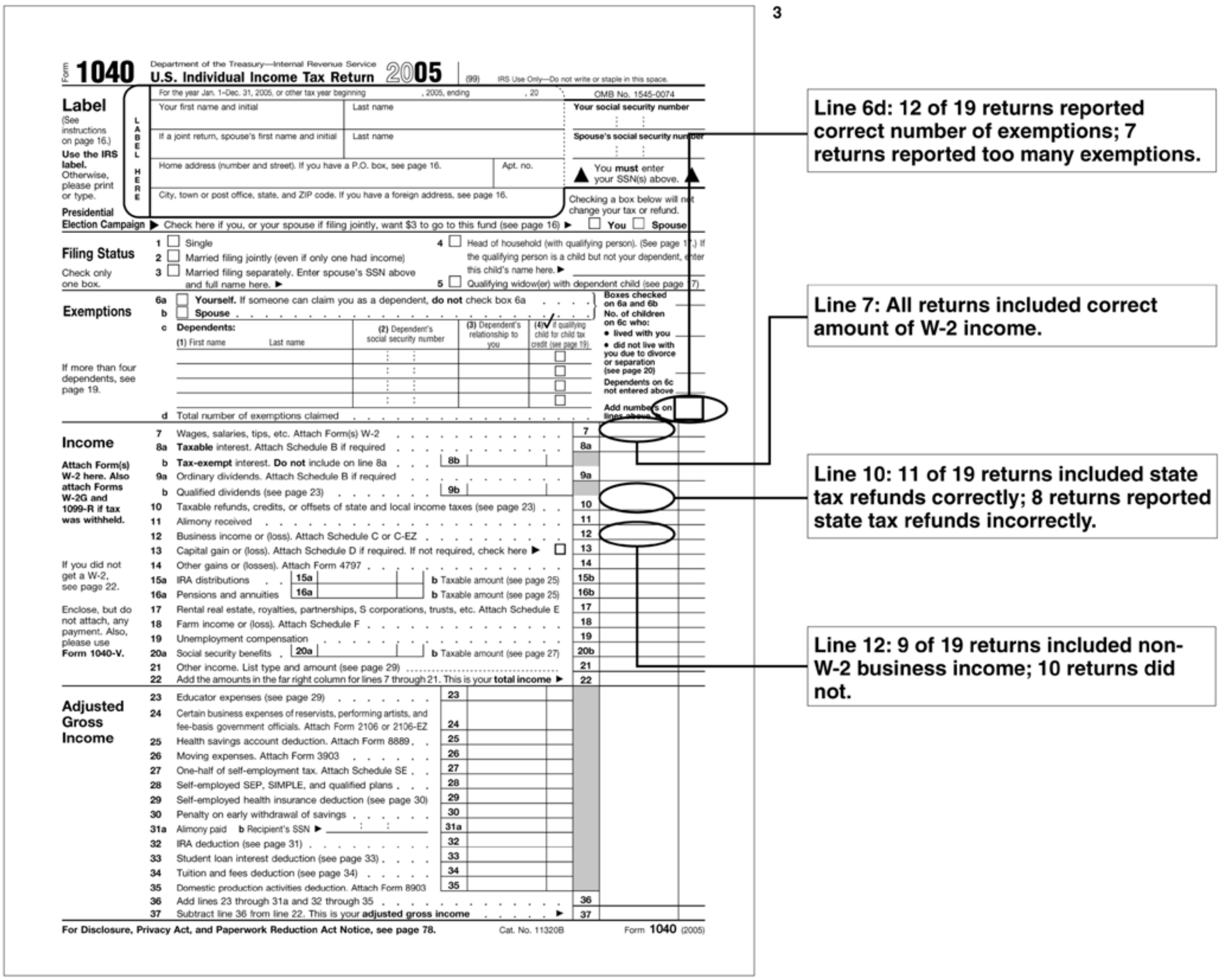
News media often conduct investigations asking tax preparers to complete a test return. These returns often are complicated and contain situations a preparer may not encounter in his practice. However, the GAO returns contained only common situations. There were actually two different scenarios.

1. This scenario involved a plumber and his wife. They had one child in college and derived almost all of their income from his plumbing job. He did some work on the side and had a mutual fund. Their deductions were high enough to allow them to itemize their deductions on Schedule A.

2. The other scenario involved a low-income single mother who was a retail sales worker. She had extra income from babysitting. She had one child who lived with her and one who did not.

The following pages are from the GAO report:[3]



[3] Ibid

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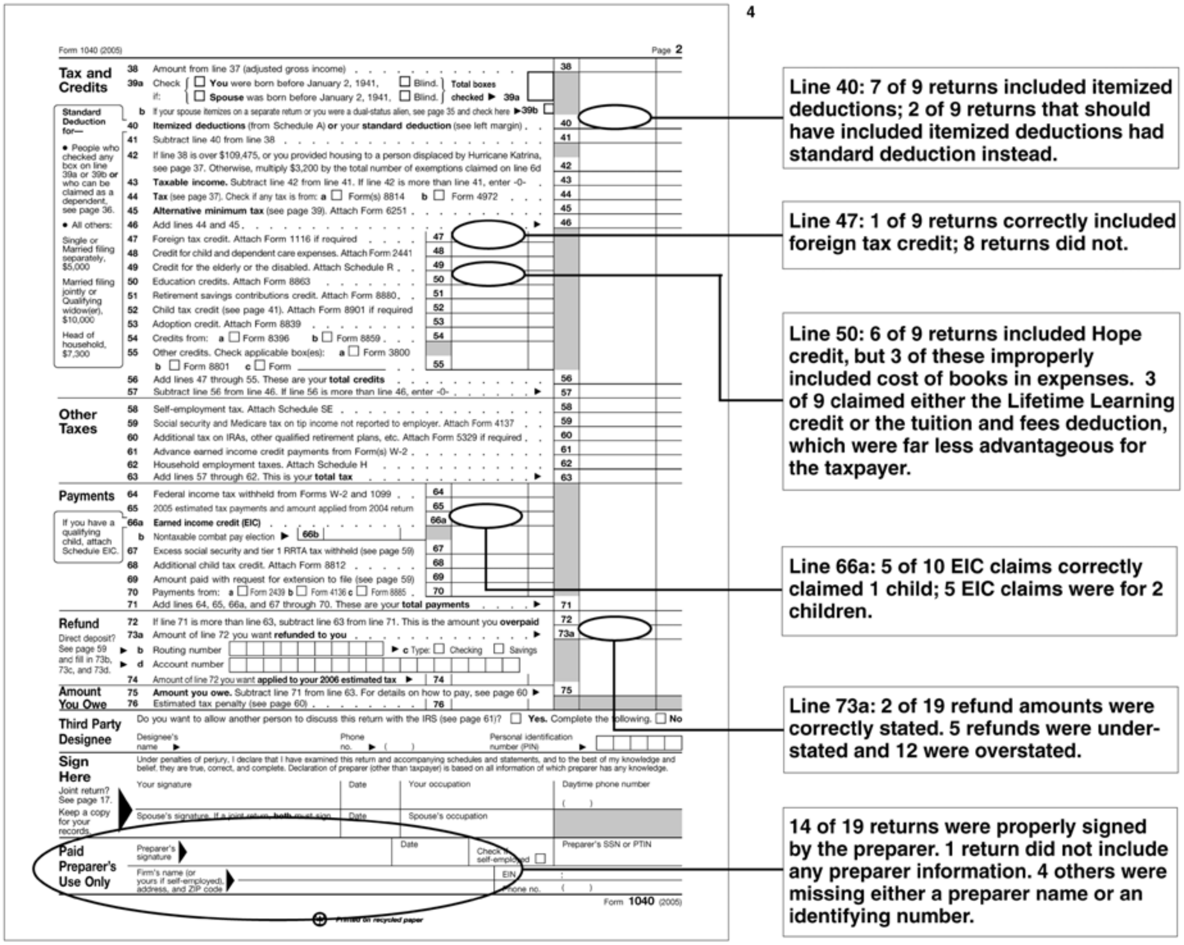

[4]

The GAO report has other interesting facts. It shows the estimated percentage of errors on the 2001 National Research Program (NRP) audits of individual returns. The report stated that the paid preparer returns were generally more complicated then the taxpayer prepared returns.

Table 7: Estimated Percentage of NRP-audited Tax Year 2001 Individual Returns with Errors[5]

Type of return	Estimate (percent)
Prepared by a paid preparer	56
Prepared by the taxpayer	47
All returns	52

Source: GAO analysis of IRS NRP data.

The entire GAO report can be found at **www.gao.gov/new.items/d06563t.pdf.**

4. Ibid

5. Ibid

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WHAT TO EXPECT

The GAO report causes renewed interest in licensing of all tax preparers. One such bill is S. 832. Passage of this bill in its original format would require all unenrolled tax preparers to successfully complete an examination before they can prepare tax returns for a fee. It is estimated that requiring registration of unenrolled preparers would affect between 200,000 and 600,000 people.

Tax preparers should anticipate increased scrutiny of their work. Auditors may be more likely to assess preparer penalties when they find errors on tax returns.

SPECIAL ENROLLMENT EXAMINATION

In January 2006, the IRS announced it had contracted with an outside vendor to prepare and administer the Special Enrollment Examination (SEE) which requires passage before a person can become an enrolled agent (EA). There are concerns that the revised exam will not be completed in time to be effective in 2006.

The IRS selected Thomson Prometric to prepare and administer the new SEE for enrolled agents. The Thompson contract allows the company 10 years to develop and administer the test at the cost of $12.5 million.

Thomson conducted a job analysis survey of enrolled agents. The survey consisted of four areas:

1. Background and general information about the respondent
2. Characteristics of the respondent
3. Questions to confirm what an EA does
4. Questions to confirm what an EA needs to know in order to perform his job

The IRS expects Thomson to administer the first test in October 2006. The test will be offered in approximately 300 testing sites across the United States. This is an increase from 90 sites used when the IRS administered the test. The test will be administered on a computer terminal rather than using a paper and pencil test. Other changes the IRS announced include:[6]

- Candidates will have an eight week window to take the examination.
- Candidates will not be required to take all parts of the examination in one sitting.
- Candidates who pass a portion of the exam will be allowed to carry over their scores.
- Candidates will be permitted to take each part of the exam up to four times each calendar year.

The new exam consists of three parts and is approximately the same length as the old exam. The questions are multiple choice. True/false questions were eliminated.

> **Observation.** Outsourcing the SEE examination, as well as rearranging its parts, makes it easier for the IRS if Congress decides to require licensing and testing of all tax practitioners.

6. IR-2006-61, April 13, 2006

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ENROLLED PREPARERS IN TROUBLE WITH OPR

The IRS is subject to various audits by the Treasury Inspector General for Tax Administration (TIGTA). In a report issued March 31, 2006, the TIGTA took the IRS to task for not enforcing the Circular 230 rules against some tax preparers.[7] The report is the result of a review of the disciplinary actions of the OPR.

Due to pressure from Congress, the IRS placed a greater emphasis on the oversight of tax preparers. The budget of the OPR increased from $1.8 million and a staff of 15 in fiscal year 2002 to a budget of $5 million and a staff of 56 in fiscal year 2005. During this time period, the number of disciplinary actions by the OPR increased. This is primarily due to an increase in expedited suspensions, an action taken after a federal or state government agency has convicted or disbarred a practitioner or revoked her license.

The TIGTA still found numerous tax practitioners whose conduct appears to warrant disciplinary action, but who escaped identification by the OPR. The TIGTA found preparers who were convicted of tax-related crimes and whose license was suspended by the state authority, but who were not suspended from practice by the OPR.

Currently, the IRS does not have a process of notifying the OPR of practitioners who are delinquent in their own tax filing obligations. The TIGTA sampled 750 preparers from the 407,000 practitioners with Centralized Authorization File (CAF) numbers, and found 34 preparers (4.5%) who were not compliant. These 34 practitioners had a total of 81 tax periods with a balance due of $826,709 and 34 tax periods for which tax returns had not been filed. Based on this sample, the TIGTA estimates 22,500 of these 407,000 practitioners are not compliant with their obligations.

Observation. The 43-page TIGTA report probably will cause increased activity in the investigation of licensed enrolled tax preparers.

PROPOSED AMENDMENTS TO CIRCULAR 230 REG-122380-02

BACKGROUND

Circular 230 contains the regulations governing practice before the IRS. In February 2006, OPR issued REG-122380-02 announcing a number of proposed changes to Circular 230.

These proposed amendments covered:

- Eligibility for enrollment
- Regulations affecting unenrolled preparers
- Sanctions and disciplinary proceedings
- Contingent fees
- Confidentiality agreements

The following sections discuss some of the proposed changes included in the February announcement.

7. www.treas.gov/tigta/auditreports/2006reports/200610066fr.pdf

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ENROLLMENT PROCEDURES

The proposed regulations clarify the requirements for renewal of enrollment to practice before the IRS. An enrolled agent (EA) must apply for renewal between November 1 and January 31 of the relevant year. The initial enrollment years are based on the last digit of the EA social security number. To renew enrollment, the EA must complete 72 hours of continuing professional education during the three-year enrollment cycle. The minimum requirement in a year is 16 hours which includes two hours of ethics. The enrollment year consists of a calendar year. Therefore an EA whose social security number ends in zero must renew enrollment between November 1, 2006, and January 31, 2007. He must have completed 72 hours of continuing professional education (CPE) between January 1, 2004, and December 31, 2006, with at least 16 hours (including two hours of ethics) during each calendar year.

The proposed amendment requires CPE sponsors to renew their status as qualified sponsors every three years. A CPE course must enhance the professional knowledge in federal tax related matters and be consistent with the Internal Revenue Code and effective tax administration.

LIMITED PRACTICE BEFORE THE IRS

> **Note.** Sections referred to in the following text relate to Circular 230 rather than Internal Revenue Code sections, unless specified otherwise.

Section 10.7(c)(1)(viii) currently authorizes an individual, who is not otherwise a practitioner, to represent a taxpayer during an examination if that individual prepared the return for the taxable period under examination. The proposed regulations revoke this authorization because it is inconsistent with the requirement that all individuals permitted to practice before the IRS demonstrate their qualifications to advise and assist persons in presenting their situations to the IRS.

The proposed regulations no longer permit the unenrolled preparer to represent a taxpayer unless otherwise authorized by Section 10.7(c)(1)(1)-(vii). These individuals may no longer negotiate with the IRS on behalf of the client during examination. They may no longer bind a taxpayer to a position during an examination. The unenrolled preparer may no longer sign Form 872, *Consent to Extend the Time to Assess Tax*, with regard to a tax return prepared for that individual. Likewise, the unenrolled preparer may not agree to any adjustment to the taxpayer's reported tax liability.

The proposed regulations do not preclude the unenrolled preparer from assisting the taxpayer in the examination if the taxpayer has specifically authorized the unenrolled preparer to assist in the exchange of information and receive confidential information from the IRS. The unenrolled preparer may still assist the taxpayer in answering questions regarding the tax return. The unenrolled preparer may still accompany the taxpayer to the audit, provided the taxpayer authorizes the IRS to disclose confidential information.

> **Note.** There is discussion about preventing any IRS audit assistance by an unenrolled preparer.

PRACTICE BY FORMER GOVERNMENT EMPLOYEES, THEIR PARTNERS, AND THEIR ASSOCIATES

The proposed regulations eliminate the prohibition in Section 10.25(b)(3) against assisting in representation in matters in which a former government employee had official responsibility during the employee's last year of service. The IRS has determined that existing statutes, regulations, and codes of professional responsibility are adequate to protect against conflicts of interest.

However, the proposed regulations continue to prohibit former employees who personally and substantially participated in a matter while a government employee from representing or assisting in the representation in the same matter while in private practice. The former employee's firm may represent the taxpayer, as long as the former employee is isolated from the matter and isolation statements are filed with the OPR.

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Example 1. Sherri was a former revenue agent who retired and opened a small tax practice. While still employed at the IRS, she began an audit of Clancy's Barber Shop. She retires in the middle of the audit. Sherri is prohibited from representing or assisting in the representation of Clancy's Barber Shop.

Jared was Sherri's group manager. He also retired and became an employee of a local CPA firm. If Jared was not substantially involved in the Clancy audit, he can assist in the representation.

CONTINGENT FEES

Currently, Section 10.27 of Circular 230 only prohibits a tax preparer from charging a contingent fee on an original return. Under the proposed regulations, the preparer is precluded from charging a contingent fee on original returns, amended returns, and claims for refund. The IRS believes restricting contingent fees discourages tax preparers from taking positions that exploit the audit selection process. They state the broader prohibition is appropriate in light of concerns regarding attorney and auditor independence.

Contingent fees may still be charged for services rendered in an examination of the IRS's challenge of an original return. A practitioner may charge contingent fees for services rendered in connection with the IRS's examination of, or challenge to, an amended return or claim for refund filed prior to the taxpayer receiving notice of the examination or challenge to the original return. A written notice of examination includes the written notice furnished to taxpayers subject to the Coordinated Industry Situation procedures requesting a statement showing additional tax due or an adequate disclosure of an item or position. The purpose of the notice is to avoid the imposition of certain accuracy-related penalties if no other written notice is received. Contingent fees also may be charged for services rendered in connection with a judicial proceeding arising under the federal tax laws.

Example 2. Tax preparer Gustof reads in a tax newsletter that the IRS ruled cat food was deductible in a recent case. Without reading the case himself and learning the facts were very specific about the cat being an important part of the taxpayer's business, he contacts all of his clients who have cats for pets. He informs them that he will amend their last three years returns and deduct their cat food expense. He plans to only charge for the preparation when the clients receive their refund from IRS. At that time, he expects to invoice for 50% of the refund. Gustof is in violation of Section 10.27 for the contingent fee. He is probably in violation of other sections as well.

Example 3. The IRS audited Scott and Angela's income tax return. The auditor disallowed a questionable deduction. This deduction was allowed by the Tax Court in some districts and disallowed in others. It has never been taken to Tax Court in Scott and Angela's district. A local CPA and attorney agree to take the situation to Tax Court for a percentage of the taxes saved if the court allows the deduction. In this situation the contingent fee is allowed by Section 10.27.

CONFLICTING INTERESTS

Currently, Section 10.29 prohibits a practitioner from representing conflicting interests before the IRS. However, if he has the express consent of all directly interested parties after fully disclosing the nature of the conflict, he is able to represent both taxpayers.

The proposed regulations clarify that a practitioner is required to obtain a written consent from each affected party before representation begins. The practitioner may prepare a letter to the client outlining the conflict, as well as possible implications, and submit the letter to the other client to countersign. An oral consent by the client followed by a confirmation letter will not suffice.

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Observation. A question exists regarding whether a practitioner can prepare the tax returns of both parties where a conflict could exist, but just not represent them in the case of an audit without signed consents. Based on the definitions section of the proposed regulations the answer is **no.** Practice is defined as:

"Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings."

STANDARDS FOR TAX RETURNS AND DOCUMENTS, AFFIDAVITS AND OTHER PAPERS

Section 10.34 discusses standards for rendering advice on tax return positions and standards for preparing or signing returns. The proposed regulation further expands this to documents or papers submitted to the IRS. The proposed regulations also provide separate standards for papers taking a position about federal tax matters and standards for advising a client to file papers involving procedural or factual matters. The word **papers** refers to returns, amended returns, or other written documents.

The proposed regulations **prohibit** a practitioner from advising a client to take a frivolous position. He cannot advise the client to submit a document that:

- Is meant primarily for delay;
- Is frivolous or groundless; or
- Contains or omits information in a manner that demonstrates intentional disregard for the law.

A practitioner is permitted to rely on a taxpayer-provided document, unless the information appears to be incorrect, inconsistent with an important fact, or incomplete. These standards supplement the existing requirement in Section 10.22 that practitioners exercise due diligence in preparing tax returns and other documents relating to IRS matters.

Example 4. Shannon owes the IRS $18,000 on her 2003 income tax return. The IRS has a lien on her property and is threatening to foreclose. Her tax preparer advises her to file an offer in compromise, knowing this will delay any collection action. The preparer also knows that the IRS will not accept any offer because of the income and assets of the taxpayer. The IRS might characterize this as a stall tactic in violation of Section 10.22.

DISCLOSURE OF DISCIPLINARY PROCEEDINGS

Section 10.72(d) of the proposed regulations discusses the publicity of disciplinary proceedings. Currently, these proceedings are closed to the public unless the practitioner asks that they be open and the administrative law judge grants the request. The proposed regulations provide that all disciplinary proceedings be open to the public. This includes hearings, reports, evidence, and decisions. However, the identities of any third parties must be protected.

Observation. As this information becomes available, it allows the public to see what issues the IRS is pursuing related to tax preparers.

SANCTIONS

Sanctions can be imposed on a practitioner if she is shown to be incompetent or disreputable, fails to comply with regulations or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. The American Jobs Creation Act of 2004 gave the IRS authority to impose monetary penalties on the employer, firm, or entity of a representative if the employer knew or should have known of the practitioner's conduct. There are monetary penalties in addition to other sanctions the IRS can impose.

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INCOMPETENCE AND DISREPUTABLE CONDUCT

Currently Section 10.51 defines disreputable conduct for which a practitioner may be sanctioned to include:

- Conviction of any criminal offense under the revenue laws of the United States
- Conviction of any criminal offense involving dishonesty or breach of trust
- Conviction of any felony which renders the practitioner unfit to practice before the IRS
- Giving false or misleading information to the IRS in connection with pending or likely-to-be-pending matters and knowing the information is false or misleading
- Solicitation of employment as prohibited under Section 10.30, using false or misleading representations with the intent to deceive a client in order to procure employment, or intimating the practitioner is able to improperly obtain special considerations from the IRS
- Willfully failing to file a federal tax return
- Misappropriation of or failure to promptly remit funds received from a client for the payment of taxes
- Directly or indirectly trying to influence the IRS by the use of threats, duress, or gift offers
- Disbarment or suspension from practice as an attorney, certified public accountant, or public accountant
- Knowingly aiding and abetting another person to practice before the IRS during a period of suspension of the other person
- Contemptuous conduct in connection with the IRS, including using abusive language and making false acquisitions or statements
- Giving a false opinion, knowingly, recklessly, or through gross incompetence; including an opinion which is intentionally or recklessly misleading; or engaging in a pattern of providing incompetent opinions on questions arising under federal law

The proposed regulations modify this definition to include willful failure to sign a tax return prepared by the practitioner. The definition also includes the disclosure or use of return information by practitioners in a manner not authorized by the Code, a court of competent jurisdiction, or an administrative law judge.

> **Example 5.** Matthew asks his tax preparer to show him how a tax return would be prepared if he had a small sole proprietor business. The preparer is concerned that the business does not exist and believes Matthew wants this information to claim an earned income credit. The practitioner prepares a return, but does not sign it or mark it as a return which cannot be filed. The practitioner may be in violation of Section 10.51 if Matthew files the return the practitioner prepared.

SUPPLEMENTAL CHARGES

Section 10.65 currently allows the OPR to file supplemental charges against a practitioner. The proposed regulation allows OPR to amend the complaint.

HEARINGS AND DISCOVERY

Several changes are in the proposed regulations regarding hearings and discovery.[8] These changes will not affect tax preparers unless they represent clients in Tax Court.

8. Sections 10.71, 10.72, and 10.73

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2006 Workbook

ETHICAL DILEMMA SCENARIOS

Tax preparers are often faced with ethical dilemmas in their day-to-day tax practice. Responses to these issues vary from person to person depending on factors such as age, education, professional stature, and locale. The following ethical dilemmas are designed to provoke thought and discussion. When evaluating the dilemma, consider the following questions:

- What are the issues of the situation?
- What alternatives are available to resolve the issue and what are the consequences of each alternative?
- What is the appropriate action?

ISSUE #: ________

What are the issues? ________________________________

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What alternatives are available and what are their consequences? ________________________________

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What is the appropriate action? ________________________________

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ISSUE #: ________

What are the issues? ________________________________

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What alternatives are available and what are their consequences? ________________________________

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What is the appropriate action? ________________________________

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SITUATION 1

When preparing Chad Timmon's 2005 tax return, Tammy Bright notices that Chad's income has dropped from the year before. She also notices that Chad sold some stocks during the year and cashed some U.S. Savings Bonds. It appears that Chad converted about $120,000 of assets into cash and shows no income from that cash. Tammy wants to be thorough in preparing Chad's tax return, so she asks him about the decrease. Chad explains he lent $120,000 to his daughter, Muffi, so she could buy a house. He further reveals that Muffi is paying an amount equivalent to 3% interest on the loan. But he adds, "We are calling the interest a gift to repay me for the expenses I incurred in sending her to college." In Chad's opinion, this interest should not be taxable income because Muffi is not allowed to deduct the amount as an expense. Muffi is not required to report the interest on Form 1099 INT as it is interest on an obligation issued by an individual. In short, there is no record of the amount being paid to Chad.

Chad insists that Tammy prepare the tax return without the amount reported as income. Assume it is unlikely that the IRS will discover that Chad has received this amount.

SITUATION 2

Every year, Straight Arrow, Inc., files its federal income tax return. In 2004, the IRS audits the tax return and disallows some deductions. The company agrees with the audit findings. Much to its surprise, five months later, Straight Arrow receives a large refund check for the year of the audit. The owner of Straight Arrow asks his accountant Jeff whether he should notify the IRS of the erroneous check. Jeff says there is a low probability of the IRS finding the error. Jeff is pondering what the appropriate action is in this situation.[9]

SITUATION 3

Millard has been Daniel's tax preparer for years. He has never questioned the income Daniel reports for his small woodworking shop. In 2005, Daniel asks Millard to look at a financial statement he prepared for the bank in order to obtain a substantial loan for new tools. Millard notices that the financial statement reports substantially more income for the last three years than Daniel reported on his Schedule C. What should Millard do?

SITUATION 4

Senator Snort invites his tax practitioner, Kelli, to his annual Christmas party. During the party, Kelli sees a constituent, Jamaican M. Y. Day, give Snort a large amount of cash and say "great job." Kelli remembers reading that Jamaican was just awarded a multimillion dollar contract by a committee that Snort chairs.

When Kelli meets with Snort to prepare his tax return, no mention is made of the money. What should Kelli do?

SITUATION 5

Larret has prepared the tax returns of Daniel and Stephanie for the past 20 years. When Daniel calls Larret for a tax appointment in 2006, he tells Larret that he will be filing for divorce, but not to mention anything to Stephanie since he is still discussing details with his attorney.

What should Larret do?

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9. Situations 1 and 2 are similar to situations W. Morley Lemon posed in his article, "A Question of Ethics" in the November 1996 issue of *CA Magazine*.

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SITUATION 6

Kimberly Debit, CPA, attends the Chamber of Commerce breakfast. She is introduced to Michael Megastore who is planning to open a large furniture store in her town in 18 months. He asks if she would consider being the business accountant and tax preparer. Kimberly estimates the annual fee would be in excess of $30,000.

Kimberly is also the accountant of Small Furniture, Inc., a competitor of Megastore. Her relationship with Small has given her a vast amount of information regarding the business potential in the area. Small's total annual fee is less than $1,000.

Should Kimberly accept the Megastore engagement? What information can she share with Megastore? What information can she share with Small?

SITUATION 7

Jerry Blabber, EA, is the tax preparer for Green Fairways Golf Club. He is also the preparer for QuickGreen Fertilizer Company. When discussing the financial problems of QuickGreen with its CEO, he discovers they are concerned about losing the Green Fairways account. The CEO mentions that they are prepared to discount their product up to 25% if need be.

When meeting with Green Fairways the next day, he is asked to analyze the fertilizer costs of three companies, one of which is QuickGreen. Should he tell Green Fairways that it can get a lower bid from QuickGreen? Should he tell QuickGreen that Green Fairways is currently comparing the costs of competitors and should place a revised bid as they are currently the highest bidder? Should Jerry decline to work for one or both clients?

SITUATION 8

Juanita Agpro is an Iowa tax preparer who specializes in preparing farm tax returns. She has prepared the return of Silas Storage for the past four years. Silas files his Schedule F on the accrual basis. He meets with Juanita on February 24 to prepare his 2005 tax return. He presents Juanita with his income and expenses and waits until she gives him an estimate of the tax liability. Silas looks shocked when he hears how much tax he owes. He takes his papers, looks at them, and then tells Juanita that his soybean inventory is overstated by 50,000 bushels. Juanita makes the change and Silas is happier.

After Silas leaves the office, Juanita remembers this is the fourth straight year Silas has changed his inventory amounts during the tax interview. She begins to wonder what the actual inventory quantities are. What should Juanita do?

SITUATION 9

Loren is a tax practitioner who lives in Montgomery County. Besides being an accountant he is the treasurer of the Montgomery County Red Cross. Renee, a first time client, comes to Loren's office to have her 2005 income tax return prepared. Part of the information she gives Loren consists of a $1,000 deduction to the Montgomery County Red Cross. Loren asks if she has a letter acknowledging the contribution and she answers in the affirmative.

After Renee leaves, Loren begins to think about the donation. Being the treasurer, he did not remember the donation. He goes into the Red Cross files and cannot find a record of the donation. He has already given the completed return to Renee and now believes she claimed an erroneous deduction. What should Loren do?

SITUATION 10

Ima Good is a very successful CPA. She primarily has a representation practice. She accompanies clients to Tax Court on a regular basis. She has been asked to represent Tamara's Beauty Shop in an independent contractor tax situation. The IRS is claiming all of the beauticians are employees and subject to payroll withholding. The beauty shop claims they are independent contractors.

Ima has researched all of the cases the IRS cited in taking the employee position. Ima has found two situations which appear to favor Tamara's position. She also found a case in Tamara's district which is directly on point and would immediately cause the Tax Court to rule in favor of the IRS. Since the IRS has not cited this situation, must Tamara bring the situation to the attention of the court?

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SITUATION 11

Peggy is a respected CPA in a small Midwestern town. The majority of the town's businesses are clients of Peggy. She was recently invited to be on the Board of Directors of the local bank. In that position, she would sit on the loan committee and help decide whether many of her clients would have loans approved. Should Peggy accept the invitation?

SITUATION 12

Jim Bob prepared Billy Bob's tax returns for three years. In January 2006, Jim Bob learns that Billy Bob has failed to report thousands of dollars of income on his past returns. When confronted with the omissions, Billy Bob decides to change accountants.

Cindy Sue, another accountant in town, brings a letter from Billy Bob to Jim Bob requesting past records. While these records are being transferred, Cindy Sue asks Jim Bob why Billy Bob is switching accountants. What should Jim Bob disclose?

ETHICAL DILEMMA SCENARIOS — DISCUSSION AND SUGGESTIONS

SITUATION 1

When preparing Chad Timmons 2005 tax return, Tammy Bright notices that Chad's income has dropped from the year before. She also notices that Chad sold some stocks during the year and cashed some U.S. Savings Bonds. It appears that Chad converted about $120,000 of assets into cash and shows no income from that cash. Tammy wants to be thorough in preparing Chad's tax return, so she asks him about the decrease. Chad explains he lent $120,000 to his daughter, Muffi, so she could buy a house. He further reveals that Muffi is paying an amount equivalent to 3% interest on the loan. But he adds, "We are calling the interest a gift to repay me for the expenses I incurred in sending her to college." In Chad's opinion, this interest should not be taxable income because Muffi is not allowed to deduct the amount as an expense. Muffi is not required to report the interest on Form 1099 INT as it is interest on an obligation issued by an individual. In short, there is no record of the amount being paid to Chad.

Chad insists that Tammy prepare the tax return without the amount reported as income. Assume it is unlikely that the IRS will discover that Chad has received this amount.

Issues. The first issue is whether the interest is taxable to Chad. Interest income is taxable, whether it is reported on a Form 1099 or not.

The second issue deals with imputed interest. Loans in excess of $10,000 must charge interest at the applicable federal rate (AFR) as determined by the IRS each month. The situation does not tell the duration of the loan or the payment schedule. If it is assumed there are only annual payments and it qualifies as a long-term loan, the AFR rates in 2005 ranged from 4.33 to 4.83%. Therefore, part of the principal payments made by Muffi must be categorized as interest.[10]

A third issue is that Tammy knows the details of the transaction. Section 10.21, *Knowledge of Client's Omission*, requires that Tammy notify the client that the interest is taxable.

Fourth, if Tammy refuses to sign the tax return because of the omission of interest, but gives the completed return to Chad, she is in violation of Section 10.51 (incompetence and disreputable conduct).

An additional issue is whether a gift tax return was filed.

Alternatives and Consequences. One alternative is for Tammy to calculate the appropriate amount of imputed interest and report it on Chad's tax return. This would be done with Chad's knowledge and agreement.

If Chad does not agree to report the income on the return, Tammy should not continue the engagement.

Appropriate Action. The appropriate action is to report the interest as income. If Chad refuses, Tammy should decline the engagement.

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10. IRC §7872

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SITUATION 2

Every year, Straight Arrow, Inc., files its federal income tax return. In 2004, the IRS audits the tax return and disallows some deductions. The company agrees with the audit findings. Much to its surprise, five months later, Straight Arrow receives a large refund check for the year of the audit. The owner of Straight Arrow asks his accountant Jeff, whether he should notify the IRS of the erroneous check. Jeff says there is a low probability of the IRS finding the error. Jeff is pondering what the appropriate action is in this situation.

Issue. The issue is whether the erroneous check should be returned and the IRS notified of its error.

Alternatives and Consequences. One alternative is to return the check to the IRS with a letter stating it is an erroneous payment. A second alternative is to keep the check, but ask the IRS for an explanation of how the refund was derived. A third alternative is to assume the IRS was correct in issuing the refund check.

Appropriate Action. The appropriate action is to request an explanation of how the refund was computed. The taxpayer should not cash the check until the IRS explains the refund. This will avoid the need to pay interest on the refund in case the IRS requires the check be returned. The IRS has up to two years to collect on an erroneous refund.[11]

> **Observation.** With e-services available to tax professionals, the preparer can view the information the IRS has in its files on which it based the check.

SITUATION 3

Millard has been Daniel's tax preparer for years. He has never questioned the income Daniel reports for his small woodworking shop. In 2005, Daniel asks Millard to look at a financial statement he prepared for the bank in order to obtain a substantial loan for new tools. Millard notices that the financial statement reports substantially more income for the last three years than Daniel reported on his Schedule C. What should Millard do?

Issues. The first issue is that the client may have underreported a substantial amount of income for a number of years. The second issue is that the tax preparer now knows of the omission. A third issue, unrelated to tax, is that Daniel may be overstating income just to get the loan and the tax returns are correct as filed.

Alternatives and Consequences. If the tax return is wrong, one alternative is for the taxpayer to file amended tax returns and report the unreported income. If he fails to do that, the preparer is obligated to tell Daniel of his suspicion of unreported income, suggest amended returns be filed and discuss the penalties to which Daniel may be subject. If the financial statement is incorrect, the preparer should suggest that a new financial statement be prepared.

Appropriate Action. The appropriate action is to file amended returns if not correct as filed. If this does not occur, Millard may want to cancel any future engagements with Daniel.

SITUATION 4

Senator Snort invites his tax practitioner, Kelli, to his annual Christmas party. During the party, Kelli sees a constituent, Jamaican M. Y. Day, give Snort a large amount of cash and say "great job." Kelli remembers reading that Jamaican was just awarded a multimillion dollar contract by a committee that Snort chairs.

When Kelli meets with Snort to prepare his tax return, no mention is made of the money. What should Kelli do?

Issue. Since Kelli was not a party to the transaction, she is only speculating that the payment to Snort was a kickback. If the payment was a kickback, it is taxable income to Snort.[12]

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11. IRC §§6532(b) and 7405

12. IRC §61

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Alternatives and Consequences. Kelli is the party that must resolve the issue. She must decide if she wants to approach Snort or forget what she thought she saw. If she confronts Snort and he denies there was a kickback, he may well find a new tax preparer. On the other hand, Kelli may ask some general questions regarding unreported income and if Snort says he has reported all income she may complete the return. If Kelli decides to go the authorities, she should contact legal counsel.

Appropriate Action. The appropriate action when seeing a crime committed is to report the crime. However, because of Kelli's professional relationship and the fact she does not know for sure that a crime is committed, she should contact legal counsel. Because Kelli was not a party to the transaction and has no direct knowledge of unreported income, the provisions of Circular 230 do not apply.

SITUATION 5

Larret has prepared the tax returns of Daniel and Stephanie for the past 20 years. When Daniel calls Larret for a tax appointment in 2006, he tells Larret that he will be filing for divorce, but does not want Larret to mention anything to Stephanie since he is still discussing details with his attorney.

What should Larret do?

Issue. This is a conflict-of-interest situation. Larret has information which could have an enormous effect on how Stephanie files her tax return.

Alternatives and Consequences. Larret must tell Daniel that he needs a written statement from both Daniel and Stephanie before he can discuss tax issues affecting both parties. Daniel should tell Stephanie he is going to file for divorce so she can immediately hire an attorney to protect her interests.[13] It is doubtful that Daniel will consent based on his remarks to Larret.

Appropriate Action. Larret should resign from the engagement. He is in a situation in which he cannot win. Regardless of what action Larret takes, he will lose one of the clients and possibly both.

SITUATION 6

Kimberly Debit, CPA, attends the Chamber of Commerce breakfast. She is introduced to Michael Megastore, who is planning to open a large furniture store in her town in 18 months. He asks if she would consider being the business accountant and tax preparer. Kimberly estimates the annual fee would be in excess of $30,000.

Kimberly is also the accountant of Small Furniture, Inc., a competitor of Megastore. Her relationship with Small has given her a vast amount of information regarding the business potential in the area. Small's total annual fee is less than $1,000.

Should Kimberly accept the Megastore engagement? What information can she share with Megastore? What information can she share with Small?

Issue. This is a conflict-of-interest situation. At issue is whether Kimberly can represent both clients, drop Small and represent Megastore, or if she should decline to represent Megastore.

Alternatives and Consequences. Kimberly can represent both clients if they sign an agreement acknowledging the possible conflict. Assuming the clients agree, Kimberly must decide whether she believes she can fairly represent both parties.

Appropriate Action. The safest action for Kimberly is to represent only one of the stores.

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13. Section 10.29

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SITUATION 7

Jerry Blabber, EA, is the tax preparer for Green Fairways Golf Club. He is also the preparer for QuickGreen Fertilizer Company. When discussing the financial problems of QuickGreen with its CEO, he discovers they are concerned about losing the Green Fairways account. The CEO mentions that they are prepared to discount their product up to 25% if need be.

When meeting with Green Fairways the next day, he is asked to analyze the fertilizer costs of three companies, one of which is QuickGreen. Should he tell Green Fairways that it can get a lower bid from QuickGreen? Should he tell QuickGreen that Green Fairways is currently comparing the costs of competitors and should place a revised bid as they are currently the highest bidder? Should Jerry decline to work for one or both clients?

Issue. How much information can an accountant disclose to a client?

Alternatives and Consequences. Jerry is in a difficult situation. If he says nothing, one or the other of his clients will lose. If he says something, one will lose and one will win.

Appropriate Action. Jerry dare not divulge confidential information to either client.

SITUATION 8

Juanita Agpro is an Iowa tax preparer who specializes in preparing farm tax returns. She has prepared the return of Silas Storage for the past four years. Silas files his Schedule F on the accrual basis. He meets with Juanita on February 24 to prepare his 2005 tax return. He presents Juanita with his income and expenses and waits until she gives him an estimate of the tax liability. Silas looks shocked when he hears how much tax he owes. He takes his papers, looks at them, and then tells Juanita that his soybean inventory is overstated by 50,000 bushels. Juanita makes the change and Silas is happier.

After Silas leaves the office, Juanita remembers this is the fourth straight year Silas has changed his inventory amounts during the tax interview. She begins to wonder what the actual inventory quantities are. What should Juanita do?

Issue. Is Juanita using correct data to prepare Silas's tax return?

Alternatives and Consequences. Silas has the option of reporting the correct inventory. Juanita can discuss the situation with Silas.

Appropriate Action. Juanita should discuss her suspicion with Silas. If he insists the final inventory number is correct, Juanita may request a written record of the inventory amounts for her file. If Juanita still believes Silas is lying, she should decline the engagement.

SITUATION 9

Loren is a tax practitioner who lives in Montgomery County. Besides being an accountant he is the treasurer of the Montgomery County Red Cross. Renee, a first time client, comes to Loren's office to have her 2005 income tax return prepared. Part of the information she gives Loren consists of a $1,000 deduction to the Montgomery County Red Cross. Loren asks if she has a letter acknowledging the contribution and she answers in the affirmative.

After Renee leaves, Loren begins to think about the donation. Being the treasurer, he did not remember the donation. He goes into the Red Cross files and cannot find a record of the donation. He has already given the completed return to Renee and now believes she claimed an erroneous deduction. What should Loren do?

Issue. Was an erroneous contribution deducted on Renee's tax return?

Alternatives and Consequences. Loren is not required to audit Renee's records. However, since he has knowledge that the contribution may be invalid, he should question Renee.

Appropriate Action. This is a difficult situation for Loren. Depending on how well he knows Renee, he may want to tell her that he does not have a record of the contribution in the Red Cross books. He could ask Renee for a copy of the contribution receipt so he can correct the Red Cross books. This is important for Renee if the IRS challenges the deduction.

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SITUATION 10

Ima Good is a very successful CPA. She primarily has a representation practice. She accompanies clients to Tax Court on a regular basis. She has been asked to represent Tamara's Beauty Shop in an independent contractor tax situation. The IRS is claiming all of the beauticians are employees and subject to payroll withholding. The beauty shop claims they are independent contractors.

Ima has researched all of the cases the IRS cited in taking the employee position. Ima has found two situations which appear to favor Tamara's position. She also found a case in Tamara's district which is directly on point and would immediately cause the Tax Court to rule in favor of the IRS. Since the IRS has not cited this situation, must Tamara bring the situation to the attention of the court?

Issue. Must Ima tell IRS about the negative impact case?

Alternatives and Consequences. Ima has no responsibility to prove the case for the IRS. Her responsibility is to Tamara.

Appropriate Action. Ima should notify Tamara of the negative case. If the IRS offers to settle the case, Tamara needs to know she would lose if the IRS found the case.

SITUATION 11

Peggy is a respected CPA in a small Midwestern town. The majority of the town's businesses are clients of Peggy. She was recently invited to be on the Board of Directors of the local bank. In that position, she would sit on the loan committee and help decide whether many of her clients would have loans approved. Should Peggy accept the invitation?

Issue. This is a conflict of interest situation.

Alternatives and Consequences. Peggy has two choices. She can excuse herself from any loan committee meeting where one of her clients has a loan for approval. She can also decline the invitation to be on the bank Board of Directors.

Appropriate Action. Depending on how many clients Peggy serves and their bank activity, Peggy should probably decline the invitation.

SITUATION 12

Jim prepared Billy Bob's tax returns for three years. In January 2006, Jim learns that Billy Bob has failed to report thousands of dollars of income on his past returns. When confronted with the omissions, Billy Bob decides to change accountants.

Cindy Sue, another accountant in town, brings a letter from Billy Bob to Jim requesting past records. While these records are being transferred, Cindy Sue asks Jim why Billy Bob is switching accountants. What should Jim disclose?

Issue. Should Jim tell Cindy Sue about Billy Bob's failure to report income?

Alternatives and Consequences. Jim has no choice other than to turn the files over to Cindy Sue as required by Circular 230. He should retain copies of his work so he can defend himself if the IRS discovers the fraudulent returns.

Appropriate Action. Jim should make sure Billy Bob understands what will happen if the IRS discovers the fraudulent tax returns. He should tell Billy Bob that he should inform the new accountant of the potential issues. **Jim may not tell Cindy Sue of the problem without Billy Bob's permission.**

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CONFLICT OF INTEREST

A conflict of interest can occur without the tax preparer being aware of the conflict. For this reason, he must be very careful when discussing any clients, even if not using names and when talking in generalities. **The safest approach is to never discuss client information.**

When deciding whether to accept a client engagement, the preparer should ask some probing questions to identify possible conflicts. One of the questions might be "How did you hear about our office?" If the client is the result of a referral, a practitioner might want to ask additional questions since this may present a possible conflict.

If the client is a partnership, the practitioner needs to know if he is representing all partners. If preparing the partnership return, the practitioner has an obligation to treat all partners the same. If one partner is a client and another is not, there may be temptation to favor the client partner. The same issue is true for S corporations, trusts, and estates.

A possible conflict could arise from a landlord–tenant situation if the preparer represents both. Representing a merchant and her large clients could also lead to a conflict.

If a practitioner is in doubt as to whether there is a conflict, he should notify all affected clients regarding the situation and let them decide. Their decision should be in the form of a signed letter stating they do not see any conflict with the representation and consenting to the representation.

ENGAGEMENT LETTERS

The area of conflicting interest is one of the major ethical problems tax practitioners face. Unfortunately, unanticipated conflicts can occur. For this reason, many tax professionals are now issuing engagement letters. A signed engagement letter also may help prevent a professional liability insurance claim.

An engagement letter should state the exact terms of the engagement, such as:

- Services to be provided, including the year and type(s) of returns to be prepared
- Expectations of the client, such as format of records and retention of records in case of audit
- Client's expectations of the practitioner
- A statement that the tax preparer will not audit the records, but will point out obvious discrepancies
- Possible conflicts of interest which could arise
- How conflicts will be handled
- Explanation of fees, billing, and payment terms
- A statement that "gray areas" will be resolved in the client's favor when possible
- A statement regarding how penalties and interest will be handled in case of a preparer error
- Whether audit representation is a part of the engagement and fee or comes under a separate engagement
- A statement regarding with whom tax information will be shared, such as individuals doing peer review or an outside tax processing service
- A statement that the engagement letter should be signed and returned
- A statement that the tax preparer will not look for fraud or embezzlement

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It is important that the scope of the engagement is narrowly defined. A 2001 insurance claim was the result of a preparer who provided tax services to a client. The client later discovered his bookkeeper was embezzling from the company. The client alleged the tax preparer should have detected the fraud while performing the tax work. Obviously, the preparer asserts the detection of embezzlement was not part of the engagement. The claim resulted in a $200,000 out-of-court settlement.[14]

Ideally, the engagement letter should be issued annually. When a client or tax preparer terminates an engagement, the client should receive a termination letter as well. Many preparers do not see the value in sending the engagement letter since accountants only provide tax services for their clients once per year. In addition, many of the clients do not return each year. However, if the letter can prevent even one liability insurance claim, the effort will pay for itself. For these simple engagements a form letter signed by the client and the company may be sufficient.

Example 6. In 2004, Helga and Hernando Shifty had their tax return prepared by Marty at the XYZ Tax service. The clients moved to a different state in 2005. In 2006, the IRS selected their return for audit. A preparer in their new state represented them in the audit. During the audit, the IRS found a large amount of unreported income and unsubstantiated deductions. The Shiftys insist that they gave the correct information to Marty and it was his fault it was not reported.

The representative suggests that Marty and XYZ may have some liability for the penalties and interest the IRS is assessing. The IRS is also considering talking to Marty. When XYZ is contacted about the discrepancies, XYZ says Marty has not been seen since 2004. XYZ finds very little information in the Shiftys' tax file.

This leads to the questions:

- What is the potential liability of XYZ?
- How could they have minimized this liability?

One answer is to keep copies of all material submitted by the client. Asking the client to list information on a proforma would also show whether the information was available to the tax preparer.

DABBLING

There are times when a client asks for advice or services which the tax preparer is not qualified to provide. In these instances, the tax professional should either recommend another professional for the engagement or have the client agree to joint representation.

Example 7. Todd's largest client asks Todd for advice on setting up a reverse like-kind exchange. Todd has never been involved in a reverse §1031, but has a book on the topic. The transaction will involve a $4 million property.

If the exchange does not meet all of the IRS requirements, the tax liability will be very high. The client is expecting accurate advice and may well look to Todd to share in the tax liability if he provides erroneous advice. Todd determines he needs help on this transaction and engages the joint participation of a qualified like-kind exchange specialist.

Example 8. Six months after the transaction discussed in **Example 7,** Todd is asked to assist another client in a reverse exchange. Because of the joint participation in the prior example, Todd may now feel comfortable in giving this client advice.

Knowing when to ask for help with an engagement is very difficult. If the tax preparer is not completely comfortable with the advice he is about to give, he should ask for help.

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One actual example of dabbling involved a CPA that provided tax advice to a client who was considering an IRC §1031 exchange. The preparer calculated that the tax liability would be higher using a like-kind exchange than selling the property and paying the tax. Later, it was determined that the preparer performed an incorrect calculation. The resulting liability insurance settlement was $285,000.[15]

Another example involves a CPA who was hired to prepare a corporate tax return. The CPA improperly structured an installment sale and gave incorrect advice. This **may** have resulted in the IRS triggering an excessive compensation reclassification. The resulting settlement was $148,105.[16]

TIMELINESS

Bernard Wolfman wrote, "The vast majority of malpractice cases arising in the return preparation context involve the practitioner's failure to file the client's tax return on a timely basis."[17] Tax preparers are faced with all types of deadlines. Not only must they meet an April 15 deadline, but there are different deadlines for corporations, fiscal year clients, and payroll taxes.

There are also deadlines for filing various elections. One deadline which is often missed is the election to be taxed as an S corporation. A practitioner only needs to look at all of the IRS letter rulings to see that there are numerous requests to extend the deadline. While the IRS grants many of these requests, they are not required to do so.

> **Example 9.** Smyth and Wefton, avid hunters, decide to go into the gun business. While they believe they will make millions, they are concerned about the length of time it will take to build the business. They meet with their long time attorney, Clint Eastmon who tells them they should have an accountant. They find the name of Sandy Newcomer, EA, in the yellow pages and invite her to attend an incorporation meeting with Clint.
>
> Everyone agrees that Smyth and Wefton should become an S corporation and revoke the S election once the business becomes profitable. Sandy files their 2004 Form 1120S on March 14, 2005, reporting a loss of $475,000. On May 1, 2005, Smyth and Wefton receive a letter from the IRS requesting a copy of their approved S election. Unfortunately, Sandy thought Clint filed the election, and Clint assumed Sandy filed the election.
>
> Sandy does not know that the company can request a late S corporation election retroactive to 2004 by following the procedures of Rev. Proc. 2003-43. So, after realizing the election had not been filed, she files the election with an effective date of January 1, 2006.
>
> The effect of these election deadline errors is that the corporation could not use the 2004 loss since there were no carryback years. The corporation also suffered another loss in 2005. Since the 2006 return shows a profit, but is now an S corporation, the shareholders will pay tax on the pass-through profits while the losses are locked into the C corporation.

If the above example were an actual situation, can the corporation sue Sandy and win? Only a judge or jury can answer this question. However, if Sandy has professional liability insurance, there is a good chance the insurance company will try to settle the case without going to court.

An example of how far a client will go when it comes to his tax return is illustrated in *Brott Mardis & Co. v. Camp.*[18] Most tax preparers have experienced the situation in which a taxpayer has failed to file tax returns for a number of years. This is the case in *Brott Mardis.* Taxpayer Camp failed to file tax returns in 1989, 1990, and 1991. He had his employer withhold taxes from his paychecks but never filed a return. In July 1992 Camp asked Brott Mardis to prepare his delinquent returns for those three years. Brott Mardis agreed, but Camp failed to deliver his tax information immediately. In April 1993 he gave the preparer his 1989 information.

15. Ibid

16. Ibid

17. Bernard Wolfman et al., *Standards of Tax Practice,* §605.2.1 (6th ed., 2004)

18. *Brott Mardis & Co. v. Camp,* 147 Ohio App.3d 71, 768 N.E.2d 1191, May 30, 2001

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2006 Workbook

On April 7, 1995, Camp delivered the 1991 information. The preparer quickly prepared the return, mailed it to the IRS on April 15, 1995. It was received on April 18, 1995. The IRS denied the claimed refund since the return was not timely filed. Camp brought suit against Brott Mardis for failing to timely file, assuming the filing deadline was April 15, 1995.

The Court agreed with Camp that the Brott Mardis should have filed the return before April 15, 1995, and made an award to Camp. Brott Mardis appealed the judgment. The Court of Appeals overturned the judgment. This case is an illustration in which a preparer is trying to do a good deed, but ends up paying a price.

> **Note.** The reason for the overturn was not based on the April 18, 1995, date. The filing deadline for a refund is two years if the return is not filed in a timely manner.[19] Because the taxes were withheld, it is assumed a return was filed on April 15, 1992. Therefore, the filing deadline to claim the refund was April 15, 1994. It is interesting that this was found by the Appeals Court rather than the tax preparer.

Tax practitioners involved in filing estate tax returns can be faced with substantial lawsuits. One court case involves a tax preparer who filed an estate return 11 days after the filing deadline. He assured the taxpayer that he would pay any late filing penalties that might be assessed. The IRS did assess a penalty of $115 and the practitioner honored his commitment.

Over one year later, the IRS notified the estate that the late filing disqualified it from using the special-use valuation and assessed over $116,000 of additional estate tax.[20] In a similar case, the issue was the use of the alternate valuation date.[21] The court did not have to decide these cases because they were dropped when the court determined the statute of limitations had expired prior to the filing of the lawsuit.

> **Observation.** As a defense in many of these cases, an attorney will often cite the statute of limitations for filing a lawsuit. The attorney may claim that the statute begins to run when the return is filed rather than when the IRS notifies the taxpayer of the additional tax liability because of the missed deadline.

DUE DILIGENCE

Section 10.22 of Circular 230 requires a tax preparer to exercise due diligence:

- In preparing papers related to IRS matters,
- In determining the correctness of oral and written representations made by the practitioner to the IRS, and
- In determining the correctness of oral or written representations made by clients with reference to matters administered by the IRS.

A tax return is a document which relates to tax matters and is presented to the IRS. Therefore, a practitioner must exercise due diligence. However, the question is, how far should he go? The answer to this question is also the subject of court cases.

19. IRC §§6511 (b)(2)(A) and 6513(b)

20. *Johnson v. Reehoorn*, 56 Wn. App. 692, January 22, 1990

21. *Cameron v. Montgomery*, 225 N.W.2d 154, Iowa, 1975

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An interesting case is *Avak Avakian v. Meher Der Ohanessian.*[22] This is a situation many practitioners face each year. Der Ohanessian (Accountant) provided tax preparation services for LA Radiators (Partnership) and its two partners Avak Avakian (Partner 1) and Boghos Boghossian (Partner 2). The partners were in the middle of a serious dispute regarding the partnership business. The dispute was so serious that Partner 2 feared for his life. Both partners had gone to attorneys to begin the process of partnership dissolution.

The attorney for Partner 2 wrote to the attorney of Partner 1 explaining that there were unanswered questions related to the partnership, including the percentages of income allocated as well as costs and expenses being charged to the partnership over the past several years. An accountant had been hired to seek answers to these questions. Later in the year, Partner 1 learned that bank officials were questioning the accuracy of the partnership return. The attorney for Partner 1 had even more serious concerns. She sent Partner 1 a courtesy copy of a letter she sent to Accountant's attorneys.

The letter, in part, stated, "I remain amazed by the 1994 tax returns prepared by [Meher] Der Ohanessian. Apparently, he declined to show as expenses, the salaries of most of the employees. His reasoning in so doing, was that these workers did not file income tax returns and were, in some instances, working illegally, and that, furthermore, LA Radiators had not paid payroll taxes and other employer contributions on behalf of the employees. The net result is that Messrs. Avakian and Boghossian have been charged with income they did not actually receive. It is my opinion that both parties should file amended returns which reflect their actual income."

As this is an unpublished case, it is difficult to find details of the tax issues involved. The transcript cited is an appeal filed alleging the statute of limitations apply and that Accountant is not liable. For the purpose of this text, the real issue is, how should a tax preparer handle this type of situation? If he takes the deduction, is he in violation of Section 10.22? If he does not take the deduction, but fails to notify the client, is he liable for any overpaid tax? If he notifies the client, but is told to "mind his own business and take the deduction anyway," is he liable for a preparer penalty?

Observation. There are times when a tax preparer should "fire" his client. This is probably one of those times.

CHANGE IN LAW OR SUBSTANTIAL AUTHORITY

Circular 230 addresses situations in which the practitioner has knowledge of a client's omission.[23] This raises the question of what is the practitioner's responsibility if the law changes or there is a change in substantial authority after the advice is given or the return filed. The tax professional has an ethical responsibility to notify clients of the change. If the practitioner does not notify the client, she may be opening herself up for a possible lawsuit. An excellent illustration is the Supreme Court's decision in the *Banks* and *Banaitis* cases.[24] The IRS has taken a consistent position that contingent attorney fees paid from a settlement are included in the gross income of the taxpayer. A few courts agreed with the taxpayers that only net settlement was taxable. Based on these cases, some practitioners did not report the attorney fees after notifying the client that the IRS might disagree. After Congress changed the law to allow contingent attorney fees to be deducted from the settlement of certain types of discrimination cases, more preparers began omitting the fees for all types of settlements. When the Supreme Court agreed to give a decision on these types of transactions, many preparers speculated the Court would rule in favor of the taxpayer. Instead, the Court ruled in favor of the IRS, except for those claims covered by the congressional legislation.

It is possible that a tax professional representing a client who received a settlement less contingent attorney fees filed his return without reporting the entire settlement amount as income. In this case, does the preparer have an obligation to notify his client that he should amend his tax return? In many cases the attorney fee is quite large.

22. *Avakian v. Ohanessian,* No. B150367, 2002 Cal. App. Unpub. Lexis 9275 (Cal. Ct. App. Oct. 3, 2002), October 3, 2002

23. Circular 230, Section 10.21

24. *Commr. v. Banks,* No. 03-892, 345 F.3d 373; *Commr. v. Banaitis,* No. 03-907, 340 F.3d 1074, January 24, 2005

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Circular 230 only requires a preparer to notify a client if he determines there is an error. It is the client's responsibility to file a corrected tax return. In many cases the client will not know of a law change unless notified by his preparer. If the IRS discovers the error before an amended return is filed, the client may be subject to numerous penalties. In some instances, the client may request that the preparer pay these penalties.

For example, if an amended tax return is filed before the IRS notifies the taxpayer of the unreported income, the IRS will not assess a substantial understatement penalty.

If the tax professional prepared a return only reporting the net settlement amount, or if he advised a client that only the net settlement amount would be taxable, he should:

- Notify the client of the Supreme Court decision,
- Advise the client of the potential consequences of not reporting the gross settlement as income, and
- Prepare an amended return consistent with the court ruling if he actually prepared the return.

Note. If the preparer can show that he notified the client of the change and that it was the client's decision not to file and amended return, the preparer may be protected from a lawsuit or IRS-imposed preparer penalties.

Note. The American Jobs Creation Act of 2004 allows contingent attorney fees from most discrimination and civil rights cases to be deducted from gross income. See Problem 4 in Chapter 2, "Individual Taxpayer Problems," for more information.

RETURN OF CLIENT'S RECORDS

Section 10.28 requires a practitioner to promptly return client records on request of the client. These records include any that are necessary for the client to meet his federal tax reporting obligations. Unfortunately, Circular 230 does not allow the practitioner to hold the records even if the client has unpaid fees. However, the practitioner is allowed to retain copies of any records he returns to the client.

If applicable state law allows a practitioner to retain records in the case of fee disputes, the practitioner only need turn over records which must be attached to the client's tax return — for example, the Form W-2. The practitioner must provide the client with reasonable access to review and copy any additional records retained by the preparer under state law if they are necessary for the client to comply with his federal tax obligations.

For purposes of Section 10.28, records include:

- Written or electronic documents provided to the practitioner that pre-existed the initial engagement by the practitioner. For example, if the preparer was given copies of old tax returns prepared by another firm, they must be returned.
- Materials that were prepared by a third party and given to the preparer to assist in the return preparation. This might include a spreadsheet of capital gains and losses provided by the client's stock broker.
- Any returns, schedules, appraisals, or other documents prepared by the practitioner or his employee and presented to the client as part of a prior engagement, if the documents are necessary to prepare the current return. This might include a detailed depreciation schedule prepared for the 2004 return, which is required to prepare the 2005 return.

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The term **records** does not include any return, schedule, appraisal, or other document prepared by the firm if the practitioner is withholding the document pending the client's performance of his contractual obligation to pay fees with respect to the document.

Example 10. Sunny asked Moody to prepare her 2005 income tax return. Moody agreed and asked for copies of the last three years returns and all documents and information needed to file the 2005 return. Sunny delivered the documents and Moody prepared the return. When Sunny picked up the completed return she disagreed with the tax liability and said she was going to find another preparer who would do the return correctly so it would result in a much lower tax liability.

Moody must return all documents submitted by Sunny. Moody does not have to give Sunny the completed 2005 return.

If the practitioner refuses to return records as required by Circular 230 or state law, the IRS can censure or suspend the preparer from practice. In some states, there are also monetary penalties. For instance, in Oregon the preparer may be fined up to $1,000 per day.

One factor which is not discussed is how fast the preparer must honor the request for the return of records. This is probably a facts and circumstances issue. Can a preparer be required to stop everything if the request is made on April 15? On the other hand, can he stall for 90 days?

INFORMATION DISCLOSURE

IRS Notice 2005-93 and Proposed Regulations §301.7216-1, 301.7216-2, and 301.7216.3

With the move into the electronic filing world, new proposed regulations on the disclosure or use of tax return information by tax return preparers have been developed. These regulations:

- Broaden the tax return preparer and tax return information definitions,
- Revise the manner and form of obtaining taxpayer consent to use or disclose tax return information,
- Add a requirement to obtain taxpayer consent before a preparer can send tax return information offshore, and
- Provide disclosure restrictions for computer repairmen needing access to tax return information to repair computers or data files.

A proposed revenue procedure, contained in Notice 2005-93, provides detailed information on the form and content of consents to use and consents to disclose tax return information.

Example 11. John Doe, tax return preparer for Smithers, determines additional advice is needed to correctly prepare the return. He contacts his good friend, Sam Smith, an expert in §1031 exchanges. John shares information about Smithers' return with Sam. Since John and Sam are not members of the same firm, John should have obtained written consent prior to to sharing the information. Since he did not obtain the consent, John is subject to a penalty for disclosure.

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